

OPEN ECONOMIES, CLOSED POLITIES:
FINANCIAL GLOBALIZATION AND AUTHORITARIAN POLITICS

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OPEN ECONOMIES, CLOSED POLITIES:
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This project investigates financial openness policies of authoritarian regimes during the modern age of globalized finance. Over the last quarter-century, increasingly restive publics and heightened international mobility of capital have complicated the task of governing authoritarian regimes. Financial globalization created immense opportunities for enrichment and further power consolidation, but it also made authoritarian elites increasingly vulnerable to political challenges that some regimes are better equipped to handle than others. Given this conundrum, I set out to explore the answers to the following questions: Why do some authoritarian regimes opt for greater financial openness than others? How are these decisions related to the tactics these regimes employ to remain in power? How does the nature of the asset base in the economy impact these decisions?

This thesis develops a theoretical framework to address these questions, and also evaluates this theory empirically. I construct a game-theoretical argument that endogenizes financial openness policies in a model that accounts for the profit opportunities from openness and the risks associated with increased economic volatility for the authoritarian elites. I argue that when rulers consider adopting a policy of financial openness, they also take into account their ability to maintain political stability after doing so. Greater financial openness is a “double-edged sword”: it can increase the value of specific assets, but it can also make the economy

more susceptible to external crises. Capacity to use distributive policies to deal with political instability resulting from greater exposure to global financial markets allows authoritarian regimes to afford more financial openness. The argument is then evaluated in the cases of Russia, China and Kazakhstan. The empirical assessment confirms that a combination of control over country-specific wealth and a developed capacity for redistribution allow an authoritarian regime to “have it all,” that is to maintain both openness and political stability.

BIOGRAPHICAL SKETCH

Igor Logvinenko was born in 1983 in Bishkek, Kyrgyzstan (formerly Frunze, Kyrgyz Soviet Socialist Republic, USSR). After graduating from Physics & Math School-Lyceum No 61 in 2000, he was selected to participate in the Foreign Leaders Exchange (FLEX) Program sponsored by the United States Department of State. He spent the 2000-01 academic year at Green Valley High School in Henderson, Nevada. Before enrolling in the doctoral program at Cornell, Igor earned an associate's degree from the Southwestern Community College in Chula Vista, California (2003); a Bachelor's of Arts in International Relations and Economics with highest honors from the University of Redlands (2005); and an M.A. in political science from Villanova University (2007). In 2011 he received an M.A., and in 2014 a Ph.D., both in Government from Cornell University. In September of 2014, Igor began his appointment as a Postdoctoral Fellow at the Harriman Institute at Columbia University in the City of New York.

To my parents,
Oleg and Elena Logvinenko.

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Washington, DC

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CHAPTER 1

INTRODUCTION: OPEN ECONOMIES, CLOSED POLITIES

In 1961, three Moscow underground currency dealers were apprehended, tried and sentenced to an 8-year prison sentence for running an illegal currency exchange with revenues reaching into the millions of dollars. Because of the scale of the enterprise, the “Case of the Money Changers,” as it would later be known, attracted much public attention. To appease the ire of the more stringent ideologues in the Communist Party, the prosecuting office initially retried the case to lengthen the sentence to 15 years. Nikita Khrushchev, upon learning that the accused stood to serve *only* 15 years behind bars, ordered a change in legislation to make private currency trading punishable by death penalty. After the sentence was backdated a second time, the three men were executed by firing squad (Nehamkin 2011).

The reaction of the Soviet leadership in this episode was indicative of just how jealously the communist state guarded its monopoly on monetary transactions. In Western coverage of today’s Russia, Vladimir Putin’s regime and its foreign ambitions are often compared to that of the Soviet Union. These comparisons, if evocative, are rarely helpful, but they are particularly ill-conceived when applied to an analysis of Moscow’s current foreign economic agenda. Fifty years after the “Case of the Money Changers,” the Russian government does not enforce any meaningful restrictions on foreign exchange operations, and even aims to promote Moscow as one of the global financial centers. Putin’s domestic economic policies are statist and his politics are autocratic, but when it comes to regulating cross-border transactions, Russia under Putin has been a champion of free flowing capital.

As I demonstrate in this dissertation, despite the pro-market orientation of Boris Yel'tsin's governments of the 1990s, Russia during that time retained significant safeguards against financial integration, and even introduced new restrictions. Similarly, the ruling Communist Party of China to this day continues to impose significant capital account controls, including for example, limits on foreign entry into the domestic stock markets. Putin's government, however, removed nearly all restrictions on capital movements in 2006. Moreover, neither the Global Financial Crisis nor the Western sanctions in connection with the Crimean annexation and Russia's support of separatists in Donbas restrained Kremlin's enthusiasm for deregulated cross-border finance (Ustinova 2014). Instead, Moscow is continuing with its financial openness policy agenda. Reacting to Russia's joining of the pan-European settlement and clearing system Euroclear, Ben Aris wrote in the *Financial Times* in 2012,

“Although this sounds like a technicality, Russia's capital market is now integrated into the markets in London and New York. It is the financial equivalent of nixing the need for visas and throwing opening the borders to money, but also building a teleport that can transport brokers into the Moscow market instantaneously” (Aris 2012).

Why are the Russian political elites far less cautious about open finance than either the Kremlin's previous occupants or their contemporary Chinese counterparts? Why do some authoritarian regimes opt for financial openness while others maintain financial closure? How are these decisions related to the tactics these regimes employ

to remain in power? How do the political resources available to the regime impact these decisions?

This dissertation is an effort to answer these questions by exploring the ways in which nondemocratic regimes have adapted to the emergence of the integrated global market for capital. Being a dictator is not what it used be. The rise of globalized finance over the last three decades has complicated the task of regime maintenance for authoritarian leaders, with some retaining financial closure and others opting for openness. A high degree of international capital mobility (ICM) has become a “brute reality” of international affairs, one that “constrains state behavior by rewarding some actions and punishing others” (Chwieroth and Sinclair 2013, 459; Andrews 1994, 193; B. A. Simmons 2001, 592–94). Financial globalization pressures all governments to make choices about the degree of engagement with globalized finance. On the upside, greater financial openness can lead to higher growth rates - especially in the short run, producing bigger spoils for the elites and placating the public (Bekaert, Harvey, and Lundblad 2005; Henry 2007). But, financial openness is also risky business: it exposes the domestic economy to financial shocks that can lead to politically devastating consequences for the regime (Kose, Prasad, and Terrones 2003; Pepinsky 2008). A state that decides to abstain from openness may avoid those perils, but it risks foregoing the benefits. Even a “non-decision” implies costs, such as currency appreciation, price “bubbles” in housing, equities or other asset classes that lead to “busts” with destabilizing socio-political ramifications. Simply put, in the age of hypermobile capital, states *have to choose* a policy stand on ICM or the choice will be made for them.

I assess financial policy choices made by authoritarian governments in a framework that weights the external costs and benefits of financial globalization against the autocrats' capacity to deal with domestic vulnerabilities. Political scientists have long understood that threats of rebellion and intra-elite conflict have important consequences for regime politics. However, relatively little research effort has gone into studying the capacity of the regime to deal with distributive demands from the citizenry. In this dissertation, I argue that the redistributive capacity of the regime has important bearing on its financial openness policies. I evaluate how – and how successfully – authoritarian regimes deal with the two-pronged challenge of financial globalization: temptations and hazards of hyper-mobile global capital from “above,” and the restive and increasingly demanding publics from “below.” I show that the gains from openness – and the chances of financial deregulation - increase with the amount of country-specific wealth that a given regime controls, because financial openness increases the economic value and mobility of those assets. However, because openness also implies greater exposure to outside risks, regimes that do not have the capacity to protect supporters from potential downsides of openness through redistribution are less likely to pursue greater openness. A combination of control over country-specific wealth and an institutional capacity for redistribution allow an authoritarian regime to “have it all,” that is, to uphold political stability and prolong authoritarian rule while maintaining financial openness.

I demonstrate this argument in several steps.

First: I situate theoretical preliminaries of the argument in the context of existing scholarship, while specifying key concepts and definitions. I then present the

argument formally: first a simple model that describes the gamble of financial openness from an authoritarian ruler's point of view, and then a more complex model with asymmetric information between the two players: elites and non-elites.

Second: I assess the model and the empirical expectations it generates by analyzing two periods in Russia's postcommunist political history punctuated by the 1998 and 2008-09 financial crises. By examining how the regime used access to global financial markets to capitalize on the value of Russia's natural resources, I demonstrate that a politically closed regime can successfully use financial openness for political benefit.

Third: I compare and contrast the Russian case against the financial openness policies of Kazakhstan and China. These two cases present an opportunity to evaluate the role of regime ownership of assets and redistributive capacity. In oil-rich Kazakhstan the regime did not have domestic competitors for control over the natural resource base. Additionally, redistributive capacity inherited by the post-independence government allowed it to share the proceeds from greater openness with the population, assuring political stability. Consequently, Nursultan Nazarbaev moved more swiftly toward financial openness than did Russia. The Chinese Communist Party (CCP) opted for a more gradual approach toward financial deregulation, primarily because it was facing an extraordinarily complicated task of managing redistributive demands from a society undergoing unprecedented transformation. Lacking in redistributive capacity, the regime chose a cautious approach towards financial openness because it is not able to guarantee political stability through mechanisms of political exchange with the public at large, especially under the

conditions of a financially open economy.

To restate the argument in brief: conditions of financial globalization alter the nature of country-specific assets making them both more valuable and less “trapped” as an economy becomes more financially integrated into global capital markets. In nondemocratic regimes, where the wealthy control the majority of assets and exclude the poor from the political process, financial openness policies are an attractive option for the elites to raise the value of the assets they control. However, the benefits of financial openness come at a price of exposure to external financial crises that can lead to perilous political consequences including even regime collapse. Regimes that (1) stand to benefit the most from increased valuation of specific assets and (2) possess significant capacities to protect supporters and placate opponents - will opt for financial openness.

2. SIGNIFICANCE

2.1 Substantive Importance: Authoritarianism in an Age of Globalized Finance

In *Road to Serfdom* Friedrich Hayek suggested that introduction of financial controls by the state was “the decisive advance on the path to totalitarianism and the suppression of individual liberty” that represents “the complete delivery of the individual to the tyranny of the state, the final suppression of all means of escape—not merely for the rich but for everybody” (1944, 92). Anyone who experienced life in the Soviet Union before its dissolution, or lives today in North Korea, Iran, or Uzbekistan could attest to this reality. These regimes watchfully control all cross border flow of capital.

But if Hayek’s diagnosis was valid seventy years ago, it is decisively

inaccurate today. Contemporary autocrats have a far more nuanced attitude towards finance than their predecessors. For example, HSBC, the largest foreign bank operating in China, earned an impressive profit of about \$500 million in 2011 – quadrupling its results from the previous year (McMahon 2012). However, HSBC’s profits in China were a mere pittance when compared to the Industrial and Commercial Bank of China, which earned \$33 billion in that year (“ICBC 2011 Net Profit up 25.6%” 2012). In 2013, ICBC jumped ahead of Exxon to become the world’s largest company (DeCarlo 2013). In 2006, during the onset of Putin’s dictatorial turn in Russia, state-owned oil giant Rosneft underwent the fifth largest initial public offering to-date, when it was listed on the London Stock Exchange (Kennedy 2006). Or consider a legal dispute over an obscure aluminum smelter plant in Tajikistan. It holds the dubious distinction of being the most expensive lawsuit in the history *not* of Tajikistan, but of the United Kingdom. Total legal fees in the case exceeded 5 percent of Tajikistan’s annual GDP (Murphy 2008). Far from suppressing all avenues of money flows, in the 21st century’s game of international finance, authoritarian regimes are big players with high stakes.

There are many reasons for this, but at least two immediately stand out above the rest. First, these economies have been “marketized” around some form of capitalistic competition that requires financial intermediation (Deeg and O’Sullivan 2009, 732). The largest banks may be state-controlled – as is the case in Russia, Kazakhstan and China - but in most daily activities they are not much different from their foreign counterparts: they make profits, they issue debt, they are listed on exchanges, and they pay dividends to their shareholders. Emerging economies

experienced unprecedented growth in recent years, and the leading firms from these economies have attracted foreign investors while venturing abroad on their own. More money now crosses the borders of these countries than ever before in history.

The second reason for the dictators' change in attitude toward finance has to do with financial globalization - what Eric Helleiner called "one of the most spectacular developments in the world economy" (E. Helleiner 1994, 1). Benjamin Cohen went as far as to suggest that the remarkable rise of the "phoenix" of globalized finance may "have irreversibly altered the meaning of geography in the world economy" (B. J. Cohen 1996, 270). Indeed, outside of the spread of communication technology, worldwide financial liberalization is perhaps the most wide-reaching aspect of ascending globalism of the last thirty years (Keohane and Nye 2000, 110). Even Kenneth Waltz, a well-known skeptic of globalization's transformative potential, singled out finance as "the only economic sector one can say has become truly global" (1999, 695). The sobering experience of the Global Financial Crisis of 2008-09 decisively confirmed this view.

Scholars who have written about the new bout of international capital mobility recognized its extraordinary potential to reshape domestic politics. New histories of the inter-war period drew up lessons about potential turbulence in domestic politics resulting from a lack of flexibility in controlling the influence of the international financial system based on hyper-mobile and hyper-reactive capital (B. Eichengreen 1992). Perceived incongruence between the politics of expanding franchise and immobilization of national policymaking by the gold standard – a radical form of "capital mobility" – would later play a key role in the establishment of the Bretton

Woods arrangement that would allow sovereign states to retain extensive policymaking autonomy, including a widespread endorsement of capital controls.

But after lasting mere three decades, the Bretton Woods system was supplanted by the new age of international capital mobility, brought on by technological advancements and the onset of the computer age that greatly lowered the cost, increasing the frequency and volume of cross-border financial transactions exponentially. Since the 1970s, when first the United States (1974) and later United Kingdom (1979) fully deregulated capital accounts, international financial liberalization has spread to the advanced industrialized economies (E. Helleiner 1994, 8). Controls on the movement of capital that were common practice during the two post World War II decades, by the mid-1980s appeared to many as relics of an unenlightened age (Blyth 2002, 4-7). A more aggressive pro-liberalization push by the United States, followed by competitive deregulation, perceived success of the central bankers from advanced industrial states in managing increasingly frequent crises and an ideational shift toward neoliberalism – all made deregulated finance an accepted and crucial characteristic of the contemporary age (Helleiner 1994, 8-17).

Unquestionably, financial globalization originated among the advanced Western economies. According to Lane and Milesi-Ferretti's measure, the average level of international financial integration increased 7 fold between 1970 and 2004 from 45% to over 300%, with most of the increase occurring since the mid-1990s (2007, p. 234). To take one extreme example, the level of financial internationalization in the Netherlands has increased nearly nine-fold between 1970 and 2007. Since about 1990, emerging and developing economies have become increasingly financially

integrated as well, largely in conjunction with various lending programs led by the international financial institutions (Haggard and Maxfield 1996; Stiglitz 2002; Stone 2002; Vreeland 2003). But even in China – where the role of the IFIs has been very limited - the measure of integration has shot up from 8 to 112 percent between 1981 and 2007 (Lane and Milesi-Ferretti 2007).

Overall, the degree of financial internationalization more than doubled among the lower-income countries from 1975 to 2002, while direct annual capital flows in constant dollars increased from \$12 billion in 1975 to over \$400 billion in 2000 (Milner and Mukherjee 2009, 173). In emerging economies, the portion of FDI and portfolio investment in the total amount of foreign assets and liabilities rose from 13 percent in the early 1980s to 37 percent in 2004. In the same period the share of FDI in the total private inflows tripled from 15 to 48.6 percent for this group of countries. Portfolio investment now accounts for about the same (12 percent) portion of total private inflows in emerging markets as it does in advanced economies (Kose et al. 2009, 17–18). In short, many modern economies of the Global East and South are full-fledged competitors in the global market for capital.

2.2 Academic Significance: Authoritarianism and the Policies of Financial Openness

Political thinkers have long observed the link between mobility of capital in an economy and political consequences for the ruling regime, but the precise nature of the relationship is still subject to some debate. For example, Jeffrey Frieden made predictions about distributional consequences of financial integration in the developed world, but he acknowledges that those consequences are less than clear in the developing world, as the attitude of the holder of mobile capital depends on other

factors and on the specifics of what is meant by “financial openness” (Frieden 1991, 436; Pepinsky 2012). We do not yet fully understand the implications and influences of a single global capital market that was organized by the rich countries on the political development outside of the rich world (Milner and Mukherjee 2009).

Montesquieu wrote centuries ago that “. . . commerce could elude violence . . . for the richest trader had only invisible wealth which could be sent everywhere without leaving any trace . . . Since that time, the rulers have been compelled to govern with greater wisdom than they themselves have intended" (quoted in Bates and Lien 1985, 60). This “fiscal” motivation behind changes in capital mobility also drives the logic of Carles Boix’s argument in his *Democracy and Redistribution* (2003). Change in asset specificity makes it difficult for the state to collect taxes and therefore to meet its redistributive commitments. On the other hand, capital mobility can have the opposite consequence: opening the doors to new competition disadvantages local holders of capital, primarily banks and investment firms, who would oppose such policies (Rogowski 1991; Haggard and Maxfield 1996).

Two recent papers have shed new light on the connection between financial openness and authoritarian politics. Dadasov *et al* (2013) present a theoretical model that studies the effects of financial openness on the expropriation decisions of authoritarian rulers. Although they do not study liberalization policies directly, they emphasize the dual nature of financial openness for autocrats: it expands the total amount of wealth that can be expropriated, while also strengthening potential regime opponents, specifically the middle class, which tends to hold predominantly mobile assets (Dadasov, Harms, and Lorz 2013, 19).

Finally, Freeman and Quinn (2012) test a relationship between levels of financial openness, inequality and regime outcomes. They extend the arguments of Bates and Lien (1985) and Boix (2003) to show that financially integrated autocracies are more likely to democratize. They argue that greater *de jure* financial openness alters the *de facto* mobility of otherwise “trapped” assets, and therefore the outcomes of social conflict within autocracies. Most crucially, they argue that financial openness “changes the meaning and economic value of asset specificity” (2012, 62). Entry into global financial markets allows the wealthy elites to diversify their assets, including “site-specific” holdings such as mineral mines and land. In practice this “amounts to an exchange of assets with foreigners who also hold diversified international portfolios” (2012, 58). According to their analysis, authoritarian governments can actually change the extent of capital mobility in the economy through *policy* action. Consequently – and in sharp contrast to Boix (2003) - financial openness policies can be understood endogenously within a political economy framework.

Freeman and Quinn’s study is a major contribution because they make a connection between financial openness policies and changes in asset specificity under authoritarianism. However, their main goal is to explain transition outcomes as they relate to inequality, so they offer few insights into the financial policy outcomes in nondemocracies *per se*. In fact, they conclude by calling for further research into two specific unanswered questions: (1) why do some autocracies choose financial openness and others opt for closure? (2) How does financial openness change the politics of “mass control,” repression and ultimately regime survival (2012, 75)?

This dissertation provides answers these two questions, by focusing on the

relationship between the nature of the assets dominant in the economy and external financial policies in authoritarian regimes. Few studies have looked specifically at financial openness policies in nondemocracies, even though there exists a vast literature on the domestic sources of financial liberalization policies in the industrial and industrializing world, focusing on interest groups, partisan interests and public opinion (Frieden 1991; J. Goodman and Pauly 1993; Kastner and Rector 2003, 2005; D. P. Quinn and Toyoda 2007; D. P. Quinn 1997). More recently, scholars who emphasize ideational causes have arrived at a tenuous consensus about the importance of the role of ideas, peer-effects and international diffusion in the spread of ICM (Brooks and Kurtz 2012; B. Simmons and Elkins 2004). Both statistical and qualitative research confirms a relationship between IMF loan programs and greater financial openness (Brune and Guisinger 2003; Mukherjee and Singer 2010; Stone 2002). Scholars disagree on the question of why this association exists, although recently the “personnel is policy” theory has been supported by the work of several scholars who have isolated a relationship between neoliberal ideas, individuals who promote them and policies of financial openness (Chwieroth 2007; Leiteritz 2005; Nelson 2014).

This thesis is informed by this literature, but it departs from these approaches for at least two reasons. First: authoritarian governments by definition are less responsive to partisan interests and public opinion. Interest group politics cannot explain the whole range of policymaking with respect to exposure to international markets in nondemocracies. Second: greater financial openness in Russia and China today cannot be attributed to either material or ideational power of international

networks or institutions such as the IMF. These states hold some of the largest current account surpluses and are unaffected by the conditionality requirements. They pursue foreign policies that are often in direct opposition to policies their democratic neighbors hold in ironclad consensus. As I demonstrate in subsequent chapters, neither does the theory that connects membership of key policymakers in the neoliberal epistemic communities with their decision-making withstand careful scrutiny, since the same policymakers who advance financial liberalization in foreign economic affairs pursue heavy-handed state involvement in the domestic economy.

3. Roadmap

The plan for the dissertation is as follows. Chapter 2 lays out the theoretical argument and the empirical strategy for the rest of the thesis. Here, I situate the key theoretical preliminaries of the argument in the context of existing scholarship and outline the key parts of the theoretical framework including concepts and definitions. Chapter 2 includes a formal presentation of the argument: first a simple model that describes the gamble of financial openness from a ruler's point of view; and then a more complex model with asymmetric information regarding regime strength. Finally, in the second half of the chapter, I outline the empirical strategy for evaluation of the empirical implications derived from the model.

In order to communicate the argument as coherently as possible, I retained the same logical structure in both empirical chapters 3 and 4. For each case (the Yeltsin and Putin periods in Russia, China and Kazakhstan), I first trace the dependent variable (financial openness policies) and the independent variables (value and control of specific assets, and redistributive capacity).

Chapter 3 assesses and elaborates on this model, relying on a comparison of two time periods of post-Soviet Russia. It shows that that with the rise of global prices of commodities, the value of specific assets in Russia increased markedly. After the regime led by Vladimir Putin gained control over the majority of oil and gas industries, the Kremlin initiated widespread financial openness policies, including removal of nearly all meaningful restrictions on the most volatile flows: inflows into the equity markets. Because of large redistributive capacity and long-standing embedded welfare pact between the Russian state and broader population, Putin's regime was relatively sanguine about its ability to maintain political instability, so long as it was flush with resources for distribution. As expected, greater financial openness carried significant downside risks, epitomized by the Global Financial Crisis of 2008-09. Putin's regime, however, was able to maintain political stability by rapidly distributing additional wealth, which reinforced regime supporters and placated its potential opponents.

In Chapter 4 ("Financial Openness and Authoritarianism in China and Kazakhstan"), I further evaluate the model and the argument by conducting two case comparisons: one between Russia and China, and another between Russia and Kazakhstan. These cases allow me to vary the components of my model (the two independent variables): control of assets and redistributive capacity. Although these variables changed within each case in non-trivial ways, on the whole, redistributive capacity of the Chinese state is far less extensive than Russia's, while the lack of domestic rivals for control over Kazakhstan's asset base differentiates it markedly from Russia of the 1990s. As I demonstrate, accounting for these differences allows

one to gain new insights into the divergent experiences of Russia, China and Kazakhstan.

The Chinese case exemplifies an authoritarian regime that, for the most part, retained significant control over all valuable assets in the economy, but possessed limited redistributive capacity. Instead it has relied on more uncertain repressive tools and *ad hoc* mechanisms to deal with widespread social unrest that has accompanied the colossal economic transformation of the last thirty years. High economic growth itself became the main channel of political exchange between the regime and broader citizenry, creating a legitimating foundation for the Communist Party's rule. Under conditions of economic volatility, however the CCP lacks reliable mechanisms by which it can remove informational asymmetry regarding regime strength and prevent potential for unrest, despite the immensity of fiscal and repressive capabilities at its disposal. I argue that this basic political challenge led Beijing to adopt a cautious approach towards capital account deregulation and accompanying potential economic instability.

The case of Kazakhstan illustrates the importance of exclusive control over assets by the regime, in addition to reaffirming the crucial role of redistributive capacity. In contrast with Russia, the Kazakhstani leadership did not give up control over specific assets to domestic actors at the start of the economic transition, instead partnering with Western-based transnational oil companies. Yet, similarly to neighboring Russia, the regime led by Nursultan Nazarbayev inherited extensive redistributive capacity as part of its state socialist legacy. Shortly after the breakup of the USSR, the Kazakhstani regime embraced a combination of an outward financial

openness and strict political control in the domestic affairs. Having successfully withstood two financial crises and gradually increased the regime's stake in the overall economy to nearly 60 percent, the Kazakhstani regime today exemplifies a model of a financially open autocracy.

The concluding Chapter 5 summarizes the findings and assesses hypotheses developed in Chapter 2 and evaluated in Chapters 3 and 4. Here, I outline limitations and extensions of this research, as well as list several important implications for academic and policy communities.

CHAPTER 2

ARGUMENT AND EMPIRICAL STRATEGY

Political scientists and economists have written extensively on the connection between the types of assets that are prevalent in a given economy, political institutions and political regime outcomes. However, there is a paucity of work that connects these variables with capital account policies. This chapter develops a theory of financial openness policies under authoritarianism in the wake of financial globalization. Because of volatility and the pro-cyclical nature of capital flows, greater financial openness exaggerates both the upside and downside risks that accompany economic globalization. Based on this premise, I argue that financial openness policies are likely to be implemented in regimes that (1) control specific assets and therefore stand to benefit from the upside of openness; (2) possess redistributive capacity to maintain political stability by protecting the citizenry from the hazards associated with financial openness. Because greater openness raises the value of specific assets, regimes that control them are likelier to pursue financial openness policies. Redistributive capacity allows authoritarian regimes to buttress the standing of supporters and placate potential opponents through welfare and labor policies in instances of financial downturns.

This chapter is divided into three parts. In part one, I situate the key theoretical preliminaries of the argument in the context of existing scholarship. Here I outline the key parts of the theoretical framework including concepts and definitions. Part two is devoted to a formal presentation of the argument: first a simple model that describes the gamble of financial openness from a ruler's point of view; and then a more

complex model with asymmetric information. In the third part, I outline the empirical strategy for evaluation of the empirical implications derived from the model.

1. THEORETICAL AND CONCEPTUAL PRELIMINARIES

My theory is based on four insights from the literatures on international capital mobility and the political economy of authoritarianism. First, I conceptualize regimes as equilibria outcomes of struggles over economic assets. Second, I argue that greater financial openness alters the nature and value of those assets. Third, I assume that from the perspective of the authoritarian elites, financial openness multiplies the potential for both gains and losses. Fourth and finally, I take into account authoritarian regimes' capacity to employ redistributive policies to maintain political stability in times of economic duress.

1.1 Regimes as equilibria outcomes of social conflict over assets

In advancing my argument, I rely especially on the theoretical advances in the study of political economy of authoritarianism and democratization (Acemoglu and Robinson 2006; Boix 2003; Bueno de Mesquita et al. 2003; M. Olson 1993; Wintrobe 2000). This approach employs economic theorizing, game theoretic modeling, and mathematical formalization to simplify complexities of politics down to the micro-motives of as few as two actors: "citizens" and "elites" (Acemoglu and Robinson 2006; Weingast 1997); "wealthy" and "poor" (Boix 2003); those "outside" or "inside" the winning coalition (Bueno de Mesquita et al. 2003); the "repressed" and the "overpaid" (Wintrobe 2007, 367). This radical simplification implies significant costs in terms of important and unaccounted for details (for example, coalitional politics or multi-dimensional utilities of actors), but what is gained in exchange is an opportunity

to establish broad patterns of interaction between the key “players” based on their preferences, exogenous parameters and the informational structure of the game.

The primary actors of my model (wealthy and poor) act strategically, that is, they anticipate the actions of the other player. They are also motivated by economic self-interest, primarily expressed as a preference to increase the value of assets they control. Political leaders do what they do “[t]o come to power, to stay in power and, to the extent that they can, to keep control over money” (Bueno de Mesquita and Smith 2011, xxiv). In contrast to studies that emphasize an independent role for political institutions (e.g., legislation and parties), my approach suggests that, in order to understand authoritarian politics, we first have to establish who has control over the assets and how those assets are distributed.¹

I conceptualize political regimes as equilibria solutions to social conflict over economic assets between groups, or “a mechanism employed to aggregate individual preferences about the ideal *distribution of assets* among those individuals governed by this institutional mechanism” (Boix 2003, 10; *emphasis added*). Authoritarianism is a type of a political regime, in which leaders “instead of representing the wishes of the population at large, represent the preferences of a subgroup of the population: the ‘elite’” (Acemoglu and Robinson 2006, 17). In authoritarian regimes,² the elites control the preponderance of assets and exclude the poor from manifesting their preferences over the distribution of those assets.

¹ This is in contrast with the “contractarian” school that focuses on a struggle *among* the elites

² I use terms like “dictatorship,” “authoritarianism” and “nondemocracy” interchangeably, even though the latter moniker is perhaps most conceptually appropriate.

There is ongoing debate about how the nature of the redistributive conflict is determined by the types of assets that are prevalent (Ansell and Samuels 2010; Ahlquist and Wibbels 2012). Several studies have identified a difference in effect between *income* and *asset* inequality, and between *mobile* and *immobile* assets (Morrison 2009; Bueno de Mesquita and Smith 2010; Ansell and Samuels 2010; Freeman and Quinn 2012). For example, Bueno de Mesquita and Smith, "...the important factor... is not the wealth of a nation, but rather the source of this wealth" (2010, 949).³ It is important to keep in mind that in terms of redistributive payouts and the tax burden, the wealthy are better off and the poor are worse off under nondemocracy, and *vice versa*. In the next section, I specifically define what features of assets are relevant for the argument, and how foreign economic policies can change the nature of the wealth undergirding the regime.

1.2 Financial openness and asset-specificity

I use the term "financial openness" in the *de jure*, as opposed to the *de facto* sense. A move toward financial openness implies capital account liberalization, which is a "decision by a country's government to move from a closed capital account regime, where capital may not move freely in and out of the country, to an open capital account system in which capital can enter and leave at will" (Henry 2007, 887). *De jure* financial openness relates to the official regulations on the movement of capital, while the *de facto* indicators measure the extent of real financial integration of a given country into the global markets. Although, regulations of inflows and outflows

³ In footnote 1 (p. 29) Ansell and Samuels concede that "asset specificity may matter in the way Boix (2003) and Acemoglu and Robinson (A&R, 2006) suggest..."

are intimately connected, I focus especially on the controls of inflows into the equity and bond markets, as the removal of these restrictions is considered to be especially laden with risk (Calvo, Leiderman, and Reinhart 1996; IBRD (World Bank) and IMF 2005; Karacadag, Sundararajan, and Elliott 2003).

Building on concepts from the field of transaction costs economics (TCE), I define “asset specificity” to be a measure of the extent to which the value of an asset is determined by the transaction costs associated with its valuation for exchange or sale (Macher and Richman 2008; Williamson 1981). In contrast to neo-classical economics, which assumes zero-cost transactions, TCE makes transaction costs the very focus of inquiry. In other words, “the principal factor that is responsible for transaction cost differences among transactions is variations in asset specificity” (Riordan and Williamson 1985, 365).

Establishing the value of an asset is fundamental to any transaction involving trade or exchange. In order to resolve the problem of valuing specific assets, parties to economic exchange create organizational structures of trade and production (e.g, planning committees, stock markets, arbitration courts, etc). My aim here is to identify the conditions under which nondemocratic regimes use access to global capital markets as a vehicle to overcome the problem of asset specificity.

Oliver Williamson maintained that there were at least four different types of asset-specificity including site, physical, human and dedicated assets (Joskow 1988, 106–107; Williamson 1983). In developing my theory of financial openness under

authoritarianism, I focus on a single dimension of asset specificity: site-specificity.⁴

Following the work of Carles Boix, “the extent to which an asset is specific is measured by its productivity at home relative to its productivity abroad” (2003, 22). In other words, the extent of asset specificity is closely connected with its value.

Specificity of assets that an entity (firm or, in this case, a political regime) controls determines in large part its flexibility in deploying those assets to accomplish various ends. When a firm is endowed with highly specific assets, its ability to borrow is compromised, because the assets cannot be used as borrowing collateral. Specific assets are difficult to value due to information asymmetries between insider and outsider investors. Macher and Richman point out that under these circumstances “parties are vulnerable to calculated efforts by others to mislead, renege, cheat or otherwise take advantage of the vulnerabilities of their trading partners” (2008, 4). In the context of political regimes, high asset specificity precludes it from using financial leverage and accessing external financing (Balakrishnan and Fox 1993; Barton and Gordon 1988; Močnik 2001).

When asset specificity is high, other transaction costs become more relevant, such as “uncertainty about the future of the relationship, the complexity of the transaction, and the frequency of trade” (Shelanski and Klein 1995, 338). These problems are multiplied in the context of the state-owned enterprises (SOEs), especially in countries with weak legal protections. In fact there is a large literature that shows that developing countries’ success in attract foreign investment is directly

⁴ Hereafter, I use terms “specificity,” “asset specificity,” “country-specificity” and “site specificity” interchangeably.

predicated on the quality of their political and legal systems (Gelos and Wei 2002; Groh and Wich 2012; Jensen 2008; Jensen et al. 2012). Faced with these challenges, SOEs and the governments who control them have to find creative ways to organize trade and exchange agreements when raising funds or increasing valuations of these assets in secondary markets. One of the contributions of this dissertation is to demonstrate that financial openness can serve as a “governance solution” that allows authoritarian regimes to overcome the problem of asset specificity.

The value of a site-specific asset declines when it is used outside of its “site,” which in this case pertains to political jurisdiction of a sovereign state. By liberalizing the rules that govern the movement of capital in and out of the country, the elites can reduce the specificity of assets they control. This in turn makes it less costly to engage in transactions related to the asset, raising its value. As Freeman and Quinn note, “[c]apital account openness changes the meaning and economic value of asset specificity” (2012, 62). Given the political implications of greater asset mobility, financial openness policies in the age of globalized finance can generate important insight about the nature of political regimes that govern their implementation.

For example, if foreign investors are allowed to purchase stocks issued by domestic commodities firms (owned by the local elites) on domestic exchanges, this effectively makes those specific holdings “more mobile,” in a sense that the owners’ wealth can be exchanged for more liquid assets held by foreign investors, and with greater ease due to increased frequency of trade. By removing the tax on exporting capital, or by inviting foreign equity investors into the domestic markets, the local economic elites make it easier to access financing, allowing them to capture yet larger

segments of the local (and often international) market, raising the valuation of their assets and further increasing their wealth and political clout. This in turn bolsters the political regime they comprise by giving it more flexibility to manage the overall economy. Financial openness policies in authoritarian regimes therefore have intrinsically political implications.

1.3 Financial openness as a political gamble

While financial openness can help reduce transaction costs and raise the value of specific assets, it also implies political costs for the regime. Capital account deregulation, greater foreign access to domestic markets and other forms of financial openness are risky policies that amplify the potential for political instability. Indeed, the formulation of “financial openness as a double-edged sword” encapsulates much of the policy debate on the subject of controls’ liberalization (IMF 2012; Gallagher 2011).

From a theoretical perspective, the upsides of financial internationalization are numerous. Greater access to foreign finance lowers the costs of borrowing, which increases investment, leading to growth in the total output (B. J. Eichengreen, Mussa, and Dell’Ariccia 1998).⁵ “Resources flow from capital-abundant developed countries, where the return to capital is low, to capital-scarce developing countries where the return to capital is high” (Henry 2007, 887). Financial openness also expands opportunities for country-specific risk sharing, which reduces volatility in

⁵ “The classic case for international capital mobility is well known but worth restating. Flows from capital-abundant to capital-scarce countries raise welfare in the sending and receiving countries alike on the assumption that the marginal product of capital is higher in the latter than in the former. Free capital movements thus permit a more efficient global allocation of savings and direct resources towards their most productive uses” (B. J. Eichengreen, Mussa, and Dell’Ariccia 1998, 2).

consumption in individual countries, producing more sustainable growth over the long term. Agents in the target countries (banks, insurance companies, pension funds and individuals) can invest in foreign assets and diversify away from their exposure to domestic risks (Obstfeld 1994). International financial liberalization can also discipline the decision-making of domestic firms and thereby boost their productivity (Bonfiglioli 2008; Haskel, Pereira, and Slaughter 2007).

However, the empirical evidence on the benefits of financial globalization is mixed. Even the most optimistic assessments suggest that financial liberalization is associated with growth only in the short term, and is connected specifically with equity markets deregulation (Bekaert, Harvey, and Lundblad 2005; Henry 2000, 2007; Minier 2009; D. Quinn and Toyoda 2008). The more critical studies suggest that the benefits of financial openness are negligible, especially for emerging and developing economies (Gourinchas and Jeanne 2006; Rodrik 1998a). Durham (2004) shows the benefits of FDI and portfolio investment to be conditional on financial and institutional development on the receiving end of foreign financing. Kose, Prasad and Terrones (2007) argue that developing countries have not experienced the upside of risk sharing that theory predicts should accompany greater openness, especially in economies with less developed financial markets.⁶

Moreover, even if there are benefits to financial openness, they come with substantial downside risks, including greater exposure to volatility, large short term

⁶ I deliberately do not side with any side of the policy debate on financial openness in the dissertation and I am ambivalent about what an “optimal” level of openness might be in any given case. In fact, the argument is premised on the notion that there are *pros* and *cons*, and that some regimes receive greater/lesser share of the benefits and have greater/lesser capacities to deal with the downsides of greater financial openness.

output declines, and “sudden stops” of capital movement, accompanied by widening bond spreads and capital outflows (Calvo, Izquierdo, and Talvi 2006; Levchenko, Rancière, and Thoenig 2009; Ramey and Ramey 1995). These significant downside risks, including most especially financial crises, are more severe and frequent among the developing economies with weak financial markets and governing institutions (Aghion and Banerjee 2005, 4; Kose, Prasad, and Terrones 2003; Prasad et al. 2003; Rancière, Tornell, and Westermann 2008). Emerging markets with underdeveloped financial and legal institutions are exposed to greater volatility and higher chances of growth reversals when they lower the barriers of entry to the flow of foreign finance (Ramey and Ramey 1995; Levchenko et al 2009; Martin and Rey 2006; IMF 2012).

To understand the timing of financial openness policies then, we must understand the cost-benefit analysis associated with the perceived consequences of those policies by the regime, including its evaluation of domestic political vulnerabilities. In a way, a study of the politics of financial openness in a nondemocratic context allows one to narrow the focus of inquiry, since the cost-benefit rundown for the political elites is more straightforward. If the costs of financial openness are so severe, why do some regimes decide to deregulate financial flows?

1.4 Redistributive policies under authoritarianism

Scholars of economic integration among the advanced industrialized democracies have long been aware of the association between exposure to the global economy and compensatory government policies (Adsera and Boix 2003; Cameron 1978; Katzenstein 1985; Rodrik 1998b). I argue that under certain conditions authoritarian leaders can both gain access to the global economy and retain political

stability domestically. I show that given substantial redistributive capacity, these regimes can shield supporters and appease opponents who are harmed by the “downsides of openness” during episodes of externally generated crisis. Having resources alone is not sufficient to mitigate the risks of openness. Redistributive capacity is what allows nondemocracies to afford more financial openness than they would be able to otherwise.

Redistributive policies are “decisions about allocations of government goods and services to identifiable localities or groups” (Golden and Min 2013, 74). By “redistributive capacity” (RC) I mean the potential of the state to use labor-market and welfare institutions to provide direct employment, subsidies, and services to the population. Nondemocratic regimes “preside” over states with varying redistributive capacities. Having (or not having) these capacities at their disposal makes regimes more or less likely to withstand the political consequences of economic slumps brought on by the “downsides” of openness. Developed redistributive capacity, then, can remove the uncertainty about the ability of the regime to withstand political instability due in an economic slump. Prior to deregulating financial flows – in addition to gaining control over specific assets – the regime must be confident of its ability to use redistributive mechanisms to contain the political fallout generated by financial volatility.

“Welfare state” is commonly understood as “a basic system of government-driven benefits that seek to provide a minimum level of income, health and safety” (Adascalitei 2012, 59). “Redistributive capacity” is a broader concept. RC includes the capabilities and reach of the welfare state, but it also takes into account laws and

regulations that, for example, include direct employment in the state bureaucracy and state-owned enterprises. To that effect, control over the most important assets by the regime implies that it directly or indirectly operates sizable segments of the economy, employing large numbers of workers, thus increasing the RC of the regime.

In order to remain in power, authoritarian rulers rely on a mix of coercion and “political exchange” (Wintrobe 1990). Although many scholars of the Soviet Union have understood this “corporatist” nature of the regime at least since the 1970s (Bunce 1983), the notion that modern nondemocracies “operate by political exchange rather than solely by repression and command” has been gathering increasing support in recent years (Wintrobe 2007, 389). Wintrobe’s economic theory of dictatorship is based on the “recognition that governments – democratic or dictatorial – provide services to citizens: they build roads, hospitals, and schools and protect property” (Wintrobe 1990, 852). Specific issues surrounding the tradeoffs and calculations associated with the use of coercion and political exchange under the conditions of openness come into play later in the argument. At this point, it is simply important to recognize that regimes differ in their capacities for political exchange, and that these differences have consequences for foreign financial policymaking.

Whether democracies redistribute more or less than autocracies is not directly relevant to my theory. Some scholars suggest that democracies redistribute more, manifesting in greater spending on primary education (Lake and Baum 2001; Stasavage 2005), better healthcare services (Kudamatsu 2012; Lake and Baum 2001), and broader access to electricity (Min 2010). Others have found no significant differences between regime types (Lott 1999; Mulligan, Gil, and Sala-i-Martin 2004;

Ross 2006)⁷. But even if democracies redistribute more, there is little doubt that nondemocracies also employ extensive redistributive policies, and that these policies are central to regime survival (Buena de Mesquita and Smith 2010; Deacon and Saha 2005; Hanson and Gallagher 2012; Yep 2008). The proposition that nondemocracies redistribute deviates from some influential models of regime continuity and change (Acemoglu and Robinson 2006; Adsera and Boix 2003), while dovetailing neatly with some others (Buena de Mesquita et al. 2003; Wintrobe 1990).

Insofar as RC matters to regime survival, it matters for foreign economic policymaking in nondemocracies. There are a number of factors that influence RC, including institutional legacies, size of the population, prior market-welfare reforms and inter-governmental arrangements (Cook 2013; Morrison 2009; Nee 1989; Tung 2003; Yep 2008). This project suggests that regimes with greater capacities for redistribution are more likely to initiate potentially risky openness policies. These capacities are not dependent on the size and source of fiscal revenue (although significant nontax revenue make redistribution far less costly than coercion), but also on the structure of welfare delivery and industrial policy.

The focus on RC, as opposed to merely welfare services, is especially germane in analyzing post-socialist political economies where the population had been accustomed to guarantees of full employment, and where legacies of state-socialist policies have persisted (and even became more influential) since the fall of

⁷ It is important to note that many studies do not have the same measures of the dependent variable concept. Michael Ross, for example, admits: “democracies seem to fund social services at higher levels than nondemocracies” (2006, 862). The point here is that authoritarian regimes redistribute wealth to a meaningful extent.

communism. However, significant differences in redistributive capacities exist even among the postsocialist regimes that trace the beginnings of their welfare states to the Leninist project (Beissinger and Kotkin 2014; Cook 2013; Pop-Eleches 2007). Hence, the approach of considering multiple facets of RC, allows us to account for a multitude of its dimensions.

In summary, elites in financially closed authoritarian regimes can increase the value of specific assets they control by deregulating financial flows. However, policies of financial openness carry with them significant political risks with potentially grave consequences for the regime. Nondemocracies can mitigate these downside risks if these regimes preside over states with significant redistributive capacity.

Consequently, the extent of redistributive capacity available determines whether authoritarian elites in possession of valuable specific assets can make use of greater international financial integration to raise the valuation of those assets, while maintaining political stability.

2. FORMAL ARGUMENT

I modify and build on the model developed by Carles Boix (2003) in order to bring the four pillars of the theory into a parsimonious formal framework. Boix connects regime outcomes with levels of inequality and asset specificity, which are exogenously altered by the process of economic development. On the one hand, growth decreases inequality, which makes the elites more amendable to democracy. On the other hand, development makes an economy less dependent on immobile assets (e.g., land and natural resources) and toward more mobile asset bases (e.g., services, finance). Both of the mechanisms lead to improved chances for democracy among

developing states (2003, 10-13). In the following pages, I bracket the discussion of inequality and focus only on changes in asset mobility.⁸ Specifically, I use this basic foundation to explore the following question. If greater *de jure* financial openness policies increase the mobility of the assets controlled by the Wealthy, while also exposing them to political risks – under what conditions do leaders in nondemocracies opt for financial openness?

While the overall level of asset specificity is subject to long-term structural patterns of economic change (i.e., exogenous to the model), the wealthy have an interest in increasing the value that assets can command abroad. Removing regulations on capital flows allows them to make the “trapped” immobile assets more “movable,” therefore increasing their valuation. In addition to hampering the ability of the poor to tax the wealthy under democracy, higher capital mobility reduces transaction costs and amplifies the wealth of the elites in a dictatorship – what I refer to as the “bonus of openness.”

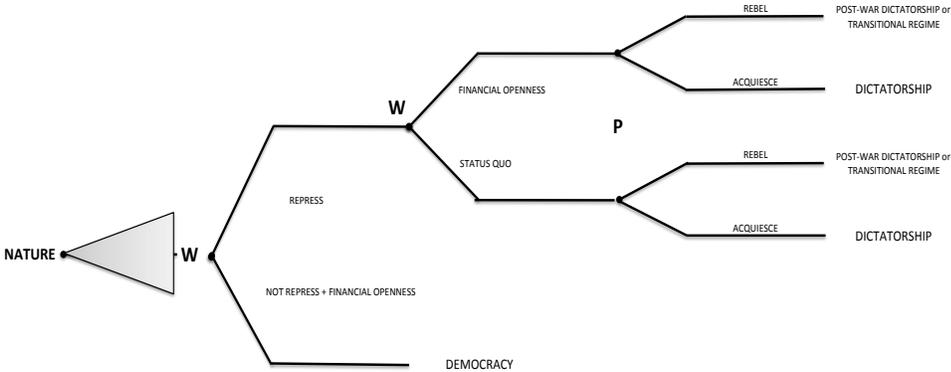
However, greater financial openness also implies political risks that can actually reduce the value of assets owned by the Wealthy (“penalty of openness”). The model explores the relationship between the exogenously given levels of asset specificity, the value of those assets and an endogenous decision of the Wealthy to opt for greater financial openness, conditional on the regime’s domestic political vulnerabilities.

⁸ I summarize the set-up of the model described in Boix (2003) in Appendix 1. The Kuznets hypothesis (inverse *U*-shaped relationship between growth and inequality) has come under new scrutiny in recent years, with some scholars finding new support (Pinkovskiy and Sala-i-Martin 2009) and others issuing new challenges (Bourguignon and Morrisson 2002; Piketty and Saez 2003; Piketty 2014).

2.1 Game with endogenous levels of asset specificity

The structure of the game is as follows. The game begins in a state of dictatorship. After observing a set of exogenous parameters (determined by “Nature”), the Wealthy move to either *Repress* (continue dictatorship) or *Not Repress* (democratize). If they choose to democratize, they always simultaneously opt for financial openness (*FO*), since it minimizes their future tax liabilities and allows them to capture the “bonus of openness” (“democracy” equilibrium at the bottom node in Fig. 2.1). This is consistent with much extant literature that suggests that democracy and capital account liberalization are closely connected in the developing world (Mukherjee, Yadav, and Béjar 2014). A transition to democracy can only happen when levels of initial asset specificity are very low. The Wealthy choose *Not Repress* and therefore allow democracy to emerge when the expected income of the Wealthy under democracy exceeds their income less the costs of repression under authoritarianism. In practice that can only happen when the cost of repression is high and/or asset specificity is low, as is the case in the industrialized West.

Figure 2.1: Game of Endogenous Capital Mobility
(No informational asymmetry)



Policy choices with respect to financial openness are a gamble. If the Wealthy

elect to continue authoritarian rule, their actions are subject to a simple rule: they get higher payoff if there is no rebellion by the Poor, but they are worse off if the Poor rebel. The conundrum is represented formally below:

$$Y_W((Repress, FO); A) > Y_W((Repress, SQ); A);$$

$$Y_W((Repress, FO); R) < Y_W((Repress, SQ); R).$$

In other words, the Wealthy prefer financial openness when the Poor *Acquiesce* (*A*), because they capture the bonus of openness [1]. However, they get a lower payoff (their status quo payment less the penalty of openness) under financial openness because when the Poor *Rebel* [2], the value of assets is diminished due to capital flight, currency crises and broad financial instability.⁹

The key feature of the game is that the strength of the Wealthy is not observable by the Poor, unless the Wealthy possess redistributive capacity. Under the condition of perfect information, both equilibria of the game involve financial openness, either under democracy or dictatorship. Setting aside the discussion of financial openness under democracy, financially closed dictatorships are indeed quite common. The assumption of perfect information, of course, is untenable, because the Wealthy do not know with perfect certainty whether a rebellion of the poor would commence.

Autocrats use a variety of mechanisms, like façade parliaments, pro-regime parties, sham elections, pliable courts and redistribution to ascertain their own

⁹ Empirical work has identified a strong association between political uncertainty and capital flight (Cerra, Rishi, and Saxena 2008; Collier, Hoeffler, and Pattillo 2001; Hermes and Lensink 2001; Le and Zak 2006; Lensink, Hermes, and Murinde 2000; Ndikumana and Boyce 2003). “Political uncertainty” is a broad category here proxied by high budget deficits, inflation, assassinations, capacity to tax, political and civil rights, war-proneness, corruption, protests, suppression of protests and others.

strength, to keep supporters and marginalize detractors in order to ultimately assure political survival (Gandhi 2008; Hale 2005; Little 2012; Beatriz Magaloni 2008; Smith 2005; Solomon 2007; Svobik 2009; Wintrobe 1990; J. Wright and Escribà-Folch 2011). Ability to successfully overcome problems of imperfect information is what separates resilient authoritarian regimes from those that have failed to survive. Policies of financial openness, in so far as they are conditioned by concerns of regime survival, also depend on the ability of the regime to overcome the problem of informational asymmetry.

2.2 Introducing informational asymmetry

Policymaking from a point of view of an authoritarian leader involves calculation about the potential for instability after financial openness policies are implemented. With respect to calculating the consequences of financial openness policies, the elites can use redistributive capacity to rely on political exchange as opposed to repression, removing the uncertainty about their position vis-à-vis the rest of society and precluding future instability. Formally, the “strength” of the Wealthy (that is, whether they can withstand a rebellion or not) depends on the cost of repression p . However RC, signified by the parameter ϕ , reduces the cost of repression for the Wealthy, such that $p' = p - \phi$.¹⁰ For simplicity, the model assumes only two possibilities for ϕ , it can either be zero (“low”) or be equal to p (“high”).

Secondly, unlike the repressive dimensions of regime strength, RC by its very

¹⁰ Higher ϕ certainly increases the payoff for the Poor in a dictatorship, but for the sake of keeping the argument as simple as possible, I do not change the payoffs of the Poor. However, it's to see that by increasing the payoffs to the Poor under dictatorship, greater redistributive capacity afford more political stability under dictatorship.

nature is common knowledge. Capacity for redistribution is a deeply embedded part of the social pact between the government and the governed, often including institutional arrangements that imply a variety of employment and non-employment based benefits (Boeri and Terrell 2002; Cook 2013; Pop-Eleches 2007). These arrangements usually have long-standing historical legacies, experienced by the population continually through regularized welfare payments, industrial and employment practices.

The natural level of asset specificity in a given economy, σ_N marks the lower boundary of σ that the Wealthy can propose. A higher bonus of openness corresponds to a high initial level asset specificity (σ_I). Both σ_N and σ_I are given exogenously, so that a financial openness policy amounts to: $\Delta\sigma = \sigma_I - \sigma_N$. In other words, the bonus of openness is greater in an economy heavily endowed with specific assets, and the global demand for these assets. When $\Delta\sigma > 0$, this action of the wealthy is called *Financial Openness (FO)*; and when $\Delta\sigma = 0$ it is called *Status Quo (SQ)*.¹¹

Parameters v and $\Delta\sigma$ account for the size of the “bonus” of financial openness policies, β , such that:

$$\beta = f(\Delta\sigma, v);$$

$$\beta = (1 + \Delta\sigma) * v * k_w^i;$$

$$d\beta/d\Delta\sigma > 0;$$

$$d\beta/dv > 0.$$

¹¹ For instance, the value of Russian mineral rents increases several-fold as a result of the energy boom between 1992-2007. In the formulation of this model, the bonus of openness in 2007 exceeded the bonus of openness in 1992: $\beta(2007) > \beta(1992)$.

2.2.1 Timing of the game

Just like the variant with perfect information presented above, the game begins with a move by “Nature,” which determines the exogenous parameters: v , σ_N , σ_I ; inequality parameters k_p , α ; the strength of the wealthy p ; cost of collection action for the Poor ϖ ; redistributive capacity of the regime. RC (denoted by ϕ) assumes only two values: “high” $\phi = p^{12}$ or “low”: $\phi \neq 0$ otherwise. That is, RC removes the uncertainty over the strength of the Wealthy.

The Wealthy move next, opting for either *Financial Openness (FO)* or *Status Quo (SQ)*, followed by a decision to either *Repress* or *Not Repress* the Poor. *FO* offer of $\Delta\sigma$ always equals to the difference between the initial level of asset specificity σ_I and σ_N ($\Delta\sigma = \sigma_I - \sigma_N$). That is, in the model, the Wealthy do not calibrate openness policy: if they offer *FO*, they allow maximally open policies. *SQ* offer implies an offer of $\Delta\sigma = 0$. When asset specificity and inequality are low, the Wealthy choose *Not Repress* and a democratic equilibrium emerges. In this scenario, tax rates under democracy are low enough to make the continuation of the authoritarian regime unappealing to the Wealthy.¹³ The game ends.

If the Wealthy choose *Repress*, the Poor can either *Rebel* or *Acquiesce*, but they do not observe the cost of repression p , only ϕ . The Wealthy observe both. The

¹² This assumption is made for simplicity’s sake to demonstrate the core of the argument.

¹³ The addition of the ability of the wealthy to lower asset specificity to the model makes it easier to understand the effects of expanded opportunities for financial internationalization over last twenty years on regime outcomes. Wealthy elites in many authoritarian countries opted for democratic rule without a major pushback. This is the mechanism by which globalization may have aided the third wave of democracy in countries that were “on the cusp” of transition based on the interplay between overall levels of asset specificity and income inequality. This outcome is described in detail in the Appendix.

game can end in Dictatorship, Transitional Regime, or a Post-war Dictatorship (Fig. 2.3).

2.2.2 Player payoffs

(a) Wealthy offer FO: $\Delta\sigma > 0$, which leads to greater financial openness and lowering asset specificity by $\Delta\sigma = (\sigma_1 - \sigma_N)$.

If the poor respond with *Acquiesce*, the wealthy (both when “strong” and “weak”) receive $\beta - p$, resulting in a payoff:

$$\hat{y}_w^{\text{dict}} = (1 + \Delta\sigma) * v * k_w^i * - \rho + \phi,$$

$$\text{where } k_w^i * = k_w^i - (k_p^i * \phi * \sigma_N) * (\alpha) / (1 - \alpha).$$

The Poor simply get to keep their income k_p^i , plus an additional transfer payment $k_p^i * \phi * \sigma_N$ when $\phi > 0$:

$$\hat{y}_p^{\text{dict}} = k_p^i * (1 + \phi * \sigma_N);$$

When the Poor rebel against the Wealthy who are strong after the FO offer, the Wealthy keep the authoritarian regime, but they pay a “penalty of openness” that equals $\Delta\sigma * k_w^i$ in addition to absorbing the costs of repression ρ :¹⁴

$$\hat{y}_w^{\text{dict}} = (1 - \Delta\sigma) * k_w^i - \rho + \phi;$$

A revolt of the poor – under the conditions of financial openness - leads to capital outflows, jittery foreign investors, sizeable drops in the stock markets and currency crises. All of this adversely affects the valuation of the assets of the wealthy that lose a fraction of their wealth that is increasing in $\Delta\sigma$. When the Poor rebel against a strong regime, they have to expend ϖ , so they are left with nothing:

¹⁴ Boix includes a parameter ϖ (collective action costs of the poor). For simplicity sake, I drop it from the model.

$$\hat{y}_p^{\text{dict}}=0;$$

If the Poor rebel against the Wealthy that are weak after *FO*, a “transitional regime” (TR) is established. The income of the players depends on the tax rate paid under this arrangement are $\tau^* = \min\{1 - k_p^i, \sigma_N\}$.

Table 2.1: Payoffs Under Democracy

tax rate (τ) scenario	PAYOFF	
	Wealthy (\hat{y}_w^{dem})	Poor (\hat{y}_p^{dem})
(1) $\tau=(1-k_p^i)$	$k_p^i * k_w^i + 1 - k_p^i - (1 - k_p^i)^2 / 2 - p$	$(k_p^i)^2 + 1 - k_p^i - (1 - k_p^i)^2 / 2 - w$
(2) $\tau=\sigma_N$	$(1 - \sigma_N) * k_w^i + \sigma_N - \sigma_N^2 / 2 - p$	$(1 - \sigma_N) * k_p^i + \sigma_N - \sigma_N^2 / 2 - w$

(b) Wealthy offer $\Delta\sigma = 0$ (*SQ*)

The payoffs under this scenario are the same as under 2.3.1, only the Wealthy do not receive the bonus or pay the penalty of openness (See the extensive form of the game in Fig. 2.3).

2.3 Solutions

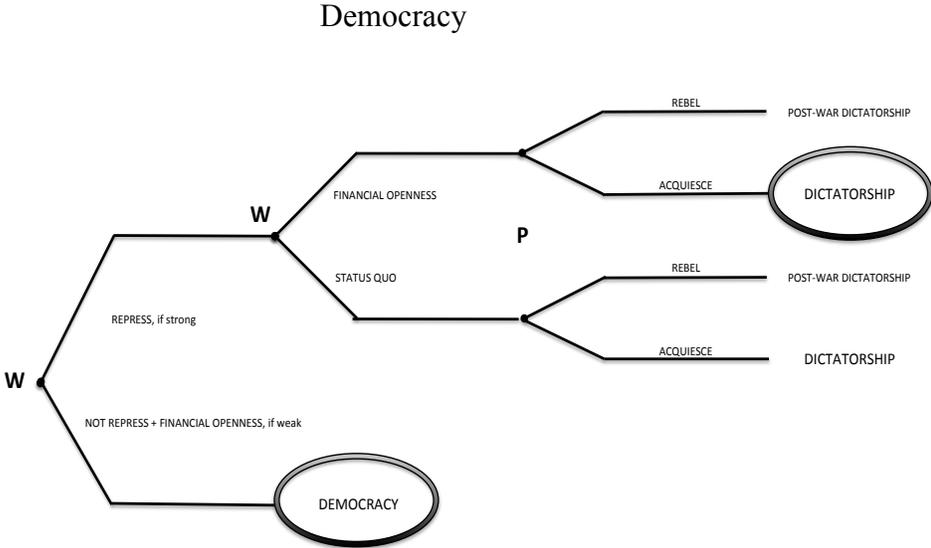
This section describes the solutions to the game stylistically, while the proofs of the equilibria can be found in the Appendix. Here, I describe two scenarios: first, when the redistributive capacity of the regime ϕ is “high” ($\phi = p$); and second, when it is “low” ($\phi = 0$).

2.3.1 High redistributive capacity $\phi = p$

High redistributive capacity removes the informational asymmetry of the game, allowing for only the following two scenarios. First: if the Poor know that the Wealthy are “strong” enough to squash their rebellion, they always acquiesce to repression. Knowing this, the Wealthy, always choose *Repress & FO*. Financial openness and continuation of authoritarianism are an equilibrium outcome (top circle

equilibrium in Fig. 2.2). Second: if the Poor know their rebellion will succeed (the Wealthy are “weak”), they never acquiesce to repression. Knowing this, the Wealthy always opt for the joint action of *Not Repress & FO* (bottom circle, this equilibrium outcome is discussed in the Appendix).

Figure 2.2: High Redistributive Capacity allows for *FO* under Dictatorship or



Proposition 1

High redistributive capacity removes informational asymmetry in the game of endogenous capital mobility, allowing for a sub-game perfect equilibrium {(Repress, FO); Acquiesce}, so long as the following inequality holds:

$$\hat{y}_w^{\text{dict}}[\phi \neq 0] > \hat{y}_w^{\text{dem}} \quad 15.$$

Put differently, redistributive capacity removes the uncertainty about the strength of the regime, especially when specific assets are highly valued on global markets. RC resolves the problem of observability and commitment for the regime (Osborne 2004, 320). So long as the bonus of openness for the wealthy exceeds the redistributive payments to the poor (and it can easily be shown that this broadly the case for all $v > 2$) the *Wealthy* can maintain dictatorship and financial openness simultaneously (see Appendix). $\{(Repress, FO); Acquiesce\}$ is then a sub-game perfect equilibrium for the extensive game with information made perfect by redistributive capacity.

2.3.2 Low redistributive capacity ($\phi=0$)

I consider the weak sequential “pooling” equilibrium solution (WSPE).¹⁶ In a WSPE, both “types” of the Wealthy pick the same action. A “pooling” equilibrium is a “mixed-strategy” equilibrium in which the Poor calculate their payoffs according to expected values, given the beliefs they assign to the Wealthy being “strong” or “weak.”

Proposition 2

A weak sequential “pooling” equilibrium with both types of wealthy picking FO and the poor choosing to “Acquiesce” occurs when the poor assign a belief that the wealthy are “strong” with probability $\pi > 1 - (k_p^i) / (\hat{y}_p^{dem} | \tau = \sigma_N) -$

¹⁵ This can easily be shown by backward induction. Because high RC reveals the *Wealthy* to be strong, the *Poor* always acquiesce in response to *Repress*. “Democratization and financial openness” outcome is outlined in greater detail in Appendix 1.2.

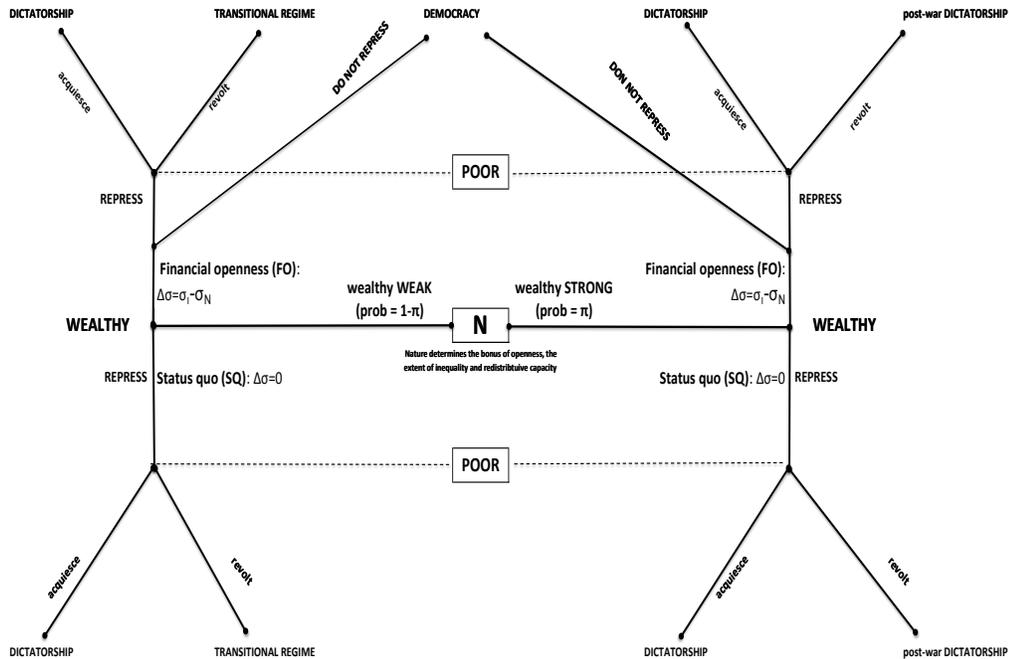
¹⁶ Proof that the game does not have a sequential “separating” equilibrium is in the Appendix.

$k_p^i * \phi * \sigma_N - \omega$)¹⁷; and “weak” with probability $q > 1 - (k_p^i) /$
 $(\hat{y}_p^{dem} | \tau = 1 - k_p^i] - k_p^i * \phi * \sigma_N - \omega)$ when they offer Status
*Quo and the poor Acquiesce.*¹⁸

In other words, the Wealthy are also able to opt for financial openness under the conditions of asymmetric information, but without redistributive capacity, they can do so only under limited conditions (when the costs of repression are low; and the cost of collective action for the Poor are high).

Figure 2.3: Game of Endogenous Capital Mobility with Informational

Asymmetry



Corollary 2.1: There exists a range of values of σ_N , such that the poor have an incentive to rebel, that is $Y_p^R > Y_p^A$. Observing this payoff structure for the Poor under

¹⁷ Indifferent when $\pi = 1 - k_p^i / (\hat{y}_p^{dem} - \omega)$, and “rebel” when $\pi < 1 - k_p^i / (\hat{y}_p^{dem} - \omega)$.

¹⁸ Proofs of the Propositions can be found in the Appendix.

FO, the Wealthy opt for *SQ*, calculating that the probability of them paying the penalty of openness is high.

For this WSPE to be sustained, the wealthy have to be sure that the poor will not rebel in sub-history *SQ*. We can easily show that the poor acquiesce for a wide range of values of q , given the assumption that the democratic tax rate $\tau = 1 - k_p^i$ (since no financial opening occurred in this scenario). I illustrate the equilibrium results and its corollaries with graphs. These are comparative statics, so in each simulation I hold some of the parameters at constant values: $k_p^i = .4$; $\varpi = .15$; $k_w^i = 3.4$; $\phi = 0$.

Observing this payoff structure for the Poor under *FO*, the poor opt for acquiesce

$$\hat{y}_p^{\text{acquiesce}} = \text{EV}_p(A) = k_p^i * \pi + k_p^i * (1 - \pi) = k_p^i;$$

$$\hat{y}_p^{\text{acquiesce}} = .4;$$

$$\hat{y}_p^{\text{rebel}} = \text{EV}_p(R) = 0 * \pi + (1 - \pi) * ([\hat{y}_p^{\text{dem}} | \tau = 1 - k_p^i] - \varpi);$$

The poor rebel, if

$$\text{EV}_p(A) > \text{EV}_p(R);$$

Given $\tau = \sigma_N$, plugging the numbers from scenario 2¹⁹ in the Table 2.1, we have:

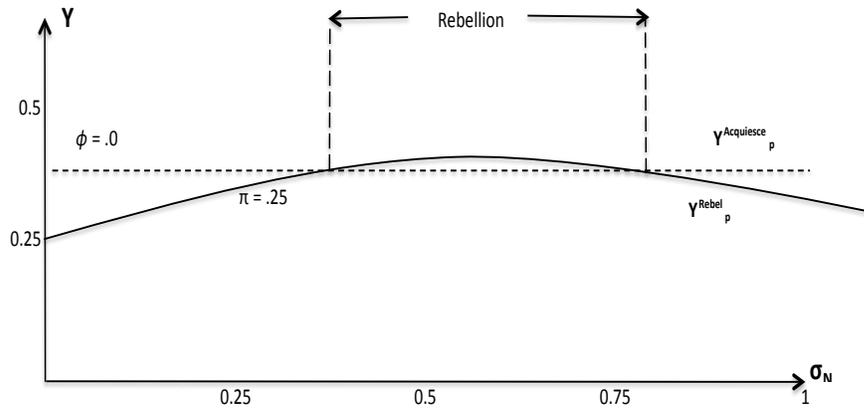
$$\hat{y}_p^{\text{rebel}} = (1 - \pi) * (1 - \sigma_N) * .4 + \sigma_N - (\sigma_N)^2 / 2 - .15;$$

$$.4 > (1 - \pi) * (1 - \sigma_N) * .4 + \sigma_N - (\sigma_N)^2 / 2 - .15;$$

$$.4 > (1 - \pi) * (-(\sigma_N)^2 / 2 + .6\sigma_N + .35).$$

¹⁹ Recall, that after the rebellion the tax rate imposed by the Poor is $\tau = \sigma_N$, because I assume that wealth inequality is far greater than even the highest measures of asset specificity (Piketty and Zucman 2013).

Figure 2.4: Incentives for rebellion under financial openness with no redistribution



Under the parameters of the simulation, the Poor have to have a strong belief that the Wealthy are weak in order to get a higher payoff in rebel (i.e., they assign the probability π to the belief that the Wealthy are strong of 25 percent or less). And even so, the payoff from rebellion exceeds the payoff from acquiescence only once the natural level of asset specificity reaching fairly high values. Knowing this, the Wealthy abstain from financial openness even if the cost of repression are relatively modest.

The modeling exercise demonstrates the importance of observability of regime strength. Even a “strong” regime can have difficulty “signaling” its strength in the absence of redistributive capacity. In the presence of high value of specific assets controlled by the regime (parameter observed both by the Wealthy and Poor), redistributive capacity becomes indispensable in signaling the regime’s willingness to “share” the proceeds of openness and therefore mitigate potential political instability.

2.4 Empirical implications

The endogenizing of financial openness policy in nondemocracies is the

central theoretical innovation of the model. Authoritarian elites care about buttressing their standing vis-à-vis the rest of the population by increasing the tradability and value of the assets they control, but they also worry about political instability. Redistributive capacity provides the regime with a mechanism to signal its strength allowing financial openness under continued authoritarian rule.

The central empirical implication derived from the model (what Gerring calls the “umbrella proposition” (2001, 90)) could be stated as follows:

Hypothesis 1: A high value of specific assets controlled by the regime (“bonus of openness”) and redistributive capacity are both necessary for an authoritarian regime to initiate policies of financial openness.

Breaking this umbrella proposition into its components, we have:

Hypothesis 2: Conversely, if the “bonus of openness” is low, high capacity for redistribution is not sufficient for openness.

Hypothesis 3: Conversely, even if the “bonus of openness” is high, low capacity for redistribution will prevent openness policies.

Hypothesis 4: When the regime’s control over the assets is tenuous, policies of financial openness are less likely to be instituted.

The rest of the chapter is devoted to describing the empirical strategy for evaluating, testing and falsifying these hypotheses. Specifically, I outline the

methodological approach, criteria for case selection, approaches to variable operationalization, measurement and data collection. I conclude with an outline of several competing explanations.

3. EMPIRICAL STRATEGY

To evaluate these propositions, I adopt a social scientific research strategy that is rooted in a broader view of science as “systematic inquiry.” Science according to this conceptualization is “systematic, rigorous, evidence-based, generalizing, nonsubjective, and cumulative” (Gerring 2001, xiv–xv). In order for the process to be systematic and rigorous, I began by building a formal model of endogenous capital mobility. Starting with a theoretical model allowed me to express a “real-world situation in abstract and symbolic terms in a set of explicitly stated assumptions” (Morton 1999, 36). The use of “formality” (mathematical formulas and expressions) allows one to assure the internal consistency of the argument at hand (King et al. 1994, 106). Although I have restated the model in informal language, the main advantage of the modeling exercise is that it makes it easier to identify faulty reasoning (Morton 1999, 102).

I evaluate these implications in subsequent chapters in comparative studies of three important cases that share a number of similarities, while offering variation on the dependent and independent variables. Qualitative evidence in support of the arguments comes from 50 semi-structured interviews with policymakers, representatives of the banking sector, academics, experts, journalists, as well as hundreds of press accounts collected during twelve months of fieldwork in Russia, Kazakhstan, China, and Washington D.C. between 2011 and 2013. Although I have

directly cited only a fraction of these interviewees, nearly every conversation yielded invaluable insights that advanced my research. To ensure a uniformity of data collection across interviews, I asked standardized, open-ended questions in the same sequence in each interview (Patton 1990). Following the guidelines of the Internal Review Board, all interviewees were offered anonymity. The list of interviews, dates and location can be found in Appendix 3.

3.1 Case selection and generalizability

Case selection is driven by “a basic and obvious rule: [it] should allow for the possibility of at least some variation on the dependent variable” (King et al. 1994, 129). To accomplish this goal, I have selected three countries ruled by nondemocratic regimes with varying levels of financial openness: Russia, Kazakhstan and China.

Because a proper evaluation of *Hypothesis 1* requires variation on the value of assets controlled by the regime (“bonus of openness”) and variation in the levels of financial openness, I first conduct a qualitative comparison of two periods in Russian postcommunist history. The case study approach is based on the method of agreement and difference. A case study is an “intensive study of a single unit for the purpose of understanding a larger class of (similar) units.” This analysis is by definition “covariational” in a sense that it can compare several individual case studies within one “case” (Gerring 2004, 342–43, 352). At the same time focus on a “single” case (Russia in this instance) allows one to “control” for several confounding socio-economic variables. The study of the Russian case makes up Chapter 3.

The puzzle of capital account deregulation in Russia is encapsulated in a shift to the *de jure* financial openness that occurred under Putin’s more politically closed

regime (2000-2008) as opposed to a softer earlier variant of nondemocracy (1992-1999). I argue that the difference between the two periods amounts to a lack of state control over specific assets and a far greater bonus of openness in the 2000s than in the 1990s, due to an unprecedented global boom in demand for commodities.

In the 1990s, a fiscally starved and weakened Yeltsin regime saw few upsides to greater financial openness. Instead of a coherent set of government policies in this arena, there emerged a system of undefined and highly legalistic and regulated, but generally unenforced system of financial controls. In the 2000s, the Putin regime – buoyed by increased tax revenues – was able to acquire direct control over the most values specific-asset industries. The already deeply embedded redistributive bargain was strengthened with increases in welfare payments issued in exchange for high approval ratings and strong pro-regime support in the population, especially among its poorest segments. A higher bonus of openness, redistributive capacity reanimated by higher oil and gas revenues, and newly re-asserted control over specific assets led the regime to initiate unprecedented financial openness policies.

Chapter 4 presents two more comparisons: between Russia and China, and Russia and Kazakhstan. The first comparison allows me to control for regime control over assets and the bonus of openness, but vary the extent of redistributive capacity. The Chinese Communist Party has held onto primary specific assets since 1979 and even for the most part, throughout the privatization period of the 1990s. However, the Chinese state lacks the redistributive capacity available to the Putin regime. The unprecedented scale of the industrial transformation and the sheer size of the population movements from rural to urban areas all have made the task of population

control costlier for the regime. Consequently, the Chinese elites had fewer mechanisms to signal regime strength through the use of redistributive capacity, leaving it in a far weaker position to initiate policies of financial openness.

The second comparison in Chapter 4, allows me to vary the extent of control over the specific industries, while keeping redistributive capacity constant. Russia and Kazakhstan both retained high levels of RC from the Soviet period. However unlike the Kazakh regime in the early 1990s, the Russian regime did not wrestle the control over the specific assets from domestic actors until mid-2000s. As I demonstrate, this difference accounted for an earlier initiation of financial openness policies by the Nazarbayev regime.

Table 2.2: Timing of Financial Openness Policies in China, Kazakhstan and Russia

Case	Timing of policy	Control over specific assets	Capacity for redistribution
Kazakhstan	late-1990s/early-200s	since early 1990s (no domestic competitors for assets)	Legacy RC from USSR
Russia	mid-2000s	2003-04	Legacy RC from USSR
China	early/mid-2010s (?)	since 1979	No legacy RC; new RC dev in mid-2000s

3.4 Measurement

Although I do my best to keep to the same standard of measurement across qualitative case comparisons, due to limitations in data coverage and varying country-context, I occasionally have to craft a specific approach to measurement “as needed” on a case by case basis (Chapters 3-4). This section offers a broad overview of the measurement approach taken in the dissertation.

3.4.1 Financial openness

To measure the dependent variable (“*de jure* financial openness”) I begin with

quantitative standardized indices, assembled by other scholars, when time coverage and data availability permit (Chinn and Ito 2008; Edison and Warnock 2003; D. Quinn and Toyoda 2008). Cross-national indicators of openness, however, have some significant drawbacks. Two of the main issues are the extent of coverage and the level of detail reported in the data (Quinn et al 2011, p. 517). Both issues are especially pressing for the emerging markets and less developed economies.²⁰

To get as complete a picture as possible, I also trace the policy changes qualitatively. In addition to the issue of coverage, understanding the qualitative dimensions of openness is important for substantive reasons. Financial regulation deals in the realm of the psychological - the notorious Keynesian “animal spirits.” Seemingly insignificant policy announcements are often of great consequence to market players, while large policy shifts can be mere *pro forma* acknowledgments of informal ways that business is already being conducted.

The goal is to specify significant changes in the financial openness policies occurring in a relatively short time window. Changes in capital account openness do not fluctuate wildly year over year. For this reason, for example, Chin and Ito’s (2008) index uses 5-year rolling averages, in order to capture only the truly significant changes. This study is limited to the post-Cold War period of about 20 years. If the data were available for all country-years, this would be a sufficient period of time, but

²⁰ Furthermore, in certain cases even when a given country is included in a particular dataset, the level of openness reported in the data doesn’t correspond with secondary literature or the opinions of many country specialists. For example, Quinn and Toyota’s index “CAP” reports a value of 62.5/100 for Russia in 2006, while nearly all interview subjects would consider Russia to have a totally deregulated capital account regime in 2006.

the best source of this information (IMF's AREAER publications) was expanded only in 1996 to include more refined measures of openness. Chinese data became fully available only in 2004. Consequently, I evaluate financial openness on a binary basis, whereby I focus on significant shifts in the financial openness policies as evidenced by changes in standardized indicators and buttressed by qualitative evidence.

3.4.2 Asset values

My theory holds that decisions about the timing of financial openness policies in nondemocracies depend in part on the value of specific assets the regime controls. Measuring the extent to which openness altered (or would alter) the value of specific assets is a subjective exercise. Establishing the value of firms located in a politically unstable environment is difficult, because the assets cannot be used as collateral and because of the informational asymmetry between insiders and outsiders (Barton and Gordon 1988; Macher and Richman 2008; Shelanski and Klein 1995).

In order to get around this problem I adopt a two-pronged approach. First, I use global prices of commodities and other specific assets as proxies for the value of specific assets. Secondly, and in addition to the first measurement approach, I present data on comparable industries elsewhere. Fortunately, the theory does not require that "the bonus of openness" be large in order for the openness policy to be attractive – only that the payoffs under openness exceed those offered by the *status quo*. In most cases, the bonus of financial openness implies an increase in valuation on the order of several hundred percent.

3.4.3 Control over assets

Authoritarian regimes under the conceptualization employed here control the

preponderance of the assets in an economy. However, in reality the extent of control varies across time and from case to case. To a degree, the measure of control is captured by the “bonus of openness”: the more the regime controls, the larger the bonus. However, it is also important to remember that the authoritarian elites also care about their relative station vis-à-vis potential challengers, so they prefer to avoid increasing the value of assets controlled by their opponents (Dadasov, Harms, and Lorz 2013). Consequently, I trace government ownership of companies as share of the total economy, total value of listed companies, as well as in asset-specific industries.

3.4.4 Redistributive capacity

I use a number of approaches to measure redistributive capacity in each case, including cruder measures, such as government consumption as a share of GDP. However, I primarily focus on tracing the qualitative and institutional aspects of RC. These include legacies of the welfare state, the structure of welfare delivery, unemployment and industrial policies, as well as the presence of patronage networks and informal access to the elites.

CONCLUSION

This chapter presented the conceptual and theoretical foundations of the argument advanced in the dissertation. Authoritarian regimes’ propensity to initiate policies of financial openness is conditioned by the extent of the benefits they receive from openness and the potential for downside political risks. In the next two chapters, I evaluate this argument by using case studies of Yeltsin’s and Putin’s Russia (Chapter 3), and China and Kazakhstan (Chapter 4).

CHAPTER 3

FINANCIAL OPENNESS AND AUTHORITARIAN POLITICS IN RUSSIA

On July 1, 2006, Russia's highest ranked evening news TV broadcast "Vremya" on state-controlled Channel 1 led with the following headline: "Ruble next to euro and dollar. All restrictions on the movement of capital are removed." The segment informed the viewers about the symbolic significance of a move toward "convertibility" of the ruble. Referring to the nation's currency as "a character in Russian history," the story focused primarily on the resurgence of the Russian economy emphasizing, for example, its newly acquired status of a creditor-nation in the Paris Club. Finance minister Aleksey Kudrin assured the viewers that repaying foreign debts ahead of schedule "decreased our dependence on world markets." The anchor went on to conclude that it would take some time for the ruble to gain stature similar to that of the euro or the dollar, mentioning capital account liberalization only briefly as a step that will "strengthen the international *renomé* of the Russian currency" (Pervyj Kanal 2006).

This news report did not mention the technical, but in effect, more significant changes in Russia's financial openness policies. Contrary to Kudrin's evaluation, these changes would make the Russian economy more interdependent with the global financial system. For the first time in nearly a century, capital would move freely across Russian borders. The Central Bank of Russia (CBR) stopped requiring exporters to sell dollar-denominated proceeds of foreign sales. Residents and nonresidents were no longer required to reserve a portion of the cross-border capital transfers with the CBR. Most importantly, the authorities removed controls on Russian

companies' foreign borrowing. Going forward, residents could purchase securities abroad, and non-residents could invest in the Russian domestic securities without restrictions. Years after the policy went into effect, policymakers, representatives of the banking sector, and other experts identified these reforms directly as a watershed moment in the modern economic history of Russia.²¹

This policy transformation, however, went largely unnoticed by the Russia-watchers in the West who, for understandable reasons, preferred to focus on the Kremlin's recent turn towards a more autocratic political model. As measured by a variety of metrics – including political participation, competition for office, freedom of expression and association – the Russian political system by the mid-2000s had become less competitive than it had been at any point since the breakup of the Soviet Union. The practice of electoral fraud, abuse of “administrative resources,” disqualification of opposition candidates, and restriction of civil liberties culminated in the outright elimination of gubernatorial elections and the introduction of new restrictive registration rules for the opposition parties by 2004 (Fish 2005, 30–81; D. Treisman 2012, 97–103).

How should we reconcile a move toward greater financial openness with political closure in Russia? Why would the government decide to abolish both elections of governors and capital controls in a span of two years? Why would a political regime obsessed with control over all economic and political life relinquish control over cross-border movement of capital?

²¹ Several interviewees (Nos. 3, 4, 9 and 10) identified the reforms as a watershed moment, though many were puzzled by how little is written on the subject.

This chapter applies the argument developed in the Chapter 2 to explain the differences in financial openness policies between the two post-Soviet nondemocratic political regimes led by Boris Yeltsin (1992-1999) and Vladimir Putin (2000-2008). The purpose of the Russian case study is to assess the model developed in the previous chapter, but also to improve the theory by confronting it with detailed empirics from a particularly important case. I show that greater control over specific assets, as well as a high valuation of these assets on global markets in the 2000s allowed the Russian government to initiate openness policies, while reliance on the Soviet legacy redistributive capacity to keep the population compliant. In other words, far-reaching redistributive capacity allowed the Putin regime to “afford” the downsides of financial openness.

The chapter proceeds as follows. I begin by providing an overview of the Russian political economy, and then present the puzzle of financial openness. I go on to trace the dependent variable (financial openness), along with the three independent variables (value of and control over specific assets, and the state’s redistributive capacity) from 1992 until 2009. In section 3 I bring the preceding discussion together to discuss how the variables interact to allow Putin’s regime to (1) take advantage of the “upside” of openness with respect to Gazprom and Rosneft; and (2) withstand an episode of short-term “downside” of openness brought about by the 2008-09 global financial crisis. The final section concludes by summarizing the findings and previewing Chapter 4.

1. OVERVIEW

1.1 From state socialism to state capitalism

Following a liberalization decree issued by Yeltsin just a few months earlier, in mid-1992 Prime Minister Yegor Gaidar and his team put in place a series of reforms that aimed to drastically reduce the role of the state in the overall economy. They were facing a dire crisis, requiring massive fiscal, regulatory, monetary and other policy changes. Between 1992 and 1998, Russia's GDP declined by 24 percent (in PPP terms measured in current international dollars) or 37 percent (measured in real international dollars). In fact, it took until the early 2000s for Russia's economy to regain the size it had been in 1992 (Letiche 2007, 3; World Bank 2012). Yet, there were notable reform successes in the 1990s. For example, the proportion of state-employed workers in the total labor force declined from upwards of 85 to under 40 percent by the end of 1994, and only 9 percent of all firms were state-owned by 1997 (Shleifer and Treisman 2000, 1).

Privatization of inherited Soviet assets was perhaps the most controversial episode in Russia's post-Soviet economic history. Most Russians opposed it when it was being debated and at least a plurality of them oppose it in retrospect today (Chernykh 2011; Denisova et al. 2009). It failed to reduce the political power of the Communist holdovers, and it did not generate substantial revenues for the state budget. Nevertheless, it did accomplish a centrally important task. The state over which Yeltsin's regime presided – with all its follies and contradictions – was not a competitor for assets. In contrast to the Soviet state, which was the sole executor of all assets, Yeltsin's government played a relatively limited role as a mere “corruptible

facilitator of exchange” (Barnes 2007, 53). Most observers identify this as a pathology, a permanent blemish on the reformers’ agenda, but it is undeniable that “asset stripping and cash diversions occurred under *private* ownership” during this period (Desai and Goldberg 2001, 226 emphasis supplied).

The August 1998 crisis is the bookend of the temporal comparison of the two Russian cases. Aided first by depreciation of the ruble, and later by a significant increase in world energy prices, the Russian economy rebounded almost miraculously, recording the highest annual increase in GDP of 10 percent in 2000 – the year that Vladimir Putin was elected president (Letiche 2007, 7). For the next seven years the GDP growth averaged close to 7 percent per annum. To quote Daniel Treisman, “[f]rom a fiscal and monetary disaster zone, Russia became one of the most macroeconomically stable emerging markets...” (2012, 233). By any meaningful economic or fiscal indicator, Russia made a remarkable turnaround in just a few years.

From an exclusive executor of assets to a “corruptible facilitator of exchange,” the Russian state under Putin emerged as a direct “competitor for assets” (Barnes 2007). Invigorated by economic growth, military victory in Chechnya, high oil prices, and electoral successes, Putin began to expand markedly the state’s participation in the economy. Whether threatened by the political influence of the oligarchs (who were undoubtedly the greatest beneficiaries of the boom), or simply jealous of their economic fortunes, Putin instructed his trusted allies to begin concentrating the most lucrative assets especially (though not exclusively) in the hands of the state-holding companies. Most remarkably, the federal government became the main player in the oil industry – an industry that was largely private in the 1990s (Weinthal and Luong

2006). By the middle of Putin's second term the regime fully embraced state capitalism as the mode of economic development.

1.2 The Russian puzzle

This chapter compares two periods of nondemocratic rule during Russia's post-Soviet history: Yeltsin's rule from 1992-1999 and Putin's first two terms as president 1999-2009.²² One could raise an objection to classifying Russia under Yeltsin as a nondemocracy. Certainly there were vibrant opposition parties that were able to gain representation in the parliament. However, as one of the most astute observers of Russia wrote in a *New York Times* editorial in 1996, "Having demonized all his opponents from 1992 to date, used violence to destroy the elected parliament in October 1993 and exploited his near monopoly over television news, Mr. Yeltsin is the real threat to democracy and reform in Russia" (Johnson 1996). In fact, it was widely known at this point that Yeltsin considered canceling or postponing the elections in 1995-96, especially after the Communists performed well in the Duma elections of 1995 (Goriaev and Zobotkin 2006, 9).

Various indices of democracy generally rank the early Putin period and Yeltsin's second term in the same category of "anocracy." Polity ranks them both as 8/10; and as shown in Figure 3.1, Voice and Accountability project ranks the first 3 years of Putin's rule as being more open than Yeltsin's last three years in power (Kaufmann, Kraay, and Mastruzzi 2009; M. G. Marshall, Jagers, and Gurr 2009).

The Economist Intelligence Unit uses a set of three indices to calculate friendliness of

²² Although still ongoing as of this writing, Putin's third term, especially after the December 2011 protests and the Ukrainian adventure of 2014, has turned out to be far more authoritarian.

government towards foreign business: “government policy toward foreign investment,” “expropriation risk,” and “investment protection schemes.” All three were given a poor assessment of 2, 3, and 1 respectively from 1993 to 2007, meaning that foreign investors saw little change from Yeltsin to Putin (EIU.com).²³

None of this is to suggest Putin’s first years in power were particularly democratic; rather it is to say that Yeltsin’s regime was not as pluralistic as many have a tendency to believe. Putin, (although different from his predecessor in many ways) was similar to Yeltsin in a sense that he tied the legitimacy of his regime to his own personality, used whatever means possible to stay in office, tilted the electoral field in his favor, rewarded those who supported him and ostracized those who dared to oppose him.²⁴ Nothing demonstrates this better than the way in which Yeltsin personally handed the presidency off to Putin on the New Year’s Eve of 1999. The post-1993 Yeltsin and Putin (before the 2009 financial crisis) are different politicians, but neither was a fervent democrat.

Whatever the similarities they shared in terms of politics, Yeltsin and Putin differed greatly on matters of economic policy. Yeltsin consistently gave up the state’s control over Russian industry in exchange from political support from the oligarchs, while Putin did everything to amass economic control in the hand of the state. After acquiring control of the “commanding heights” of the economy in his first term, Putin began to rely increasingly on more “forward” authoritarian political tactics. The

²³ One aspect of the FDI policies that did warm foreign investors to Putin was the corporate tax burden, which was reflected in the best score of 5/5 given to Russia from 2003 to 2007.

²⁴ For my theory to be evaluated in this context Yeltsin and Putin to be identical, just not to differ for reasons having to do with capital account policy.

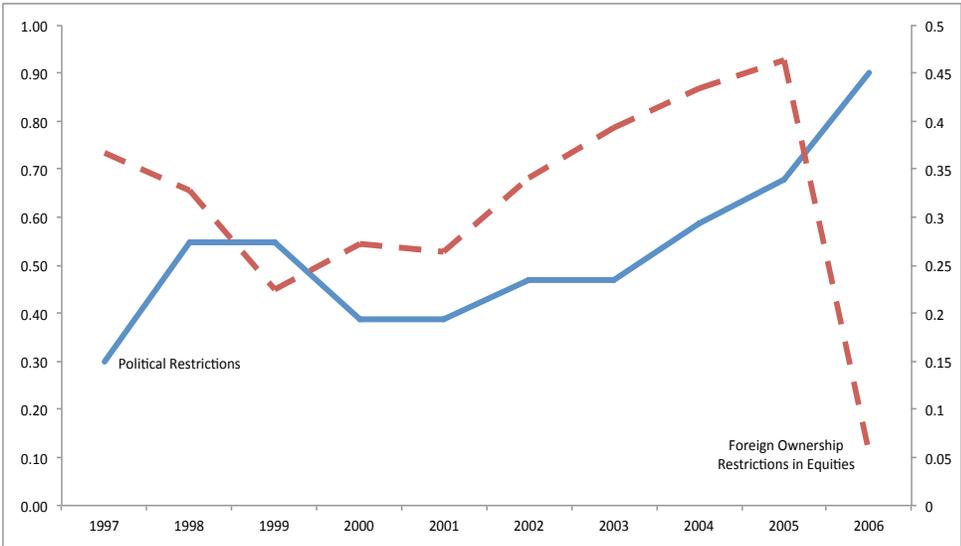
president acquired the legal authority to appoint regional heads of police and prosecutors. The electoral threshold for political parties attempting to gain representation in the Duma was raised from 5 to 7 percent. Elections of the regional governors were abolished in 2004. New party registration rules effectively made it impossible for small opposition parties to gain representations, while many forms of political protests became unlawful. In the 2003 parliamentary elections, the Kremlin-organized United Russia party won a constitutional majority and Putin easily won re-election in March of 2004 with over 70 percent of the vote. As M. Steven Fish put it, these elections “accelerated the drift toward expunging uncertainty from electoral competition” (Fish 2005, 79). Abroad, the infamous Khodorkovsky case and the seizure of the main national opposition TV channel NTV secured Putin’s reputation as an autocrat (Treisman 2012).

The relinquishing of controls over the financial flows by the otherwise control-obsessed Kremlin at this time is puzzling for at least two reasons. First, the politicians at the helm of the Russian state in the early to mid-2000s were keenly aware of the dangers of financial exposure based on the experiences of the late 1990s (Johnson 2000, 212–16). Russia was less financially open then, and certainly the crisis stemmed mostly from a prolonged domestic economic crisis. However, in addition to these deeper causes, the instability in Asia and worldwide capital scarcity contributed to the severity of the downturn.

Putin was well aware that the 1998 crisis, sovereign default and devaluation brought him to power. As one IMF official, familiar with the events, noted in an interview, the crisis “...was a breakpoint, both because controls were introduced to

stem the crisis and because the Putin timeline really began.”²⁵ For the next seven years under Putin’s leadership, decontrol of cross-border economic transactions and increased control over domestic political and economic life went hand in hand (Figure 3.1).

Figure 3.1: Political and Financial Openness in Russia, 1997-2006



- - - - : Foreign Ownership Restrictions on Equities by Edison and Warnock (2003, with later updates). (Right axis)
- — : Political restrictions are measured using the Voice and Accountability Index from World Bank’s Worldwide Governance Indicators by Kaufmann et al (2012). It is presented in inverted form, with larger numbers representing fewer freedoms of participation, expression and association. (Left axis, captures only small part of the [-2.5, +2.5] V&A scale)

Putin and his allies made the contrast between the “stability” of the 2000s with the “chaotic” 1990s into a rhetorical, legitimating foundation of their rule. “Political

²⁵ Interview No 18 (IMF official). Washington D.C., March 2012.

stability” and economic prosperity were sold together in a single package. Just two months before the financial openness reforms went into effect, he reassured the public of his commitment to financial stability in his annual address to the Federal Assembly:

“... after a prolonged period of life in conditions of budget deficits and sudden fluctuations in the ruble exchange rate, situation is changing drastically. It's imperative that we safeguard the attained financial stability as one of the baseline conditions of increased trust of people toward the government” (Putin 2006).

Greater openness, whatever benefits it may bring, does little to promote greater financial stability, especially in an economy mired by structural imbalances. A regime that did everything to avoid sharing power would now become more beholden to foreign capital markets. In short, greater financial openness and exposure to external financial pressures could severely harm “the baseline conditions” of people’s trust. Putin and his cabinet must have understood this possibility, yet they decided that benefits of the policy outweighed the costs.

The second puzzling aspect of openness under authoritarianism in Russia has to do with the fact of it being in stark contrast to the government’s other economic priorities, especially in the domestic arena. Starting with the takeover of Yukos, the government began acquiring major holdings, especially in the extractive industries, often not relying on outright expropriation, but by underpaying for the assets under pretexts of environmental or other concocted concerns. Indeed, on its surface the expansion of state participation in the national economy was at odds with the

campaign of financial liberalization. While the renationalization was initially advertised as a policy advancing national security that would preserve natural treasure in the hand of the state, in fact it was not exclusively bound to extractive industry. For example, the number of state-controlled banks increased by 50 percent (Vernikov 2009, 9).²⁶

The two inconsistencies – between liberalization at the international level and renationalization of industry in the domestic arena and, second, between the regime basing its legitimacy on economic stability and the potential external risks brought about by financial internationalization – appear in conflict only when considered individually. The puzzle is resolved once we consider the connection between financial openness policy, control and valuation of specific assets, and redistributive capacity – as part of a single policy package. Once Putin’s regime gained control of the most valuable specific assets and assured its popularity by making use of legacy redistributive capacity, greater financial openness allowed it to multiply the benefits of control through diversification, asset exchange, and greater financial leverage. All of this ultimately buttressed the regime, enhancing its standing vis-à-vis opponents.

2. COMPARING THE TWO PERIODS

In this part of the chapter, I trace the four key variables of the model in order to evaluate the temporal differences in the Russian case. First, I outline the changes in

²⁶As Vernikov notes, most of this control is not direct, but rather channeled through other state-owned corporations that owned public capital. Renationalization of the Russian banking system over the past decade, makes it more similar to China or Vietnam, than to other East European economies. “After 20 years of experimenting with private financial intermediation, Russia appears to be backtracking towards a state-run credit system” (Vernikov 2009, 19).

the dependent variable to demonstrate the contrast in the openness policies between the two periods. Second, I briefly demonstrate the changing valuation of specific assets between the two periods, precipitated primarily by the global commodities boom beginning in 1999. Third, I document the changing role of the state between the two periods, with a deep contraction of state-ownership in the 1990s and its sharp rise under Putin. Finally, I show that the redistributive capacity of the Russian state was largely unaltered through the two periods, though the latter regime had access to far greater resources to make use and revitalize the welfare state Russia inherited from the Soviet Union.

2.1 Financial openness policies

2.1.2 Measuring financial openness in Russia

In order to measure the dependent variable (“*de jure* financial openness”) I employ quantitative standardized indices, assembled by other scholars, when time coverage and data availability permit (Chinn and Ito 2008; Edison and Warnock 2003; D. Quinn and Toyoda 2008). Cross-national indicators of openness, however, have some significant drawbacks. Two of the main issues are the extent of coverage and the level of detail reported in the data (Quinn et al 2011, p. 517). The purpose of this section is to “map out” the Russian government’s approach towards cross-border regulation during the two periods under study.

Making a judgment about the potential consequence of any given policy change is necessarily subjective, but in combination with other data and taken over a longer stretch of time, I am able describe the general trends and “sudden” swings in the liberalization policy (or lack thereof). Here, I rely on official government

announcements reported in the Russian-language press; interviews conducted in Moscow between January and May of 2011, and in Washington, D.C. between March and August of 2013; IMF data; secondary sources and newspaper archives (using *EastView* information services database, provided by Cornell University library).

2.1.2 Openness policies: 1992-1998

Initial attempts to open up the economy began in the late Soviet period. Mikhail Gorbachev encouraged joint ventures with Western businesses, with the hope that in addition to capital, foreign investors would transfer new technologies and managerial know-how. Even Soviet officials spoke of the need to improve the investment climate in the USSR, and some urged simplifying laws to attract foreign investment (Yur'ev 1989). Close to two hundred Soviet enterprises founded a Moscow Stock Exchange in late 1990, after Gorbachev signed a decree allowing citizens to purchase domestic securities (AP 1990). However, once the economic crisis fully commenced in 1991, and Soviet officials and authorities connected to the Russian republic started battling for control over (among other things) monetary policies, all the talk of “investment climate” was promptly abandoned (Bohlen 1991).

Although this chapter provides some background on openness policies prior to 1994, the initial period of financial policymaking was quite chaotic. The new government understandably did not prioritize policies on financial flows regulation during the very early post-Soviet period, as far more pressing problems were at hand. In addition to the hyperinflation problem, the Central Bank of Russia had to first establish its authority over the money supply, as the Soviet banknotes remained in circulation until August of 1993. Many Russian citizens lost lifelong savings during

the hastily announced two-week “exchange period” between July 26 and August 7 of that year (Troitsyna 2013). The Central Bank limited cash withdrawals to only 35,000 rubles, while the rest would be required to be kept as a saving deposit – all in the midst of double-digit monthly inflation (Treisman 2012, 201). Foreigners were given only one day to trade in 15,000 rubles – worth about \$15. This blundering operation seriously damaged the public’s support for the government and emboldened the anti-Yeltsin coalition in the parliament leading up to the October 1993 standoff.

Furthermore, during the early period the state did not control the physical, let alone the financial borders. Truck-loads of Russian currency were being brought into the country from the former Soviet republics which were introducing currencies of their own (Efron 1993). Finally, the scope conditions limited the application of the argument to nondemocracies. By most accounts, until the shelling of the parliament by Yeltsin in October 1993, the Russian political system was far more pluralistic with real power sharing between the executive and the legislature. With the violent dissolution of a democratically elected parliament in October, the introduction of a super-presidential constitution in December 1993 and subsequent usurpation of power by Yeltsin, Russia began a slow descent towards authoritarianism that would be only congealed under Putin a decade later.

In the middle of this initial economic pandemonium, the CBR issued the first major change in the regulation of inflows by way of an official instruction to private banks to institute an investment account (“I” – account) for nonresidents (in addition to the “T”- account for current account transactions). Even though the instruction contained a host of limitations, including onerous reporting and monitoring

requirements for banks, this was the first official attempt to provide some guidance for foreign investors and to “legalize” their entry into the Russian market (Katsman 1993). Struggling to implement a functioning market for domestic bonds, in March of 1994, the CBR allowed nonresident investors to purchase up to 10 percent of any given domestic treasury bill issue (Bekaert and Harvey 2002).

Given severe economic depression, uncertainty over property rights, and by then an ongoing brutal war in Chechnya, relatively few foreigners dared to risk investing in Russia. As economic conditions began stabilizing by the mid-1990s, several key institutional reforms were introduced, including a law that guaranteed Central Bank independence (Treisman 2012, 209). The Moscow Interbank Currency Exchange (MICEX, established in 1992 for currency trading) was coming into maturity as the main platform for currency trading. In 1995 the Russian Trading System (RTS) was launched and relatively quickly became the main trading platform for stocks, and later derivatives and other more complex instruments. Both exchanges made it easier for foreigners interested in short-term investment to have access to Russian assets (Goriaev and Zobotkin 2006, 4). Still, according to the FORU measure (Fig. 3.1), foreign access to Russian equities was fairly limited even at the height of the pre-crisis stock market boom in 1997.

After Yeltsin’s re-election in 1996, many expected the government led by the “young reformists” Anatoly Chubais and Boris Nemtsov would build on the stabilizing macroeconomic conditions and a strengthening financial infrastructure by removing controls on inflows. Instead, the earlier spurt toward openness came to a halt as Yeltsin’s re-election approached. From 1996-1998, a series of limitations on foreign

ownership of domestic equities was put in place, including limits on foreign ownership of shares in the telecommunications and energy companies. The most conspicuous individual example of this was the presidential decree that placed a 9 percent ceiling on foreign ownership of Gazprom shares, which could only be done through American Depositary Receipts – and not in Russia itself. In January of 1998, several months before the crisis, another decree placed a 20 percent limit on foreign currency positions of commercial banks (Bekaert and Harvey 2002).

In the aftermath of the August 1998 crisis the CBR announced a slew of new restrictions on capital account transactions, including a moratorium on loan repayment amounting to \$3.4B during this period (Johnson 2000, p. 216). After a 50 percent devaluation of the ruble, foreign exchange trading on MICEX was halted, as most private banks declared bankruptcy. In October, the CBR introduced new restrictions on foreign exchange repatriation, most notably requiring exporters to exchange 50 percent of dollar proceeds into rubles. Finally at the start of 1999, the Duma passed even tighter restrictions on foreign ownership of Gazprom shares (Starobin 2001).

By the time Putin came into office, Russia had a closed capital account, with especially significant restrictions on foreign ownership of domestic equities. Many of these policies were the result of the authorities' attempt to regain control over the monetary policy immediately after the 1998 crisis. But in other ways, a relatively closed financial system was a consequence of government policies going back to the pre-crisis days. Successive Yeltsin cabinets refrained from fully opening the economy to foreign inflows. For several years, Putin continued and even further restricted the financial openness regime he inherited from Yeltsin, only to expeditiously and

drastically remove restrictions on flows in 2006.

2.1.3 Openness policies: 1999-2009

By contrast, Putin's government did not wait to pursue liberalization policies on other fronts. As Daniel Treisman writes, Putin – the “accidental president” – “turned out to be an enthusiast for free market ideas.” So much so, that in an interview with a conservative, pro-statist TV personality he was comfortable suggesting that “Russia needed six or seven more Chubais” (2012, 93).²⁷ Following these words with legislative action Putin spearheaded policy changes that included a flat 13 percent income tax, reduced corporate, payroll and value added taxes. Land reform, along with some deregulation in the electricity generation sector and measures for investor protection signaled to investors that Putin was intent on continuing the reformist agenda abandoned during Yeltsin's last years in office (Bekaert and Harvey 2002).

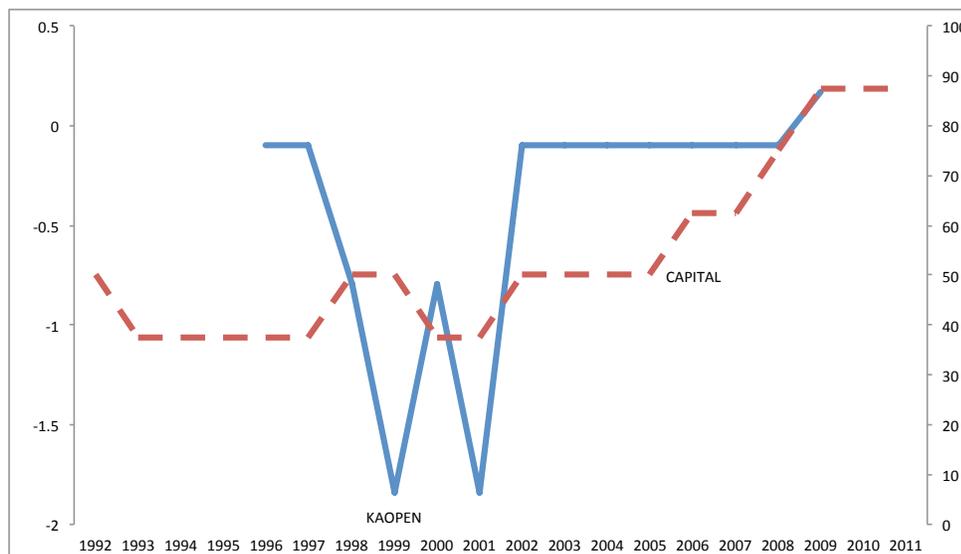
It took three years for the government to raise the issue of openness. By 2003 key state officials began announcing plans to introduce full ruble convertibility – a popular signifier of the restoration of Russia's role on the world stage. But other, more technical changes were in the offing as well. In an newspaper interview, then-deputy finance minister Alexey Ulyukaev announced the government's intention to considerably pull back from regulating cross-border flows. “Individual permits for import and export of currency, quantitative restrictions, temporary freezing” would become a relic of the past, he promised. Importantly, the law would also allow nonresidents to freely trade ruble-denominated securities within Russia (Mytarev

²⁷ To this day, Anatoly Chubais's name is synonymous with highly unpopular privatization programs of the 1990s.

2003).

Notably in the same span of time, the government passed new restrictions on foreign direct investment in “strategic industries.” The Strategic Investment Law stipulated that any foreign investor interested in acquiring more than 10 percent²⁸ would be required to apply for special state-granted permission to proceed with the acquisition (Usa 2010, 121). Heralding this development, Rawi Abdelal wrote in the *Harvard Business Review* in 2010: “[t]here’s no longer any doubt about who is in charge or what the state wants. There is money to be made in Russia, as long as companies play by [Putin’s] rules...” (2010, 128).

Figure 3.2: Financial Openness in Russia, 1992-2009²⁹



- - - - : CAPITAL measure from (D. Quinn and Toyoda 2008, with later updates) (Right axis).
- — : KAOPEN measure from (Chinn and Ito 2008) (Left axis).

²⁸ A common international convention, established in the IMF’s record keeping, makes the 10 percent a threshold that separates portfolio from foreign direct investment.

²⁹ Higher values correspond to greater financial openness in both cases.

The new rules for foreign investors were based on two central tenets. First, investors can speculate on the equity markets without limit, so long as one does not buy in large chunks. Second, large ownership stake in any one firm, would require Kremlin's permission. In other words, the Russian state would be able to have it both ways: ease up the entry for foreign finance to raise valuation of state-owned companies, while maintaining control over them. As Figures 3.1 and 3.2 demonstrate, initial levels of openness under Putin either remained the same (KAOPEN and CAPITAL), or even declined (FORU). Once the government gained control of key industries by the mid-2000s, we see the indices registering the highest ever (in terms of post-Soviet history) records of financial openness in Russia.

The most dramatic changes occurred in the liberalization of access for foreign participants in Russia's domestic equity markets (Edison and Warnock 2003, updated through 2006). After several years of gradually building up restrictions, the index "suddenly" fell. As of 2006 the Russian authorities no longer imposed any restrictions on the flows of portfolio capital. Russia became the most financial open economy in the BRICs group³⁰.

On the aggregate, between mid-1990s and mid-2000s, Russia retained significant controls, with key restrictions introduced and maintained after the crisis of 1998. Liberal policymakers in charge of economic policy like Nemtsov and Chubais did not move toward full financial openness after Yeltsin's re-election in 1996, even though they might have been expected to initiate such policies. Putin, the "unexpected liberal," advanced far deeper domestic economic reforms upon assuming office, but

³⁰ Interview No 7 (finance industry professional). Moscow, Russia, April 2011.

waited several years to deregulate financial flows. By 2006, when the restrictions were removed, Putin's reputation as a free marketer began fading from memories, as his government had taken on a decidedly statist approach, beginning about 2003. What accounts for this strange pattern? Why did the two nondemocratic regimes of Yeltsin and Putin pursue divergent policies? To answer these questions, we turn to tracing three key causal variables: value of specific assets, control over those assets, and the redistributive capacity of the state.

2.2 Value of specific assets

2.2.1 Measuring asset values in Russia

As discussed in Chapter 2 (section 2.2), greater financial openness can reduce transactions costs of exchange involving specific assets, thus raising the value of these assets. In a sense, a more welcoming administration of financial openness installed in the mid-2000s was a low cost solution to a transactions cost problem faced both by foreign investors and the regime. By making it easier for foreign investors to buy shares listed in Russia and to expropriate proceeds from sales, the government increased the supply of capital and therefore raised valuations of companies it controlled. From an investors' point of view, openness of financial markets assured them that they could withdraw money quickly.

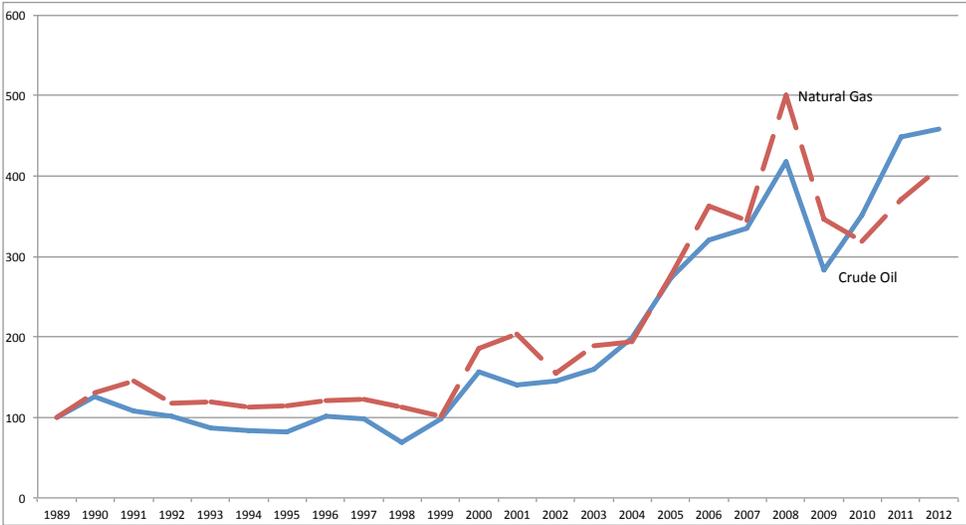
The Russian case offers two possible ways to get around this problem. First, much of Russian industry was privatized in the 1990s and the sale prices of these assets are part of the public record. Second, when estimating the value of extractive industries, the most straightforward metric is to use world commodities' prices. I adopt a very conservative approach, only highlighting as evidence significant changes

in asset values measuring in the orders of magnitude.

2.2.2 Specific asset values: 1992-1998

Czar Alexander III famously said that Russia has only two allies: the army and the navy. Since the Soviet breakup however, Russia’s only two allies have been oil and gas. Fossil fuels exploration, production and export have made up the largest share of Russian and Soviet total economy going back to the mid-1970s. This exposed Russia’s fiscal policy to global fluctuation in commodity prices. As Figure 3.3 reveals, Yeltsin’s time in power coincided with ten years of flat or even declining energy prices. In real terms, the average price of a barrel of oil for the 1992-99 period (\$20.3) was less than half than during the 2000-2008 period (\$54). Similarly significant disparities in the price of natural gas differentiate the two periods (WBDI).

Figure 3.3: Crude Oil and Natural Gas Prices, 1989-2012



- Crude oil [- - -], Brentd, \$/bbl; Natural gas 5[—], Europe, \$/mmbtu. Real 2010\$. 1989=100. Source: World Bank, Global Economic Monitor Commodities.

Because privatization programs were conducted in a non-transparent and

rushed manner, many previously state-owned assets fetched only miniscule fractions of their real values. For example, Hoffman argues that because foreign investors were restricted from participating in the restructuring of Gazprom, its value after partial privatization (\$228 million) amounted to “about one-thousandth of the value put on it by foreign investment banks” (2003, 205). Indeed, at the peak of its share-price in 2006, when it became the third largest company in the world, Gazprom was valued closer to \$350 billion. Using voucher sales, Hoffman calculated the overall value of Russian industry in the early to mid-1990s to be under \$12 billion. Soviet manufacturing giants like car and truck-makers Zil and Gaz were valued at \$16 and \$27 million respectively. The heavy-machinery manufacturer (including nuclear and drilling equipment) Uralmash was valued at \$4 million (2003, 205-06). “In other words, the equity of all Russian factories, including oil, gas, some transportation, and most of manufacturing, was worth less than that of Kellogg or Anheuser-Busch” (Hoffman 2003, 205).

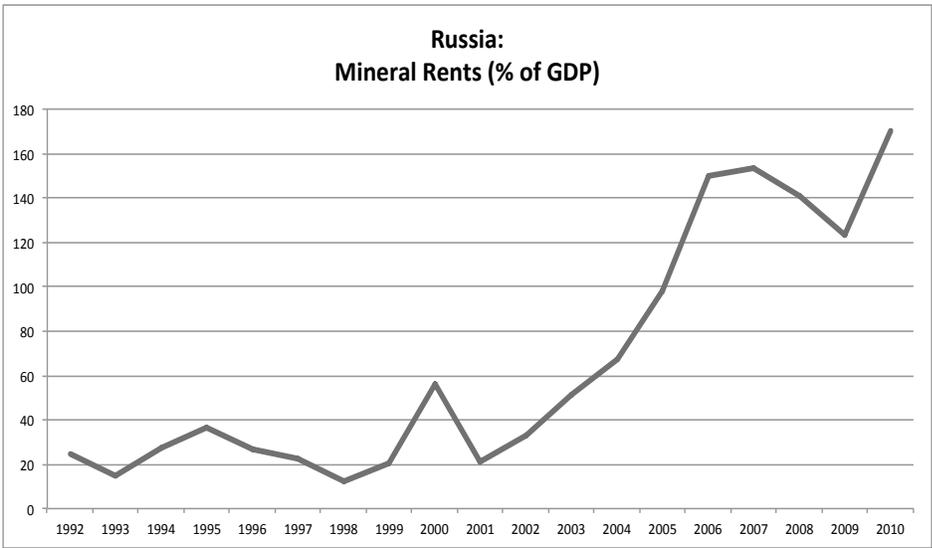
2.2.2 Specific asset values: 1999-2009

Vladimir Putin’s rise to power coincided with a global commodities boom. Even a few months before he assumed office in August of 1999 as Yeltsin’s last head of cabinet, the prices of Russia’s energy exports were still declining. Just a year later in August of 2000, when he had already been elected president, the price of crude oil more than doubled (Letiche 2007, 6). Between 1996 and 1999 (data coverage begins in 1996), fuel exports as a percentage of all merchandise averaged 42 percent. This number would go up to 60 percent by the mid-2000s (OECD 2008).

While global prices increased nearly across all categories of commodities, it

was oil (largely produced by privately held companies before mid-2000s) that was responsible for Russia’s resurgence during this period. The global oil boom that began in 2000 (and continued largely unabated for well over a decade) has been unprecedented in modern history. Between 2003 and 2008 the price of oil increased nearly five-fold, which is a bigger spike than the one that accompanied the oil embargo of 1973 or the Iranian revolution of 1979. Moreover, the recent boom has lasted longer than any of the previous episodes, and so has not been reversed in spite of the global financial crisis of 2008-09 (Kesicki 2010, 1596).

Figure 3.4: Mineral Rents in Russia



- Source: World Bank, Global Economic Monitor Commodities.

Russian oil companies responded quickly by vastly expanding production.

Between 1999 and 2006, Russian natural gas production increased by only 13 percent, while oil production shot up by 60 percent (OPEC).³¹ Similarly the Wellhead price

³¹ Source: EIA, <http://www.eia.doe.gov/emeu/cabs/Russia>; In 1999, Russia exported about 3.2 million barrels of oil per day. By 2006 this number exceeded 7.5 million. For both crude and natural gas, domestic consumption saw only marginal increases although more for the former than the latter.

calculated by the U.S. Energy Information Administration and the “German Border Price” both tripled between 2000 and 2008 (EIA.gov, Melling 2010). Even assuming a uniform taxation regime during this period³² on extraction and export of energy (given largely deregulated domestic petroleum market), this indicates more than a ten-fold increase in energy revenues alone for the Russian government between 1998 and 2007. The value of mineral rents as a percentage of GDP increased from just 20 percent in 2000 to 150 percent in 2006 (Fig. 3.4).

Higher global commodities prices meant higher values of specific assets and the firms that controlled their production. As Reynolds and Kolodziej suggest, energy firms are better targets for nationalization when energy prices are high, since whatever decreases in valuation might follow such political actions, the company would still be generating significant revenues. “If oil prices are low, the government may be happy with collecting taxes from a less risk-averse company because it is better positioned to expand production” (2007, 964). In the same vein, Guriev *et al* find that nationalizations in the oil industry are more likely during the episodes of high commodities prices. In Russia, the rise in the value of specific openness made the “bonus” of financial openness ever more attractive to the owners of these firms, who would be able to raise valuations of their companies, tap into foreign money markets and diversify political risks, associated with doing business in Russia. However, greater financial openness policies were instituted only in mid-2000s, after Putin’s regime gained control over the most valuable assets in the economy, particularly in the

³² A generous assumption, since by all accounts tax collection, especially in large corporations improved greatly during this time (Chernykh 2011, 1240).

oil and gas sectors.

2.3 Control over specific assets

2.3.1 Measures of control

Measures of state control over specific assets are rather straightforward and include ownership (or part-ownership) by state agencies or subsidiaries of state-owned corporations of previously privately held enterprises. The goal of this section is to trace the trend with respect to state ownership vis-à-vis privately held firms between the two periods. As I demonstrate here, control over large portions of the economy is what principally distinguishes Yeltsin's time in power from Putin's regime.

2.3.2 Giving up control: 1992-1998

Reducing the share of state ownership in the overall economy was one of the key goals of the privatization campaign between 1992 and 1996. Scholars have exhaustively documented the many problems with the conduct of Russian privatization (Boycko, Shleifer, and Vishny 1997; J. S. Hellman 1998; McFaul 1995; Shleifer and Treisman 2000). The main peculiarity of the market transition in the post-communist context generally, but especially in post-Soviet Russia, was that partial reforms undertaken during the last years of Communist rule created winners who then opposed more radical measures that were advanced by the liberal reformers (Hellman 1998). For example, the 1989 Law on State Enterprises gave wide-ranging authority to the heads of enterprises – the so-called “red directors” – to set up legal entities that permitted them to lease these assets to themselves (Desai and Goldberg 2001, 221). Following the 1992 privatization law, many innovative “red directors” were able to acquire ownership by restructuring the leases or by acquiring ownership rights from

workers, or doing both. Subsequently, they did everything to stall the reform process in order to retain their advantages, including monopolistic rents and arbitrage opportunities (J. S. Hellman 1998, 204).

The privatization reforms failed on the grounds of economic efficiency (revenues from sales were low or non-existent, state property was not allocated to the most innovative owners). They also failed on political grounds because they did not diminish the power of the corrupt formal and informal institutional arrangements that had been inherited from the Soviet past. But, for better or for worse, these reforms accomplished the task of reducing the role of the state in the overall economy. Between 1994 and 1999 the share of private outside owners in the average Russian enterprise increased from 12 to 47 percent. The capital share of various state agencies decreased from 20 to 3 percent in the same period (Desai and Goldberg 2001, 223). In the course of the initial voucher program alone, 14,000 firms accounting for 2/3 of the industrial labor force were privatized (Boycko, Shleifer, and Vishny 1997, 110).

There were some important differences between privatization in the natural gas and oil industries, as section 3 will describe in more detail. As a vestige of the planned economy, distribution of oil and petroleum products was not as politically germane as the distribution of gas. The majority of Soviet households were connected to an enormous and heavily subsidized system of gas pipelines, car ownership rates were very low, so the distribution of petroleum was politically less salient. For these and other important reasons, Yeltsin's governments privatized nearly all of the oil industry, while remaining the largest shareholder of Gazprom. Still, this only underscores the overall trend: in the 1990s the role of the state in the economy was

reduced drastically. By 1999, after the “dust” of buyouts, mergers and acquisitions had settled, a handful of “oligarchs” came to dominate the Russian economy generally and the oil industry specifically (Puffer and McCarthy 2007).³³ The state was reduced to a secondary role, but that would quickly change under the new president.

2.3.2 Reasserting control: 1999-2009

When Putin assumed the presidency, the Russian economy was largely privatized. Privately held firms took up 8 of the 10 top spots on the list of the companies with the largest capitalization. The government did not even hold a majority stake in Gazprom. In fact it had been in a protracted open conflict with its management and the minority stakeholders since the 1990s.

At the very start of his presidency, Putin demanded that the oligarchs stay out of politics and abstain from complaining about the ineffectual government. As Putin openly announced during a roundtable with 21 of Russia’s leading oligarchs, “I only want to draw your attention straightaway to the fact that you have yourselves formed this very state, to a large extent through political and quasi-political structures under your control. So perhaps what one should do least of all is blame the mirror” (cited in J. Hellman, Jones, and Kaufmann 2000). However, the state the oligarchs formed was “theirs” only so long as their support was needed to finance its operation. Once the oil revenues burgeoned, the state no longer belonged to the oligarchs. Instead, the oligarchs’ wealth became the target of the state’s unannounced, but ambitious program of renationalization that commenced in 2003-04.

³³ For example, in a 1996 interview to the Financial Times, Boris Berezovksy (the oligarch with greatest fondness for politics) suggested that seven tycoons owned about 50 percent of the Russian economy (Hoffman 2003, 358).

By 2008, only five of the top 10 companies were privately owned, and the three largest by capitalization – that is, Gazprom, Rosneft and Sberbank – were all under government control (*Expert Rating*; raexpert.ru). Sprenger counts 107 acquisitions that resulted in the government acquiring at least a 25 percent stake, with 64 of these resulting in a complete takeover during this period (2012, 8). In a 2006 survey, OECD reported 29 major state takeovers in industries ranging from natural resource extraction to media (OECD Economic Surveys, cited in Chernykh 2011, 1238). In 2004, SOEs accounted for 31.4 percent of the capitalization of the top-200 Russian companies. By 2008, the number increased to 47.5 percent (Sprenger 2010). Both takeovers of private firms by the SOEs and new IPOs of SOEs were responsible for this dramatic increase (Sprenger 2012, 2).

Nationalization of the Yukos oil company and the “show trial” and imprisonment of its founder and primary owner, Mikhail Khodorkovsky, received wide coverage in international media in 2003-04. But the Russian government made a number of other less visible, but no less significant acquisitions of previously privately held assets. After acquiring a controlling stake in Gazprom in 2005, the state purchased oil company Sibneft from oligarch Roman Abramovich for \$13 billion. In 2006, Gazprom bought the stake of the Royal Dutch Shell in the lucrative Sakhalin II project for over \$7 billion.³⁴ State-owned Rosneft quickly became the largest Russian oil company after it acquired the assets of Yukos.³⁵ In 2007, Putin initiated the

³⁴ This happened after the environmental agency of the government found a number of “improprieties” in the drilling operations, so the sale was not altogether voluntary.

³⁵ In 2012, Rosneft reached an agreement to buy a 50 percent stake in TNK-BP, the second largest private oil producer in Russia.

creation of enormous new state-owned corporations, each responsible for a particular sector or project (Treisman 2012, 116). Mammoth conglomerates like Rostekhnologii (“Russian technologies”) and Rosoboronexport (“Russian defense exports”) began consolidating holdings in railways, telecommunications, media, heavy manufacturing, transportation, and other lucrative sectors (Sprenger 2012; Woodruff 2007).³⁶

Table 3.1: Top nationalizations in Russia, 2003-08
(majority stakes only)

<i>Target</i>	Rank (2003 sales)	Industry	Date	<i>Acquiring entity</i>
Gazprom	1	extractive	06/01/05	Federal Government
Yukos	5	extractive	12/01/04	SOE (Rosneft)
Sibneft	9	extractive	10/01/05	SOE (Gazprom)
AvtoVaz	13	engineering	10/01/05	SOE (Rosoboronexport)
United Heavy Machinery	62	engineering	11/01/05	SOE (Gazprom)
Irkut	66	engineering	06/01/08	SOE (United Aircraft Co)
UMPO	87	engineering	12/01/08	SOE (Rosoboronexport)
VSMPO-Avisma	121	extractive	10/01/06	SOE (Rosoboronexport)
Promstroibank	142	finance	12/01/05	SOE (VTB bank)
Ulan-Ude Aviation Plant	166	engineering	07/01/05	SOE (Oboronprom)
Kazan Helicopter Plant	170	engineering	03/01/07	SOE (Oboronprom)
Saturn	172	engineering	12/01/08	SOE (Oboronprom)

Sources: Chernykh 2011, Russian financial press, RA *Expert* agency (www.raexpert.ru/ratings/expert400)

2.4 Redistributive capacity

2.4.1 Redistributive capacity in the Russian context

As discussed in section 2.4 of Chapter 2, redistributive capacity is a broad concept that, in addition to the reach of the welfare state, includes “decisions about allocations of government goods and services to identifiable localities or groups” (Golden and Min 2013, 74). Following standard literature on the welfare state

³⁶ IPOs of some of these state corporations were only delayed due to the 2008-09 financial crisis and the subsequent Eurozone crisis.

development, I postulate that differences in redistributive capacities have deep roots in patterns of historical development that are path-dependent (Esping-Andersen 1990; Pierson 2004). The redistributive capacity of the Russian state is inherited entirely from the Soviet model of “welfare-state authoritarianism,” remaining one of the most entrenched remaining legacies of state socialism (Breslauer 1978; Bunce 1983; Cook 1993). Consequently, I do not divide this section into two time periods (this is the variable that “does not vary” in the comparison of the two Russian regimes). This section outlines the contours of the Russian redistributive capacity, which I argue, but for a few notable changes under Putin denoted below, has retained attributes of the vast Soviet welfare model that was centered on labor control.

Following Adascalitei (2012) and Aidukaite (2009), I chart the specifics of the “post-Soviet” model. It is different from both the East European post-socialist variant that was reformed substantially and adopted many West European welfare state characteristics (Cook 2013); and the Chinese model of underdeveloped redistributive capacity of “manifestly residual approach to social care” (Wong 2005, 190). Russian welfare apparatus is peculiar enough to lead some researchers to grant it a special moniker of the “Russian model” (Gimpelson and Kapeliushnikov 2011; Hemment 2009). Indeed, Russia stands out even among other former Soviet economies as an example of a particularly widespread redistributive state apparatus with an odd mix of regulations, wide-ranging subsidies (*l’goty*) and norms with respect to social welfare and guarantees of employment.

As a consequence, any regime that can centralize power and gain control over the main industries is also able to control channels of redistribution in the country, and

thereby be politically quite secure. In this section, I highlight three of the most prominent facets of the “Russian model” and its impact on regime maintenance: the low-benefit and wide-coverage legacy welfare state; labor markets characterized by flexible wages and inert employment; and enterprise-based system of social benefit provision. I conclude this section by summarizing the welfare reforms put in place by Putin, which have streamlined and targeted redistributive policies to identifiable politically relevant groups, allowing the state to withstand volatile short-term economic fluctuations generated by outside global forces.

2.4.2 Legacy of low-benefit, but universal coverage welfare state

In Chapter 2 (Section 2.4), I argued that redistributive policies play a crucial role in authoritarian regime maintenance. As the Soviet economy began to export raw materials to the West, the issue of asset distribution became the core of the conflict underlying politics even in the otherwise fairly autarkic economic system. Valerie Bunce argued in the early 1980s that starting in the Brezhnev era, Soviet authorities began to “minimize conflict, while cultivating the support of the mass public through an expanding welfare state” (Bunce 1983, 131). In the case of the Yugoslav Republics, Schnytzer and Šušteršič show that “rents distributed to the population were far more important than the popularity of economic policies and perhaps even more important than repression” (1998, 117). These authors were not surprised that both polities disintegrated once the sources of distributable income disappeared (Bunce 1999b, 35-36).

The communist welfare state did not provide unemployment insurance, since state socialism guaranteed full employment (Orenstein 2008, 82; Przeworski 1996,

535). In particular, the Soviet system was based on “categorical benefits” that entitled certain classes of citizens to in-kind benefits and subsidies (*l’goty* in Russian), including public transportation, medication, utilities and even housing. These benefits were extremely popular, because they were considered as compensation for accomplishment (not means-tested programs strictly directed at poverty alleviation).³⁷ Because these benefits dated back to the struggles of the Great Patriotic War (Second World War), recipients of *l’goty* were often held in high social esteem, signifying achievement, contribution to public service, and membership in respected career fields, like military, healthcare and education. By the 1980s the reach of the Soviet redistributive state, combined with education stipends and retirement pension benefits) was nearly universal, enveloping the population in a wide network of benefits and perks, even if the monetary value of these services was relatively low (Cook 2013, 3). When the economy collapsed in the 1990s, hamstrung by falling tax revenues, regional governments had little choice but to introduce new subsidies and *l’goty* to shore up political support and compensate public sector workers (Hemment 2009, 39). When Putin came to power in 2000, most of the state-society interactions involved welfare payments, giving his regime reins over an untargeted and swelled, but very large redistributive capacity.

The Russian retirement pension system is the best example of a low-benefit/wide-coverage legacy welfare program. Under the Soviet system (and to this day) pension payments are the responsibility of the state, which transfers contributions

³⁷ Even in the Cold War era surveys of émigrés, “Soviet citizens from all social strata valued state provision of social services and welfare, and that this was the most positively evaluated feature of the system” (Cook 1993, 68).

of current workers to pay pensioners. Historically, these payments have been low, but they covered the entire population of retired adults. At the time of the break-up nearly a quarter of the Russian population received pensions, but as a percentage of GDP these payments amounted to a small fraction of 5 percent, as compared to the international standard of about 12% of GDP (Cook 2000, 367).

This made pensioners into a powerful, easily mobilizable political force that still accounts for an enormous (35 percent and rising) portion of the active electorate (Kudrin and Yakovlev 2012). The Communist Party of Russian Federation – Yeltsin’s most formidable opponent in the Duma – relied on the pensioners as its main base of support through the 1990s. As I describe below, even under Putin the retirees were able to force the government to roll back some of the welfare reforms, especially the monetization of benefits. The regime’s ability to directly and quickly raise incomes of over a third of the population³⁸ in a country of 140 million people, describes just one of several levers of its redistributive capacity.

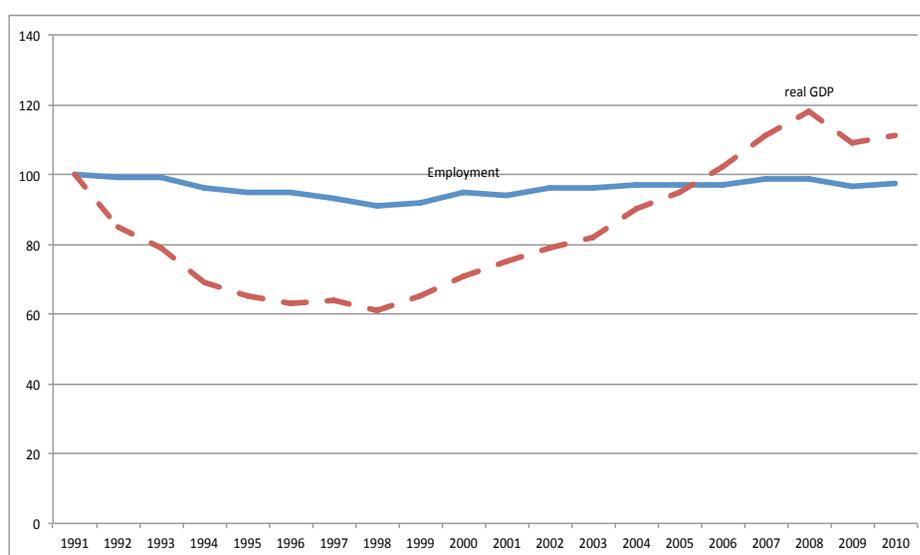
2.4.3 Flexible wages and inert employment

One of the odd attributes of the economically harrowing market transition from state socialism in the former Soviet Union (as opposed to Eastern Europe) has been its relatively benign impact on unemployment (Boeri and Terrell 2002, 52; Cerami 2009; J. S. Hellman 1998, 211). During the transition, and the 1998 and 2008 crises, Russian firms systematically reduced hours, drastically lowered real wages and delayed payment, but rarely used layoffs to cut costs (Adascalitei 2012; Aidukaite 2009, 25–

³⁸ The proportion of the population collecting pensions increased to 27 percent in 1999 (Cook 2000, 370).

26; Gimpelson and Kapeliushnikov 2011, 2) To this day the combination of flexible wages and inert employment is what cushions the governing regime from political blowback of economic shocks (Gimpelson and Kapeliushnikov 2011, 2-3).³⁹ As Fig. 3.5 demonstrates, a 40 percent decline in GDP between 1992 and 1998 resulted in a top unemployment rate of “only” 13 percent. Similarly, unemployment did not rise steeply in response to either the 1998 or the 2008 crises.

Figure 3.5: Russia: Gross Domestic Product and Employment, 1991-2010



- Real GDP [---]; Employment[—]; 1991=100
Source: World Bank 2012, World Development Indicators.

There are two related explanations for this phenomenon. First, during the 1990s, in an attempt to shore up political support, local governors significantly expanded public sector employment, diverting federal transfers or relying on in-kind benefits and even barter as a form of payment. Gimpelson and Treisman find that

³⁹ See Eichengreen (1992, 390-91) on the connection between unemployment and financial openness in the inter-war Europe. See also Bhaduri and Marglin (1990) and Burda, Bean, and Svejnar (1993) for the summaries of the connection between political change and unemployment in Eastern Europe during the postcommunist transitions.

remarkably, despite a huge contraction in the economy and a fall in government revenues, by the late 1990s the number of teachers and doctors actually increased from an already high Soviet base. For example, between 1990 and 1998, the number of state-employed secondary school teachers increased by 23 percent (2002, 157). At the same time, according to the national public opinion survey conducted by VCIOM, the percentage of respondents reported delayed wages increased from 7 to 40 percent between 1993 and 1997 (cited in Gimpelson 2001, 29). This speaks to the incredibly powerful legacy redistributive capacity – a state capable of reaching the population by distributing “benefits” even during a severe fiscal crisis.

The second reason for the persistence of the “flexible wages/intern employment” model has to do with the employment protection legislation, specifically the Code of Laws on Labor (KZOT). During the Soviet period, “its major explicit objective was to limit flows of workers in the state-owned economy, which was chronically ridden by labor shortage” (Gimpelson and Kapeliushnikov 2011, 13). Even though a new labor law was put in place in 2002, employment protections that make it difficult for firms (but especially state enterprises) to terminate employees remain on the books as of this writing. As Gimpelson and Kapeliushnikov note, after several updates in 2002, 2004 and 2006, with “some contradictory and obsolete requirements were abolished, the EPL [employment protection legislation] part of the [Labor] Code changed little” (2011, 17). With the re-emergence of state-owned enterprises under Putin, the EPL’s impact on redistributive capacity has only been reinforced, giving the state an additional lever of influence over the labor force in exchange for guarantees of continuous employment.

2.4.4 Enterprise-based benefits' provision system

The third key feature of the “Russian model” of redistributive capacity has to do with the legacy system of enterprise-based social benefits. The Russian government maintains the approach of binding workers to state enterprises, by connecting provision of fringe benefits with employment. This approach has resulted in a continual merging of industrial and welfare policies in Russia since 1991, but especially under Putin (Adascalitei 2012).

Because the Soviet welfare state was developed on the model of employment-based social benefits, most Russians were willing to work for low wages in order to retain access to the benefits (Cook 2013, 8). Under the Soviet planning system, when faced with the choice of cutting benefits or cutting wages, the state always chose the latter since it involved fewer political risks (Cook 1993, 83). Often one was forced to rely on the employer not only for “in-kind” benefits, but also for the procurement of basic goods, such as foodstuffs and even housing. Because a market mechanism was absent, shortages of many of these goods were frequent and the state used enterprises as an administrative vehicle of “vertical integration” in the planning economy (Orenstein 2008, 82).

Gazprom’s managers in the days of its semi-autonomy made use of this industrial legacy to advance their fortunes and political power. For example, in 1998, government officials openly threatened to seize and sell Gazprom assets to compensate for unpaid tax debts (D. Treisman 2012, 217). In response, in a Duma address Vyakhirev reminded the parliament that about a quarter of the total labor force in Russia was employed because Gazprom continued to subsidize domestic industry.

Vyakhirev lamented (on the floor of the parliament) that the halting of deliveries to its domestic customers was perhaps the only choice Gazprom was left with due to the chronic non-payment and continued pressure from the government regarding Gazprom's unfulfilled tax obligations. Struggling Russian industry depended on Gazprom's subsidies for its survival, and the parliamentarians depended on the industry for re-election. In the 1990s Western European customers accounted for only about 20 percent of Gazprom's gas production. Close to 50 percent was sold on domestic market, where customers paid for only about 13 percent deliveries in cash (Narzikulov 1996).⁴⁰ Duma deputies, in turn, asked Gazprom to continue its deliveries – a proposition Vyakhirev agreed to consider, so long as the Duma would encourage the government to “stop its intrigues around Gazprom and stop constructing schemes aimed at its destruction” (Rodin 1998).

The federal and regional governments continued to rely on the Soviet redistributive system in the 1990s; only by this point the problem was the shortage of funds and not of goods. With some minor changes, this feature of the Russian labor market continues to this date – especially in the public sector and state-owned enterprises. Receiving meager enterprise-based services and a low wage was preferable to getting unemployment benefits that amounted to just 10 percent of the average wage (Orenstein 2008, 85).⁴¹ The persistence and even entrenchment of the

⁴⁰ Even those domestic customers who paid in cash were charged only a fraction of the European price. Hence, although only a fifth of total production was sold in Europe, it accounted for a lion's share of the total revenues earned by Gazprom during the decade of the 1990s. In 1996 combined debt (domestic and foreign) owed to Gazprom by various levels of the Russian government amounted to \$11 billion or 3 percent of the Russian GDP (Narzikulov 1996)

⁴¹ This might explain why "the budget of the Russian Federal Employment Service was [miraculously] in surplus until the mid-1990s " (Boeri and Terrell 2002, 72).

employment-based benefits model explains why by 1996, after several years of reform, the employment share of firms with less than 100 employees was only 14 percent. Even at that point, this figure was three times less than in neighboring Eastern Europe (which by that point had numbers that approached US levels) (Boeri and Terrell 2002, 56; also see Easter 2012). By the mid-2000s, small businesses employed only 20 percent of the labor force (compared to 50 percent in Europe and 80 percent in Japan) (Puffer and McCarthy 2007, 10).

2.4.5 Putin's welfare reforms

In summary, Putin's government inherited a remarkably powerful set of redistributive institutions, including: (1) a welfare state that directly reached between a third and half of the electorate; (2) labor markets that were largely unresponsive to economic fluctuations, and (3) a firm-based benefits system that tethered employees to enterprises that state has come to control directly in the 2000s.

Although numerous observers have criticized Putin for the "neo-liberal" bent of the welfare reforms he initiated in his first term, in large part he was following in the reform footsteps of Gorbachev (not Yeltsin who did not attempt welfare reform). It was Gorbachev who upon assuming office criticized Brezhnev's policies as filled with "contradictions in the sphere of labor and distributive relations" that led to a "deformed" understanding of social justice (cited in Cook 1993, 70). And while Putin was successful in reforming some features of the Russian welfare state, a decade hence, most of the key Soviet legacies remain in place.

In 2004, Putin "dismantled the massive system of state-administered, untargeted social benefits and privileges to which more than a quarter of the

population remained entitled” (Cook 2013, 145). Yet Putin, unlike Gorbachev, was far more attuned to the political context of economic reform. While preserving some of the more politically expedient features of the Russian welfare state, at the start of his time in office, Putin’s government introduced three related reforms that strengthened the regime’s hold on power. First, he shifted welfare provision toward a more targeted model with identifiable beneficiaries. Simultaneously the “blame assignment” for potential mishandling of benefits was moved to regional governors, who were by then directly appointed (and could be removed) by Putin. Second, he increased the number of executive branch officials, prosecutors and police, while stripping his potential opponents (especially regional elites) of the power to employ bureaucrats. The third change was not directly “a reform,” but it massively increased the regime’s capacity for redistribution. As a consequence of the rising role of the state in the economy under Putin, the state accounted for a far greater portion of total employment, which generated a major constituency for his support. Additionally, the return to statist policies allowed the regime to use subsidies to direct political support – especially with the help of Gazprom. All three features increased the redistributive capacity of the regime, were political in nature, and went hand in hand with the agenda of rebuilding the “vertical of power.”

As I wrote earlier in the chapter, one of Putin’s main political objectives was to centralize political control in the Kremlin at the expense of regional elites. Shortly after assuming power, he demoted the upper house of the parliament (the Federation Council), created seven federal districts with personally appointed “plenipotentiary” representatives and revised or abolished nearly all federal-regional bilateral treaties

and agreements (Hahn 2003). Revenue-sharing agreements were also revised in favor of Moscow, allowing Kremlin to raise pensions and the salaries of bureaucrats and police. Finally, in 2004 gubernatorial elections were abolished and replaced with presidential appointments contingent on confirmation by regional parliaments.

If Putin was concerned with his political survival, he was probably also correct to fear both the oligarchs and the governors, who were the main and most dangerous opponents of Yeltsin and who had amassed independent bases of support in the 1990s. Oligarchs and governors were especially dangerous when they created alliances with each other (Stoner-Weiss 2006). For example, even a few months after Putin was elected president, Rem Vyakhirev (then still the CEO of Gazprom) was able to decide the outcome of some regional elections with just a single visit. So important was Vyakhirev's endorsement, that during a contentious 2000 gubernatorial campaign in the northern Arkhangelsk region, both major candidates openly proclaimed their most sincere fondness for Gazprom's management. In a comical twist, during a live broadcast of the joint press-conference with the incumbent governor, Vyakhirev mocked the challenger announcing, "I don't know him and never saw him...[however] this man here, visits me two-three times a month. I think I'm going to grow tired of him soon and won't know what do with him..." At the conclusion of his visit, Vyakhirev promised to finance two of the local industrial plants that would produce drilling platforms for Gazprom and explore the possibility of producing gas in the region (Filippov 2000). The incumbent governor was subsequently re-elected in a runoff election.

After gaining control over the main extractive industries, imprisoning,

expelling or otherwise limiting the influence of oligarchs and abolishing the elections of governors, Putin's welfare reforms shifted responsibility for major welfare provision down to the regional level (Cook 2012; Hemment 2009). The most infamous part of this reform agenda was the so-called Law 122 (hastily passed in the Fall of 2004, after the Beslan attacks and after the abolition of gubernatorial elections) that aimed to monetize welfare benefits by replacing *l'goty* with cash payments. "While the 'most socially meaningful' categories of *l'gotniki* remained the responsibility of the federal government, responsibility for the majority... was shifted to the regions" (Hemment 2009, 40). In the Yeltsin era, opposition governors tended to employ more public employees, suggesting that politicians distributed public employment for political support (Gimpelson and Treisman 2002, 171) (2002, 171). The new arrangement would require now-appointed governors to assume all political risks associated with welfare provision, without being able to take credit, independently of the Kremlin.

Passage of the Law 122 led to one of the biggest waves of protests under Putin. Protestors composed primarily of older citizens blocked roads between major cities to attract attention. In some instances, authorities "reported clashes between *l'gotniki* and bus drivers who tried to enforce the new rules" (Wengle and Rasell 2008, 746). The regime was quite surprised by the extent of the protests, having to quickly roll back some provisions in the new law, blaming implementation shortcomings on poor communication, not the substance of the laws. After several months, Putin took to upbraiding the bureaucracy and regional governors (all of whom he personally controlled) for improperly putting the law into practice. Finally, he acknowledge that

reform was not sufficiently well-prepared and postponed monetization (Overland and Kutschera 2011, 324).

Parts of the law were finally implanted in 2006, but on the whole monetization of benefits failed – a failure that is attributable to the widely and deeply held “socially oriented” preferences of the Russian population with respect to redistributive policies. Still, the reform succeeded in important ways by streamlining provision of welfare and arranging it in a way that gave the regime greater flexibility. Finally, in addition to (partially) reforming the welfare provisions, the pro-Putin party began establishing direct connections with the electorate through the so-called youth “volunteer” projects (Hemment 2009, 38). Based on the Soviet era *Komsomol* youth leagues, Putin and the ruling United Russia party gave groups like “Nashi” direct support in the form of financial contributions and public relations campaigns.

Perhaps most importantly, Putin’s regime vastly increased the number of bureaucrats. Peter Katzenstein once wrote, “the core of the modern state lies, as Max Weber knew, not in economy and society but in the state’s monopoly over legitimate means of coercion” (Katzenstein 1996, 6). Putin, who certainly would agree with this dictum, also was attuned to the economic dimension of coercion. Control over the coercive apparatus, including police and prosecutors was the key vehicle of political power for regional governors before 2004 (Taylor 2007, 429). Daniel Treisman points out that during Yeltsin’s time in office, “the police, security services, army, and economic ministries” were not always on his side (2012, 208). Putin’s power centralization was accomplished in large part by a rise in police, prosecutors and other executive branch bureaucrats. Remarkably, there are over three times as many police

per capita in Russia today than there were in the Soviet Union (Demchenko 2012).

Although covered broadly elsewhere in this chapter (sections 3.2 and 4), in addition to providing the regime with an incentive to deregulate financial flows, increased control over specific assets also afforded it additional redistributive capacity it could use to respond to the public's discontent during economic slowdowns. This, the consequences of emergent state capitalism were two-fold. First, the return of state control over large portions of the economy reinvigorated the employment-as-welfare model. Second, control over energy giants allowed the Kremlin to make better use of subsidization as a political tool.

Energy subsidies – especially in gas and heating – are one of the more politicized issues in Russia (Orttung 2009, 66). According to a survey conducted by Levada Center in 2009, even the relatively affluent Muscovites ranked the issue of utility bills as a top concern. Fifty-five percent of responders said they worried about rising utility payments, while only 27 percent worried about unemployment (cited in Overland and Kutschera 2011, 329). This is despite the fact that Russian domestic consumers pay only about 10-20 percent of the price of gas that Gazprom charges its European customers (AP 2009).

In summary, legacy institutions of the Soviet welfare state were unaltered, and even expanded during the 1990s. By the time Putin came to power, his regime had at its disposal an instrument of wide redistributive capacity that allowed it to target payments to politically relevant groups and to signal a commitment to sizable redistribution. Even after several semi-successful reform efforts, the legacy of a universalist welfare state, inflexible labor markets and a system of enterprise-based

welfare provision continued to buttress the massive redistributive capacity of Putin's regime. Putin's welfare reforms only streamlined welfare delivery, making targeting of politically relevant groups easier. Finally by increasing the size of the bureaucracy and solidifying the role of the SOEs, Putin increased his regime's ability to rely on several levers of control over the distribution of jobs and benefits to prop up supporters and punish detractors. As section 4.2 ("Downside of openness") will demonstrate, this enormous redistributive capacity has allowed the government to mitigate the downside risks associated with a more financially open economy.

3. HOW THE VARIABLES INTERACT:

GAZPROM, ROSNEFT AND THE 2008-09 CRISIS

The aim of this section is to bring the preceding discussion of how the variables of interest changed between the two regimes into a coherent picture based on specific episodes. The first part (which I term "The upside of openness") presents brief histories of the two state-controlled energy giants Gazprom and Rosneft. In the course of 15 years these firms transitioned from Soviet ministries to weakened quasi-independent entities with tenuous connection to the state in the 1990s, to finally emerging as state-controlled modern corporations with a global presence, backed by the regime in the 2000s. The cases of Gazprom and Rosneft illustrate how financial openness policies were interrelated with the regime's control of specific assets.

The second part (summarized as "The downside of openness") discusses how the Putin regime⁴² handled the external financial shock of the global recession of

⁴² At this time Dmitry Medvedev served as president, while Putin acted as prime minister. Most observers of Russian politics agree that Putin remained a *de facto* head of the regime, before returning to presidency again in 2012.

2008-09. Short-term declines in stock market indices and capital outflows were substantial. In fact, Russia was one of the worst performing emerging markets in the aftermath of the crisis. Yet, as I demonstrate the regime quickly made use of the considerable redistributive capacity of the Russian state to deploy accumulated resources to successfully contain potential political instability.

3.1 The “upside” of openness: Gazprom and Rosneft

3.1.1 Gazprom: return to state control

In 1993 after then-chairman of Gazprom Viktor Chernomyrdin was made head of the cabinet, his deputy Rem Vyakhirev became the head of Gazprom, the partially reformed Soviet Ministry of Gas Industry. With his former boss as the head of government, Vyakhirev was able to build up a fence of policies, regulations and limitations on the handling of Gazprom equity, putting him in charge of every major sale of stock during his 8-year reign as the head of the company.

While the government remained the largest shareholder of Gazprom in the 1990s, it did not control the company until 2005. Aside from an informal relationship with the Prime Minister, Vyakhirev relied on the so-called “trust agreement” with the government. In the 1990s the federal government owned a 40 percent stake in Gazprom: 5 percent were managed directly by the government, while Vyakhirev was made a kind of “executor” of the other 35 percent. Even though Vyakhirev served as a proxy for the government, in a strange twist, by the end of the decade he came to rely on the votes of the other equity holders for support. Vyakhirev even spoke in favor of decreasing the government’s stake in Gazprom to 25 percent, since too large a share owned by the government “inhibited Gazprom’s operational effectiveness”

(Koshkareva and Narzikulov 1997). When in the summer of 1999, prior to Putin's appointment as prime minister, one of the ministers in the Russian cabinet announced the idea of completely revoking the trust agreement with Vyakhirev, he reportedly told the media that he "never saw a more stupid piece of paper" and that "35 percent could not rule 65 percent" (Evstegneeva 2000).

In fact, Yeltsin partly owed his reelection in 1996 to Vyakhirev, who agreed to openly campaign for him. He travelled widely to convince key regional political elites and heads of enterprises that favorable cooperation with Gazprom was only possible under another Yeltsin administration. For example, during his visit to one of the more industrialized regions of Nizhny Novgorod in April of 1996, two months before the presidential election, Vyakhirev reached an agreement with the local governor⁴³ that Gazprom would provide gas to the region's energy-starved power-generation facilities in exchange for tax-free operation of Gazprom's local subsidiary. Numerous local enterprises, suffering from a prolonged economic downturn, accosted Vyakhirev with projects and varieties of goods they could sell to Gazprom – one of the few companies in Russia likely to pay in cash. Needless to say, heads of local factories so keen on securing Gazprom's future investments were all too eager to make certain the workers they employed voted for Yeltsin (Chebanov 1996).

Acrimonious relations between the government and Gazprom continually resurfaced in the 1990s. But Gazprom's management would not have been able to acquire such autonomy were it not for the government's heavy dependence on taxing

⁴³ Incidentally, Nizhny Novgorod's governor, who so favorably met Vyakhirev, at that time was soon-to-be vice-PM Nemtsov, who would be put in charge of the "natural monopolies" and become one of the most vehement opponents of Vyakhirev.

exported gas revenues and the persistence of severe political fissures between various branches and levels of the government. The federal government was placed in the odd position of being both the largest shareholder and an often-obsequious petitioner of Gazprom's graces in the form of political favors and tax revenues. In 1996, Gazprom's taxes (often delayed) were widely reported to be responsible for about a quarter of the Russian budget (Volobuev 1997).

Table 3.2 Gazprom's Ownership Structure, 2001-2005

	2001	2002	2003	2004	2005
<i>Owner</i>					
Federal Government	39.262	39.262	39.262	39.262	50.002
Private citizens	16.066	15.06	14.031	13.319	13.068
Russian firms	33.172	34.179	35.207	35.92	29.482
Non-residents	11.5	11.5	11.5	11.5	7.448
Total	100	100	100	100	100

Source: Official Gazprom statistics: <http://www.gazprom.ru>

While occasionally failing to meet Gazprom's tax obligation, the management did not forget to translate its informal autonomy into sizable personal fortunes. In the course of Yeltsin's presidency, about 10 percent of the company's profits was widely reputed to have been diverted into private accounts of the managers. The fortunes of Chernomyrdin and Vyakhirev were estimated to exceed \$1 billion each in the early 2000s, despite the fact that Chernomyrdin never owned Gazprom stock (Olcott 2002, 72).

The political ramifications of Gazprom's reach into the Russian economy and the economic potential the company were not a secret to anyone, least of all the new Russian leadership in 2000. Re-establishing control over the company became one of Putin's main priorities, and he dispatched people personally close to him to re-

establish control over the company. A source in the Russian Audit Chamber told a Russian business magazine that the relationship between Gazprom and the state began to change with Putin's arrival. "There was a kind of an unofficial agreement that existed until the end of the 1990s... Gazprom effectively subsidized the Russian economy, and the state did not interfere in company's business. Today, when the economic situation has changed, the state quite fairly wants to increase its role in the company" (Vlasov and Vlasova 2001).

At the annual meeting of Gazprom shareholders in 2001, the government withheld support of Vyakhirev for another term as the CEO. Instead, the government supported the candidacy of Aleksei Miller, Putin's close friend and associate from St. Petersburg. Dmitry Medvedev (then head of presidential administration, and future prime minister and president) was appointment chairman of the board. In June of 2005, the government-controlled group "Rosneftegaz" bought 10.74 percent of Gazprom's shares from three of its subsidiaries for \$7.1 billion⁴⁴, thus increasing the stake of the Russian government to 50.002 percent (Derbilova et al 2005).⁴⁵

3.1.2 Rosneft: the steal of the century

For reasons ranging from the politics surrounding privatization in the 1990s to the infrastructural characteristics of the oil (versus gas) industry, the Russian government privatized most of the oil industry by 1997 and did not directly own a great deal of oil production until the mid-2000s. It did retain the ownership of a

⁴⁴ This amounted to about 80 rubles per share – close to the trading level at the time of the purchase. In December of 2007, Gazprom's shares traded for close to 350 rubles on the Russian Stock Exchange – a four-fold increase in two years.

⁴⁵ Rosneftegaz was able to qualify for a loan of \$7.4 billion from a group of foreign banks, making it to-date the largest credit received by a Russian company.

beleaguered, much maligned and unproductive Rosneft. Just like Gazprom, Rosneft was a relic of the Soviet ministry of oil. Unlike Gazprom, it faced competition from several successful private firms that by the end of 1990s were starting to modernize, taking on a decidedly multinational approach to the energy business.

Shortly after the Soviet Union's disintegration, Yeltsin (through several presidential decrees) reorganized the former ministry of the oil industry into ten vertically integrated companies (VICs). The government retained control over the companies, but through the infamous loans-for-shares scandal preceding Yeltsin's 1996 re-election, the most potentially lucrative of the 10 VICs were privatized, reducing the state's role in oil production to just 10 percent (Hashim 2010, 266). After a surge of consolidation in the industry in the late 1990s, most of Russian oil industry by early 2000s was concentrated in the four companies (Lukoil, Yukos, TNK and Surgutneftegaz), which were responsible for two-thirds of production and 57 percent of exports (Locatelli 2006, 1077).

Headed by Mikhail Khodorkovsky (then Russia's richest man), Yukos was the most successful and modern among Russian companies in any industry. Several accounts of the origins of the Putin – Khodorkovsky conflict have been written, some suggesting that Khodorkovsky was quite brazen in publically attacking Putin and even supporting opposition parties (none of which are crimes according to official Russian laws) (Reynolds and Kolodziej 2007, 946). In any case, the outcome remains the same: Khodorkovsky and his partner Platon Lebedev were arrested in 2003 on charges of tax evasion of over 20 billion dollars. After their trial and conviction, the assets of the company were seized and sold at a nearly comical auction, whereby an opaque

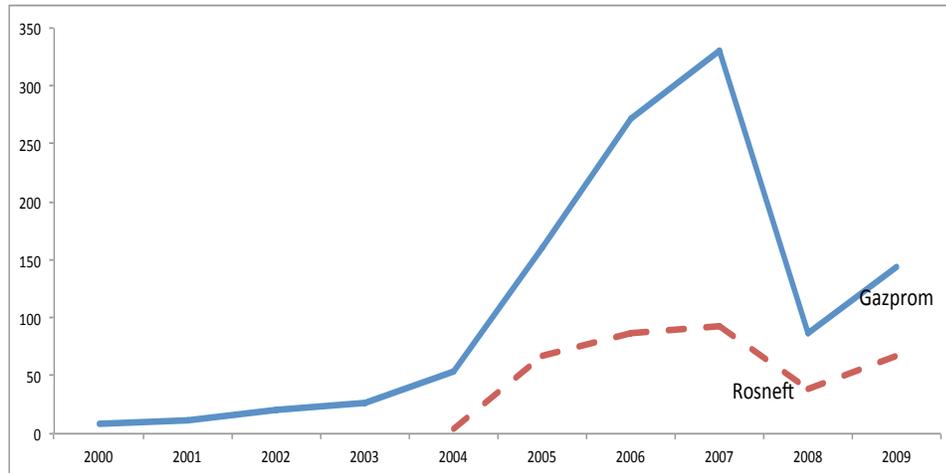
company Baikalfinancegrup (registered just a day before the auction) was able to purchase Yukos's largest production asset Yuganskneftegas. Subsequently, Rosneft acquired Baikalfinancegrup.

In July 2006, Rosneft underwent an initial public offering, in which 15% of shares were sold on the London Stock Exchange and on the Russian exchanges for a total of \$10.7 billion. Rosneft, having been appraised at about \$4 billion in 2004 would be valued at \$100 billion in 2007 (Fig. 3.7), emerging as Russia's biggest oil company and the 10th largest in the world (Treisman 2012, 95-95; Woodruff 2007).

3.1.3 Gazprom and Rosneft: timing and the impact of financial openness

Liberalization of trading in Gazprom shares, equity market liberalization along with broader capital account deregulation, and the Rosneft IPE all took place rapidly from January to July of 2006. Between September 1, 2005 and September 1, 2006, capitalization of Gazprom increased by three-fold and that of Rosneft by 23-fold (Fig. 3.7). As is the case with almost all other Russian listed companies (state and privately-owned), the majority of shares were retained by a single blockholder (government or an individual). As a result, the percentage of floating shares was small in these two cases. Furthermore, various restrictive rules on foreign investors were put into place prior to liberalization of 2006, restricting direct investment into "strategic industries" such as natural resource extraction (Poussenkova 2007).

Figure 3.6: Gazprom and Rosneft Capitalization



- Rosneft [---]; Gazprom [—]; in \$US billions.
- Source: Rosneft and Gazprom annual financial statements. 2004 valuation of Rosneft is based on averaging of “discounted cash flows” approach and “relative acquisition approach” by BrokerCreditService (BCS).

Greater financial openness allowed these SOEs to raise funds, but more importantly, these policies allowed them to raise total capitalization, which indirectly eases access to financing, makes borrowing cheaper, allowing them to expand further both domestically and abroad. An economist who frequently advised the government suggested in an interview that a great deal of the policies addressing financial openness had to do with raising the valuation of the companies and less with attracting foreign capital.⁴⁶ Additionally, higher valuation makes the SOEs a weightier component of various influential emerging market indices (such as the "Morgan Stanley Capital International"), which makes it easier to attract investment from large investment institutions, such as pension funds (Bloomberg, 2006). Finally, an important, but less quantifiable benefit of these listings relates to the reputational

⁴⁶ Interview No 4.

bonus and the opportunity for asset exchange with respected Western industry peers and investors.

Foreign investors reacted enthusiastically to equity market liberalization. Foreign buyers invested especially heavily in the shares of Gazprom and Rosneft. There is little doubt that the stock market highs registered in late 2006 were gained with the help of the non-resident investors (Kommersant, 2006). Even William Browder, the head of "Hermitage Capital Management," who would later become the main crusader against state predation in Russia, welcomed liberalization of trading in Gazprom shares for foreign investors (Bloomberg, 2006).

Goriaev and Zobotkin argue that the Russian stock market entered a qualitatively new stage of development after these changes. The “depth” of the market (measured by the frequency of trades) increased significantly during this time. In large part, changes were attributable to a more active participation by international investors. Depository receipt for 75 Russian companies became available for foreigners, with most of those having emerged during Putin’s tenure (2006, 6). While previously there were large price discrepancies between Gazprom’s ADRs and locally traded shares, in 2006 the government united the market for Gazprom shares, creating a bonanza in the companies’ share price.⁴⁷ Figures 3.7 and 3.8 show that changes in the law did not significantly increase the actual number of foreign participants, rather they vastly increased the intensity of their activity in terms of the volume of trade. Their contribution to the total trading volume increased by about 4-fold from December of 2005 to November of 2006.

⁴⁷ Interview No 8.

Figure 3.7: MICEX exchange participants (by type)

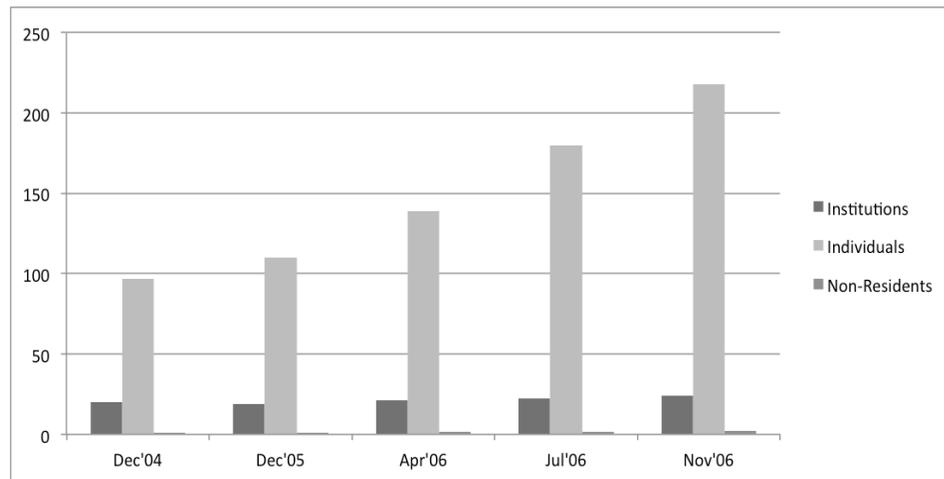
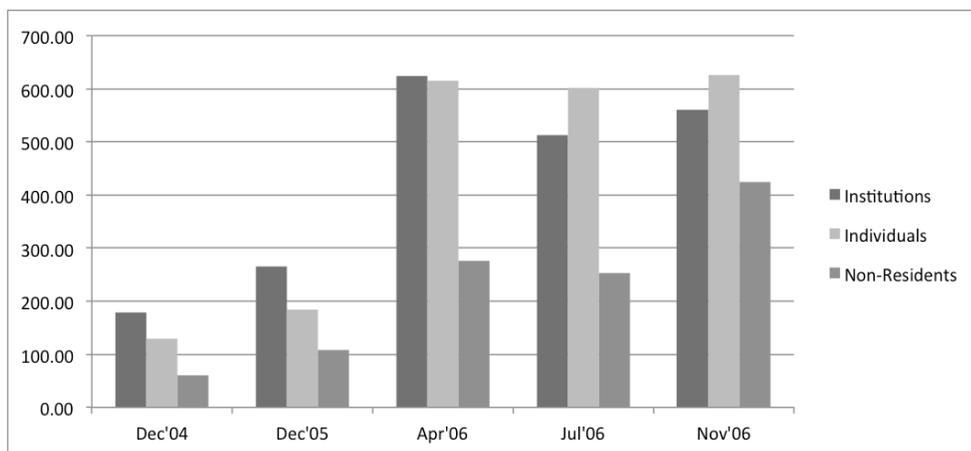


Figure 3.8: MICEX exchange participants (by volume of trade)



- Source (Figs. 3.7 & 3.8) MICEX official statistics.

It is notable that, while the Putin regime had about as bad a reputation as one could have with respect to the predatory behavior of the state vis-à-vis private industry, during the first two terms foreign investors generally welcomed the greater stability of the Putin era. This was reflected numerous times in my interviews with foreign market participants in Russia, but it was also reflected in some rankings and even on the opinion pages of publications like the *Wall Street Journal* (Chazan

2002).⁴⁸ The fact that the Russian stock market increased by nearly 8-fold between 2004 and 2007 is another piece of evidence that suggests that the authoritarian turn was quite palatable to the foreign investors (Kim 2013, 154).

In summary, greater financial openness, including equity market liberalization for foreign participants, followed the Russian government's state-capitalist policies that included both above-board acquisitions and outright nationalizations of several large privately owned companies. Russian SOEs, while continuing asset acquisition, began tapping international markets for capital in order to finance those purchases. By opening equity markets to foreign investors, the Kremlin was able to both obtain additional financing and give a stamp of legitimacy to its flagship SOEs. As Daniel Treisman writes in his recent book *The Return*, "foreign investment was key to boosting the capitalization of Kremlin-connected companies and opening doors to major bank loans." The goal was "... to legalize wealth through reprivatization and share offerings, and to diversify through Western asset purchases" (Treisman 2012, p. 116-17). In line with the argument presented in Chapter 2, financial openness provided the regime with additional financial resources by reducing the costs of transacting with foreigner, and therefore raising the value of the state-owned specific-asset based companies. Capital account liberalization was successfully used as a tool to secure the regime's future.

3.2 THE "DOWNSIDE" OF OPENNESS

3.2.1 The Global Financial Crisis of 2008-09

⁴⁸ Interview No 6 (financial industry professional). Moscow, Russia May 2011. This particular individual lamented that other expats who were not U.S. citizens are able to take advantage of a 13 percent income tax.

As I have emphasized through the dissertation, greater financial openness is a gamble that has costs. Increased exposure to externally generated crises is a price governments pay in exchange for easier access to foreign money. The global financial crisis (GFC) of 2008-09 presents us with an opportunity to evaluate how the Russian regime was able to maintain political stability in the midst of economic downturn while ultimately keeping the openness policies in place. According to the argument outlined in Chapter 2, greater capacity for redistribution allows the elites in nondemocratic settings to maintain financial openness even in the face of economic turbulence. The evidence from the Russian case overwhelmingly supports this part of the argument.

The GFC originated as a crisis in the residential property market in the United States, but quickly spread to other markets around the globe. The Russian economy was particularly badly battered. On Tuesday, September 16, 2008 further trade on the RTS and MICEX was suspended, after the exchanges registered the largest losses since the 1998 crisis (Reuters 2008). By this point the RTS index had plunged by 54 percent since the start of the year (Lesova 2008). The financial carnage continued through the fall. Another selling panic broke out in October 6, 2008 when the two exchanges dropped by 20 another percentage points (RIA Novosti 2008). By November, the price of oil settled at \$50 per barrel (down from \$140 in July). By the end of the year the Russian stocks lost more than \$1 trillion in valuation. In October of 2008, Russia registered the largest to-date monthly capital outflows of \$50 billion, as the official reserves declined by \$100 billion (Faulconbridge 2008).

The crisis quickly spread into the real economy, although the initial prognoses

severely underestimated its impact. The World Bank, for example, changed its forecast for 2009 from a 3 percent increase (November, 2008), to 4.5 percent contraction (March, 2009) to an 8 percent decline in the GDP (June, 2009). The Bank projected that six million Russians would be pushed into poverty, unemployment would reach 13 percent, with no sign of return to growth for years to come (cited in Feklyunina and White 2011, 390–91). The Russian GDP would decline by close to 8 percent between 2008 and 2009 (World Bank 2012, 607).

Several prominent Russian and Western commentators predicted fairly catastrophic political consequences of the GFC within Russia (Baev 2009; Gontmakher 2008; Whitmore 2008). Brian Whitmore, writing for *Radio Free Europe/Radio Liberty*, summed up the situation in the following way:

“Easy petrodollars allowed Putin and his cronies to purchase the loyalty of Russia's sprawling bureaucracy and to buy at least the passive consent of a critical mass of the population. Now something clearly has to give” (2008, 2).

Feklyunina and White, reflecting on the reactions to the crisis among the Russian elites, suggested that “the Putinist ‘social contract’ was most obviously at risk if living standards began to stagnate, or even decline” (2011, 389). In December of 2008, as the crisis was in full effect, Anatoly Chubais (at this point serving as the head of the state-owned Russian Nanotechnology Corporation), assigned a 50 percent chance for the potentiality of “serious economic, social, and perhaps even political turmoil” (cited in Whitmore 2008). Pavel Baev, wrote of a “pronounced fear factor in

[Putin's] political behavior... TV pictures of angry demonstrations in Reykjavik and Athens, Riga and Vilnius accentuate this fear" (Baev 2009). None of the dire scenarios materialize.

While there were some protests, most of them were in response to new restrictions on imports of used foreign cars, or concentrated in the so-called "mono-towns." Political upheaval in the one-factory towns, where some 12% of the Russian populations resides, appeared as the most threatening to the regime. Vladimir Putin personally visited one of these towns, publically confronting Oleg Derepaska (one of the Kremlin-friendly oligarchs), while Derepaska's conglomerate received billions of dollars from state-controlled banks to save his business from bankruptcy (Overland and Kutschera 2011, 327). As Gerald Easter points out, during the crisis "when local administrations or big businesses failed to pay employees on time, Putin went into good tsar mode by publically chastising chief executives, after which money for back wages was found" (Easter 2012, 113).

As the spring of 2009 approached, protest activity quickly subsided. In March 2009, only 26 percent of Russians stated they would likely participate in a protest (up by only two percent since March 2008, and actually down by 1 % since the March 2005, monetization reforms). More than 50 percent of Russian citizens had not heard about any protests associated with lowering living standards (Levada Center 2009). Gimpelson and Kapeliushnikov show that there "was no revival in strike activity during the 2008- 09 crisis... despite a visible deterioration in wage and employment conditions for a large part of the labor force" (2011, 21).

Summarizing the government response to the crisis, Treisman concedes that

the regime “succeeded in sheltering the public from the full pain of the crisis.” Despite a severe decline in total output (close to 8 percent), real wages declined by only 2.8 percent, while pensions rose by 10.7% in real terms. Because of the far larger government footprint in the economy prior to the crisis, the stimulus package was quite effective in preventing a spike in unemployment: it increased by only 2.5 percent from 5.7 percent (July 2008) to 8.2 percent (December of 2009), and subsequently declined further as the stimulus went into effect (Daniel Treisman 2011, 607).

Certainly, reserves accumulated during this period played a role: the National Wealth Fund, stood at \$225 billion, or 17 percent of GDP, with no external official debt (Berglöf, Plekhanov, and Rousso 2009, 3). However regime’s access to a vast redistributive capacity of the state aided the effectiveness of this redistributive effort, as it raised payments to pensioners, bureaucrats and socially vulnerable sections of society. Gimpelson and Kapelushnikov argue that all the levers of redistributive capacity were used to maintain political stability after the crisis. The approach was to

“...to provide a short-term shelter (whatever it costs) – to the public from the full pain of the crisis. Financial resources previously accumulated allowed to mix policies targeted at supporting employment and at retaining wages in large firms and the budgetary sector” (2011, 26).

The government made use of the accumulated reserve funds to direct financial aide, specifically, to welfare recipients and industries with large number of employees (Kramer 2009c). For example, Avtovaz, which directly employed 70,000 people in Togliatti – a town largely dependent on this industry – received more than \$1 billion in

support during the crisis (The Economist 2011). The 2009 budget proposed a substantial fiscal stimulus, amounting to additional discretionary spending of 4.1% of GDP, with close to fifty percent of the package earmarked for social spending and 30 percent for direct support of large enterprises (Berglöf, Plekhanov, and Rousso 2009, 4). The \$90 billion stimulus package emphasized increased spending for the elderly and young families, which would rise by 18 percent (Kramer 2009a). Finally, the government quickly took action to raise wages of federal bureaucrats by up to 30 percent (Easter 2012, 113).

By the end 2009, the Russian stock market was the best performing in the world, more than doubling in this span of time (Shiyin Chen 2009). Finance Minister Kudrin was visiting bankers in London to discuss new bond issues on the order of \$17.8 billion in 2010, as the risk spread on Russian sovereign debt narrowed from 7 to 2 percent (Kramer 2009b). In the course of the crisis, Sergey Ignatiev, the head of the Central Bank of Russia, firmly announced that the monetary authorities were "not planning to introduce direct controls on the movement of capital, which were in place before 2006. Capital account will remain free and liberal..." (RBK 2010). As of this writing, five years after the GFC, the Russian authorities remain committed to open capital account, even in the aftermath of the sanctions associated with the annexation of Crimea and civil war in Donbas (Evans-Pritchard 2014).

4. CONCLUSION

This chapter compared policies from two periods of Russian post-Soviet political history. Between the shelling of the Russian parliament and the sovereign default of 1998, Yeltsin's regime consistently gave up control over the specific asset

base to domestic economic interests when the value of these assets on global markets was relatively low. Putin's presidency coincided with the longest commodities boom episode in modern history. Greater financial openness went hand-in-hand with the return of state-capitalist policies that included both above-board acquisitions and outright nationalizations of several large privately owned companies with domestic and foreign ownership participation, most especially in the energy sector. Russian SOEs, while continuing asset acquisition, began accessing international markets for capital in order to finance their expansion. By opening domestic equity markets to foreign investors and entering foreign markets the Kremlin was able to "have it all"; that is, to raise the valuation of the assets it controlled, obtain additional financing for new acquisitions and give a stamp of legitimacy to its flagship SOEs, all the while maintaining a tight grip on political life in Russia.

Putin and a close network of people he trusted were made heads of major state-run companies, many of which would become major multinational corporations. As the model in Chapter 2 predicts, the decision about financial openness was made by the nondemocratic regime to take advantage of the "bonus of financial openness," but only once the regime was able to exert more control over the asset base and affirm and fine-tune the redistributive pact with the population. As one finance industry expert noted, "taxing oil and gas is easy, but getting the most out of these assets once you control them, is difficult without openness."⁴⁹

It is this rise of regime connected "state capitalists" in Russia that makes the

⁴⁹ Interview No 9 (prominent economist). Moscow, Russia March 2011.

assumption of the “wealthy” acting as a unitary actor in the model plausible.⁵⁰

Undoubtedly, there were divisions within the regime coalition about the nature of these policies, but most individual members of the government benefited from greater financial liberalization. Greater openness produced enormous payouts for connected officials whose interests diverged from those of the broader public. As one former official noted in an interview, “government's interests and national interests are not aligned in Russia. It would be in the national interest to protect the economy from things like sudden stops, but those who support the regime have other goals, like openness.”⁵¹ The oligarchs, who had acquired their wealth before Putin’s rise to power, were informally pressured to buy stocks of state-owned energy giants during their IPOs to generate demand and to display loyalty to the regime. Three individuals (Lisin, Abramovich and Deripaska) accounted for the purchase of about 10 percent of the issued shares (Izvestiya 2006).

The model developed in Chapter 2 assumes that redistributive capacity to be common knowledge among the relevant actors. Some readers might find this a problematic assumption, since most models of authoritarianism are fundamentally based on the inability of nondemocracies to commit to redistribution once the regime assumes power (Acemoglu and Robinson 2006, see esp. Chs. 5-6). However, the case of nondemocracy in Russia demonstrates that (a) the population at large expects redistribution; (b) the regime understands and guards against political instability that

⁵⁰ Combining the terms “siloviki” (term for security services political elites) and “oligarch” Daniel Treisman called these actors “silovarchs” (2007).

⁵¹ Interview No 1 (former government official). Moscow, Russia May 2011.

will ensue should these expectations be unmet.

In public opinion surveys between 1998 and 2005, “the social orientation of reforms in the country” was consistently named as the second most preferred direction of government activity. With 30 percent of respondents, it was second only to economic growth with 50 percent, while spots 3-5 were taken by “return of state regulation of the economy,” “repayment of wage and pension debts,” “state support to basic industries of the economy” (Levada Center poll cited in Poussenkova 2007, 86). The regime’s renationalization program was very popular, with a plurality of Russians supporting renationalization, while 70-80 percent of the Russian population believes “large private ownership obtained through privatization as illegitimate” (Chernykh 2011, 1240). So widely accepted is the “social orientation” preferences of the Russian electorate that even the free market champion Mikhail Khodorkovsky argued in his writing (from prison) that any future democratically elected government in Russia will have to maintain the heavy redistributionist approach (Khodorkovsky 2005).

In contrast to many theories of authoritarianism and democratization that emphasize the credibility-enhancing role of democratic institutions (Acemoglu and Robinson 2006; Weingast 1997), the statist, interventionist and deeply redistributionist orientation of the population and the redistributive capacity of the state inherited from the Soviet past buttresses the authoritarian regime in Russia. So significant is this feature of the Russian polity that it allowed the Putin regime to pursue gains from financial openness, without being much concerned with the consequences of short-term financial crises. Gimpelson and Kapeliushnikov point out, the regime

“feels quite satisfied with this model largely because

unemployment tends to stay at a low level. This minimizes possible political risks associated with quantitative adjustment given that strong fear of unemployment is so widespread in the Russian society. In addition, low unemployment contains the fiscal costs associated with social protection of the unemployed” (2011, 22).

The Russian case demonstrates that while the size of the currency reserves and “stabilization funds” are important for fiscal and (ultimately) political stability of the regime, its capacity to deploy these resources to the population in times of crisis is equally, if not more important.

The argument advanced here can be situated in the group of explanations that emphasize the domestic sources of financial openness policies, but also take into account the changes that have occurred in the international financial system over the last quarter-century (Andrews 1994; J. Goodman and Pauly 1993; Kastner and Rector 2003). The Russian case allows us to safely reject some of the more common alternative explanations prominent in the literature. It is often argued that capital-scarce extraction industries that dominate the Russian economy benefit from lowering the barriers to foreign finance. However, the extraction industry was not able to push through these reforms when it was politically strongest – before 2003. After the astonishing increase in the role of the state – especially in the oil and gas sector from 2003 onwards, but also in the banking industry – it was no longer clear which sectoral interests the state would weight against the potential risks of greater openness.

Instead, financial openness policy put in place in 2006 in Russia was a

calculated decision by the political elites to increase the value and mobility of the assets they controlled. They cared about the domestic implications of these policies not in ways that it would affect the immediate coalition (the benefits were obvious), but rather insofar as these policies increased the chances of increased political instability.

The Russian case study also allows us to rule out the ideational explanations of financial openness, at least as they are commonly framed in the extant literature.⁵² It is true that the policymakers who were in charge of the technocratic aspects of the reform were of the neo-liberal persuasion. Sergei Ignatiev (head of the Russian Central Bank) and Alexei Kudrin (former finance minister) both were well-known proponents of capital account deregulation. However, they also had powerful opponents within the regime. For example, during the 2008-9 crisis, Vladimir Yakunin – head of the state-owned Russian Railways Corporation, and a known member of the “statist” camp within the Kremlin – called for the immediate reversal of the reforms and restoration of capital controls. His concern was that foreign currency being spent by CB to support the ruble would leave the country if controls are not instituted (Polit.ru 2009). Even after Kudrin publically lambasted new spending on government workers and the military in 2011, the new social policy went into effect (Putilov 2013). His subsequent resignation, however, altered neither the domestic statist-distributive policy orientation of the government, nor the “neoliberal” financial openness approach in foreign economic policy (Belton 2011).

⁵² These are usually framed as the “influence of social identifies, norms, and other collectively-shared idea and beliefs” (Abdelal 2009, 63). I return to the question of the merger between global finance capital and “state capitalism” in the concluding Chapter 5.

The policymaking elites played a strictly technocratic and advisory role during the rollout of the policies in the mid-2000s.⁵³ Moreover, these same officials with ostensibly “neoliberal” economic proclivities either supported (or were too weak to oppose) statist policies in the domestic realm. Several of the liberals in the government did resign throughout Putin’s tenure in office, including Putin’s first Prime Minister Mikhail Kasyanov, his chief economic advisor Andrey Illarionov and later even Aleksey Kudrin; while the individuals like Yakunin, Sechin and Miller are still the government today. The technocrats performed important roles in the government, only as long as their preferences for policies coincided with the material interests of the individuals in charge. Indeed, the Russian case makes it very difficult to argue for an independent role of ideas in the initiation of financial openness policies under Putin.

Similarly, the 2006 reforms were put in place after Russia paid back its IMF loans, so the conditionality requirement had no influence on these decisions. These policies certainly were meant as a “signal” to the international financial markets that Russia was “open for business.” But these policies had little to do with signaling commitment to not impose controls in the aftermath of the 1998 crisis, since it took almost 8 years for the decontrol of the capital account to be implemented. Instead, greater financial openness (especially openness to short money flows) was a mechanism of reducing the costs of transacting with foreign investors.

Certainly the reality of political life in a country like Russia is complex, and factors other than enormous redistributive capacity, regime’s control over specific assets and high global commodities prices also contributed to financial opening in

⁵³ Interview No 9.

Russia. However, this explanation appears to do the best job among the possible alternatives.

The next chapter assesses the argument by turning to the cases of China and Kazakhstan. Kazakhstan liberalized movement of capital earlier in the transition than Russia, although the government also retained control of the extractive industry from the start. The Communist Party of China, did not go through a rapid privatization program, although the role of the Chinese state in the economy fluctuated more in the last three decades than most causal observers appreciate. Notably for the purposes of the argument – as compared especially to China – we see that Russia had far more advanced tools of redistributive capacity to control potential discontent. In China, where a welfare state had not been developed before the 1979 opening and political control over the population control was a more pressing problem, the regime was far more sensitive to the potential downsides of openness, and therefore it adopted a far more cautious approach to financial openness policies.

CHAPTER 4:
FINANCIAL OPENNESS AND AUTHORITARIANISM IN CHINA AND
KAZAKHSTAN

In Chapter 2, I developed a theory of financial openness under authoritarianism that suggests that nondemocratic regimes initiate openness policies when they stand to collect a “bonus of openness” brought on by higher valuation of specific assets they control, and when they also command expansive redistributive capacity to attenuate political instability associated with greater exposure to global financial markets. Moreover, I have argued that in a nondemocratic context, “redistributive capacity” (RC) is the most dependable mechanism to accomplish this objective, as extensive RC can allow the regime to remove uncertainty about its “strength” vis-à-vis the non-elites. Extensive RC allows a nondemocratic polity to endure the political consequences of greater volatility that often accompanies deregulation of financial flows.

Chapter 3 used the case study of post-Soviet Russia to assess and elaborate on this model. I showed that with the rise of global prices of commodities, the value of specific assets in Russia increased markedly. After the regime led by Vladimir Putin gained control over the majority of oil and gas industries, the Kremlin initiated widespread financial openness policies, including removal of nearly all meaningful restrictions on the most volatile flows: inflows into the equity markets. Because of large redistributive capacity and a long-standing embedded welfare pact between the Russian state and broader population, Putin’s regime was relatively sanguine about its ability to maintain political stability, so long as it was flush with resources for

distribution. As expected, greater financial openness carried significant downside risks, epitomized by the Global Financial Crisis of 2008-09. Putin's regime, however, was able to maintain political stability by rapidly distributing additional wealth, which reinforced regime supporters and placated potential opponents.

In this chapter, I further evaluate the model and the argument by conducting two case comparisons: one between Russia and China, and another between Russia and Kazakhstan. These cases allow me to "vary" the components of my model (the two independent variables): control/anticipated value of assets, and redistributive capacity. Although these variables changed within each case in non-trivial ways, on the whole, the redistributive capacity of the Chinese state is far less extensive than Russia's, while the lack of domestic rivals for control over Kazakhstan's asset base differentiates it markedly from Russia of the 1990s. As I demonstrate, accounting for these differences allows us to gain new insights about the divergent experiences of Russia, China and Kazakhstan.

The Chinese case exemplifies an authoritarian regime that, for the most part, retained significant control over all valuable assets in the economy, but possessed limited redistributive capacity. Instead it has relied on more uncertain repressive tools and *ad hoc* mechanisms to deal with widespread social unrest that has accompanied the colossal economic transformation of the last thirty years. High economic growth itself became the main channel of political exchange between the regime and broader citizenry, creating a legitimating foundation for the Communist Party's rule. However under the conditions of economic volatility, the CCP lacks reliable mechanisms by which it can signal regime strength and prevent potential for unrest, despite the

immensity of fiscal and repressive capabilities at its disposal. I argue that this basic political challenge has led Beijing to adopt a cautious approach towards capital account deregulation and accompanying potential economic instability.

Table 4.1 (2.2): Timing of Financial Openness Policies in China, Kazakhstan and Russia

Case	Timing of policy	Control over specific assets	Capacity for redistribution
Kazakhstan	late-1990s/early-2000s	since early 1990s (no domestic competitors for assets)	Legacy RC from USSR
Russia	mid-2000s	2003-04	Legacy RC from USSR
China	early/mid-2010s (?)	since 1979	No legacy RC; new RC dev in mid-2000s

The case of Kazakhstan illustrates the importance of exclusive control over assets by the regime, in addition to reaffirming the crucial role of redistributive capacity. In contrast with Russia, the Kazakhstani leadership did not give up control over specific assets to domestic actors at the start of the economic transition, instead partnering with Western-based transnational oil companies. Yet, similarly to neighboring Russia, the regime led by Nursultan Nazarbayev inherited extensive redistributive capacity as part of its state socialist legacy. Shortly after the breakup of the USSR, the Kazakhstani regime embraced a combination of an outward financial openness and strict political control in domestic affairs. Having successfully withstood two financial crises and gradually increased the regime’s stake in the overall economy to nearly 60 percent, the Kazakhstani regime today exemplifies a model of resilient authoritarianism under the conditions of financial openness.

This chapter is divided into three main sections. The first two are devoted to

case studies of China and Kazakhstan. They follow the same structure adopted in the previous chapter. Each begins with an outline of financial openness policies pursued by the regime in question, followed by a discussion of the state's role in the economy and the extent of redistributive capacity at its disposal. Before concluding, I address some alternative explanations in the third section.

1. POLITICS OF FINANCIAL OPENNESS IN CHINA

This part of the chapter is devoted to the study of Chinese financial openness policies, which I tackle in several steps. I begin with a brief background on the changes in Beijing's financial policies before and after the Asian Financial Crisis of the late 1990s. Contrary to a widely shared view, Beijing's approach to economic reforms generally, and capital account openness specifically, did not always follow a neat "gradualist" trajectory. In sections 2.2 and 2.3, I offer a focused analysis of financial openness policies that zeroes in on the period bookended by the 1997-8 and 2008-09 international financial crises. This period was characterized by high growth in the two already deeply marketized economies of Russia and China with nondemocratic political rule installed in both (1998-2008) (Sonin 2013). Here, I connect the differences in financial openness policies between China and Russia, and important temporal differences *within* the Chinese case over the last two decades, to changes in the share of state control over site-specific assets and (more importantly) to generally low levels of redistributive capacity available to the Chinese regime.

The contrast between Russia and China is illuminating because the two economies share histories of an "autarkic" communist past, underdeveloped financial markets, lack of competitive politics and a legacy of state-owned enterprises playing

an oversized role in the economy. At the start of this century, both countries accumulated enormous resources to advance foreign economic policy agendas independent of other nations or the International Financial Institutions (Cohen 2008, 461). During this period the Chinese economy more than doubled in size, growing at nearly 10 percent per annum on average (World Bank 2012). Beijing refrained from accumulating undue foreign debt, maintaining a stable 15 percent ratio of external debt to GDP (Prasad and Wei 2007). All the while, Beijing stockpiled enormous reserves of foreign currency, which by the end of the first decade of this century approached half of China's GDP (Steinberg 2014, 71). This amount of economic autonomy and reserve buffer should have given the Party sufficient confidence that they could withstand any "storm" in the global financial markets.⁵⁴ Yet, in contrast to Russia, the Chinese regime has remained reticent with regards to further financial opening.

During the last three decades, two of the largest experiments in transition economics took place in China and Russia. Both countries underwent enormous changes, although the process of political transformation and economic policies adopted by the respective governments diverged considerably. Russia during the early transition years experimented meaningfully, albeit briefly, with democratic reforms. Economic reforms, including massive privatization and "shock therapy" were obviously far more radical and tumultuous in Russia than in China. Despite the

⁵⁴ There is an ongoing debate about whether Beijing can even deploy the accumulated foreign reserves to address domestic issues. However, large external reserves do give China greater flexibility to maintain exchange rate stability. Additionally, the regime has made steps to create a sovereign wealth fund (Central Huijin Investment Company, which later merged into the China Investment Corporation). Huijin was used to bail out domestic banks in early 2000s, and CIC was capitalized to the tune of \$200 billion in 2007, or close to 20 percent of China's total foreign currency reserves (Pettis 2013, 37–40; Truman 2008, 169).

different routes taken, by early 2000s both economies were deeply “marketized,” with sizable private sector, consumer economies and stock and debt markets. At the same time, both were governed by monopolistic regimes dominated by fantastically wealthy elites that systematically rooted out political competitors while also relying on various tactics of “political exchange” to remain in power. In contrast with the Russian political system, which morphed into authoritarian state-capitalism only by the mid-2000s, the Chinese Communist Party (CCP) retained absolute monopoly over the political and economic life throughout the transition.

The literature on postsocialist transitions often presents the Chinese case as a success story of careful “gradualism,” while Russia is depicted as an embodiment of failed radicalism of “shock therapy” that led to the blundering of economic reform (Hellman 1998; Li 1999; Naughton 1995; Naughton 2007). In contrast to the “big bang” reform method taken up by the early reformist government under Yeltsin (implemented however imperfectly), Chinese authorities maintained the central planning system, whereby production in excess of the plan was sold on the market. This, according to several accounts, prevented short-term output collapse in China. By maintaining central control, Beijing was able to mitigate coordination failures that plagued most post-Soviet transitions and to “grow out of the plan” (Li 1999; Naughton 1995). By preserving functioning state institutions and an operational industrial structure, the Chinese gradual reform scheme outperformed the more radical “big bang” market transition adopted in Russia.

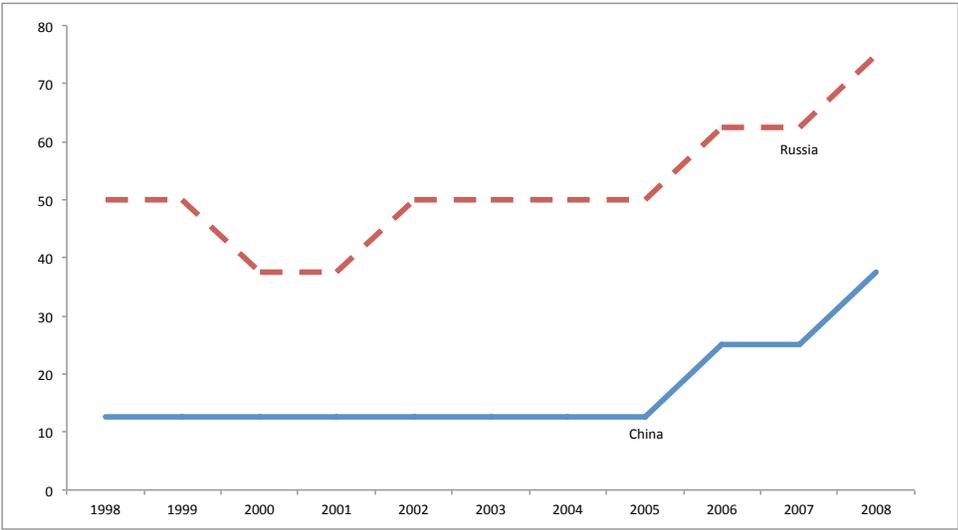
This is, of course, a rather simplified story that omits many important dissimilarities between the two transitions, including a greater level of

industrialization in Russia, the severity of the ethno-federalist divide of the late Soviet period, and the export-oriented economic model adopted in China (Bunce 1999; V. Popov 2007; Popov 2000; Woo 1994). Even if the “gradualism” story of domestic reforms is true, the piecemeal, state-centric approach need not necessarily spill into the realm of foreign economic policy. For example, after the reversion to statist domestic economic policies, Putin’s government’s external financial policies became *more* “market-friendly.” The Chinese government however continued to maintain barriers, especially towards the more ostensibly volatile portfolio inflows, despite the potential enormous upside for state-controlled enterprises. In matters of external financial policy-making during the decade under study (1998-2008), the difference between Russia and China could be accurately described as one of “gradualism” versus “big bang.” Until the mid-to-late 2000s, the Beijing has retained a relatively closed capital account, and even to this day fundamental restrictions on capital flows persist.

As I demonstrate in the next section, the CCP abstained from putting in place policies that would raise the value of assets under its control, such as equity market liberalization. These policies that would have made shares of state-owned companies more liquid, raising the valuation of state-controlled assets. While greater openness also implied significant political risks for the regime, as I argue in greater detail later in the chapter, Beijing’s cautious approach cannot be attributed to the clairvoyant foresight of its leaders. Rather, despite their “pro-people” socialist rhetoric, the Party elites neglected to develop welfare institutions, social insurance and labor protections. Instead during the 1990s SOEs reforms they actually weakened the “rice bowl” safety net inherited from Mao’s rule. Lacking redistributive capacity, as the model predicts,

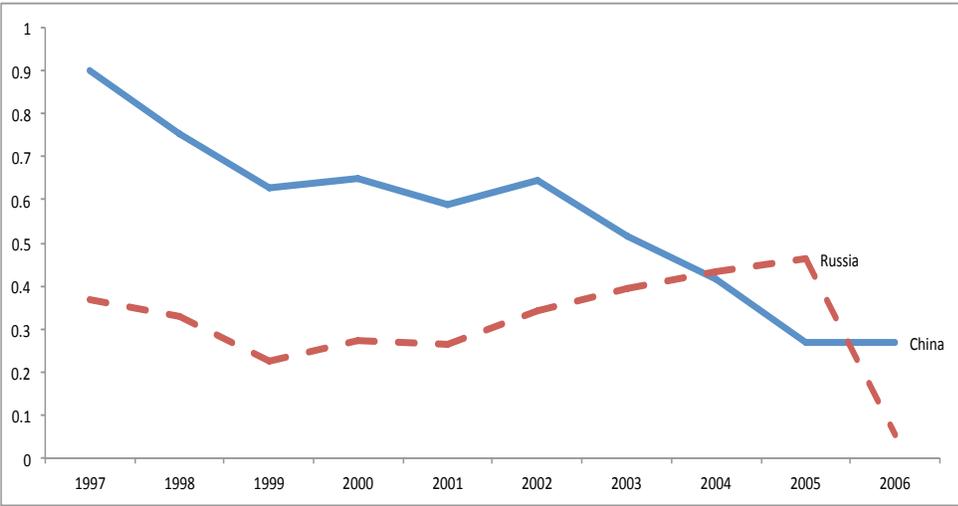
the regime has few mechanisms to remove information uncertainty about the its intentions and therefore prevent the citizenry from rebellion, which would be especially damaging under the conditions of openness.

Figure 4.1: Financial Openness in China and Russia



- Source: CAPITAL by Quinn and Toyoda 2008, with later updates (zero refers to a closed capital account).

Figure 4.2: Foreign Ownership Restrictions on Equities in China and Russia



- Source: FORU by Edison and Warnock 2003, with later updates (zero refers to “no restrictions”).

Figures 4.1 and 4.2 capture the differences in financial openness between the two cases, using the two commonly-used indices for 1998 to 2008 period (Edison and Warnock 2003; D. Quinn and Toyoda 2008). The differences are illustrative, but in many ways they do not capture the full extent of controls still maintained by Beijing. The Chinese government enforces many fundamental restrictions (which I detail later in the chapter), despite the overall trend towards openness seen during this period. For instance, debt and portfolio inflows are subject to strict limits, while the equity market is divided into two separate segments for local and foreign buyers (Guo and Huang 2010; Prasad, Wang, and Rumbaugh 2005). When the Russian government moved towards full liberalization in the mid-2000s, Beijing largely continued with the gradualist approach.⁵⁵

Why did Beijing forego greater financial openness, despite being better “insulated” by the size of its reserves and high rates economic growth? Why did it maintain so many restrictions on capital inflows into the equity markets, instead of following the example of Moscow, which deregulated capital flows? I argue here that these differences are primarily attributable to the political regime’s fears of domestic political instability and lack of redistributive capability to manage it.

Beijing’s approach towards financial policymaking has been a subject of careful scholarly attention that led to the development of numerous theories about Beijing’s guarded approach towards financial globalization. Most scholars agree on

⁵⁵ It is important to note that while the Edison and Warnock’s data is one of the better quantitative measures of restrictions on foreign participation in domestic equity markets in emerging economies, their data is a bit misleading in the case of China. Foreign investors were prohibited from buying domestic A-shares until 2003, but the Figure shows China to be “only” about 70 percent “closed” in 2002. The other 30 percent is likely attributable to various derivative shares of mainland

the direction of the overarching trend, even if the pace of change has been slow. The Chinese economy, its flagship state-owned enterprises and its currency will continue to be more integrated into the global financial markets in the future (Eric Helleiner and Kirshner 2014; Prasad and Wei 2007; Subramanian 2011). As Helleiner and Kirshner point out, "internationalization is clearly coming; the question is largely a matter of how much, how fast, to what extent, and with what "ceiling" (2014, 7). As opposed to scholars who focus on the fragility of the Chinese banking system, role of ideas or the model of economic development, my explanation of the slow pace of financial opening in China supports the literature that focuses on the interests and calculations of the "business-party-state" elites (Lardy and Borst 2013; Pettis 2013; Wang 2014). At least until the onset of the GFC, constrained by low redistributive capacity, the authoritarian leadership of the country opted against greater financial openness, despite its potential to benefit the regime.

1.1 Financial openness in China

Although it went through several distinct phases, China's financial openness policies since 1978 have been based primarily on two consistent doctrines. First: financial openness is to be introduced in limited experiments, at first with the goal of accessing foreign exchange, and later in order to create incentives for long-term foreign investment that would aid the development of domestic industries and transfer foreign technological and managerial expertise. Second: monetary autonomy is to be retained through significant controls and regulation on operations with foreign exchange and prevention of short-term fluctuations in the markets. Even though the

companies listed on offshore exchanges, primarily in Hong Kong and Singapore.

official Beijing made commitments to a more open capital account during the turn towards “Socialism with Chinese Characteristics” and the period of SOE reforms in the 1990s, few of these intentions were put into practice, especially after the Asian Financial Crisis. In the mid-2000s the Chinese regime began liberalizing riskier types of capital flows, but these policy initiatives were also experimental and narrow in scope and application. In the following pages, I briefly review the first two decades of the transition period, including the impact of the Asian Financial Crisis. I then delve into the financial policies of the Chinese government during the decade preceding the Global Financial Crisis of 2008-09.

1.1.1 Background (1978-2001)

The period between the start of the transition in 1978 and the accession to the WTO in 2001 can be divided into two waves of openness reforms, both of which were demonstrative of the commitment to the “easy in, difficult out” approach. Between 1978 and 1992, Chinese authorities allowed joint ventures between domestic and foreign investors, but limited those to several coastal Special Economic Zones. Beginning with Deng Xiaoping’s “Southern Tour” and the initiation of the “Socialism with Chinese Characteristics” platform in 1992, the government activated more adventurous liberalization policies that opened much of the rest of the country to foreign direct investment (Chinn and Ito 2011, 2–3). Riskier inflows of portfolio and debt flows however remained off limits.

From the start, the Chinese regime practiced a restrained approach, whereby it adopted financial policies that were explicitly limited to specific types of flows and a confined geographic location. Only after the success of the experiment was

demonstrated, the regime would scale the policy out to other regions and industries. As early as 1980 the State Council approved an administrative process for joint ventures with foreign entities in certain provinces and enterprises. These required long and onerous reviews by various state entities, including the State Planning Commission, Foreign Investment Control Commission, State General Administration of Exchange Control, and even the State Construction Commission. However ventures that had operation plans of 10 years or longer or whose earnings were to be reinvested in China were offered significant tax incentives. Foreign exchange proceeds, however, were required to be kept at the Bank of China (Prasad and Wei 2007, 462–3).

The Tiananmen Square massacre of June 4, 1989 and crumbling of communist systems in Eastern Europe and the Soviet Union sent shock waves through the ranks of the Communist Party. Millions of party members were investigated following the June 4th events. According to the account of the former Beijing chief of the *Financial Times* Richard McGregor,

“The Tiananmen crackdown prompted a brutal reassessment of the free-wheeling eighties and a ruthless reordering of the leadership’s priorities, drawing a dividing line between two eras of reform in China. The vanities of the relatively open political and economic atmosphere... were out. With the political and fiscal power of Beijing seemingly inexorably in retreat ... from the nineties onwards the party centre was resolved to reassert its authority once and for all” (McGregor 2010, 36).

Deng Xiaoping and the cadre of pro-reform CCP members had to withstand the onslaught of invigorated critics from the left, but Deng ultimately won. In a television appearance with the troops just a few days after the Tiananmen uprising, Deng said that the “[s]ingle biggest mistake of leadership had made in the eighties... had not been opening the economy, as many of his critics had begun to argue forcibly, but a lack of ideological and political education to go with it” (McGregor 2010, 41). Still, the many of the major reforms were put on hold for 2-3 years (Wong 2004, 155), until the 1992 “Southern Tour” of Deng, which signified a full victory of the pro-market faction within the party.⁵⁶

Starting in 1992, foreign investors were invited to participate in ventures outside of the special economic zones and coastal areas. Total inflows increased drastically during this period from about \$10 billion in 1992 to 40-50 billion in the mid-1990s, almost entirely comprised of FDI (Chinn and Ito 2011, 14). This period was characterized by major reforms in the SOE sector, including the state-controlled financial services sector. During this time, the four biggest specialized state banks were converted into commercial entities, and a new law allowed non-state banks to be set up (Bekaert and Harvey 2002). The Chinese financial system, however, remains one of the major weak features of the Chinese economy. Despite unprecedented growth of the industry, Chinese state banks have required several rounds of capital infusions and bailouts.

⁵⁶ Even during the uncertain period between 1989 and 1991, local governments in Shanghai and Shenzhen were given authority to approve FDI projects not exceeding \$10 million. The Shanghai Stock Exchange the Shenzhen Stock Exchange opened in December of 1990 and July of 1991 respectively (Weber and Zhang 2012, 383).

In 1996 China signed onto several important articles of the IMF's Articles of Agreement. By accepting Article III, Chinese authorities committed to current account convertibility for the renminbi (Hu 2005, 358). At times, Beijing even made pronouncements about its intentions for full capital account deregulation by the year 2000 (Prasad and Wei 2007, 453). In reality, many restrictions remained on the books for years to come. Nonresidents were not permitted to sell or issue capital market securities. Residents, except for authorized financial institutions, were not allowed to purchase, sell or issue securities abroad, unless these actions were coordinated with the People's Bank of China, the State Administration of Foreign Exchange and the Securities Supervisory Board (Prasad and Wei 2007, 462–4). Essentially all transactions with money market instruments, collective investment securities, and derivatives were either prohibited or limited to only state-approved entities.

The Asian Financial Crisis of 1997-98 led many among the policymaking elites to slow down the already glacial pace of capital account deregulation (Guo and Huang 2010, 454; Hu 2005, 360; Prasad and Wei 2007, 453). The experience of the crisis would inform the decision-making of many among the Chinese elite for years to come, especially those who were already predisposed to favor the conservative approach toward globalization (Chinn and Ito 2011, 3). Even a decade later, during the boom years on the Chinese stock markets (2005-07), several commentators made references to the Asian financial crises and the potential of hot money to “create bubbles in the stock market and real estate market, as exactly what happened to Southeast Asian countries” (Guo and Huang 2010, 454). According to an account by Eswar Prasad and Shang-Jin Wei,

“The psychological impact of the Asian financial crisis may have been profound. Several countries that China had regarded as role models for its own development process (especially Korea) went into deep crises in a very short period of time. It was a common perception among policymakers in China that the swings in the non-FDI part of the international capital flows had played a crucial role in the process. In this sense, the Asian financial crisis caused a rethinking of the Chinese approach to capital inflows” (2007, 453).

1.1.2 Another round of experimentation with openness: 2001-2008

Still, by comparison to its neighbors China came away from the AFC relatively unscathed. The CCP leadership interpreted the events to be a confirmation of its cautious approach towards uncontrolled capital flows – the culprit that produced such political havoc elsewhere in East and Southeast Asia. At the same time, in the years following the crisis, different aspects of Chinese policymaking (including capital flows and exchange rate management) started to contradict one another. For example, upon joining the WTO in 2001, China pledged to liberalize the financial services industry (Yongding 2009, 5). WTO accession also required a deregulation of the current account settlements. Indeed, as of 2003 China overtook the United States as the largest recipient of foreign direct investment (Prasad and Wei 2007, 421). During this period, Beijing did remove restrictions on current account settlements and loosened the controls on outflows later in the decade, but it continued favoring state-

owned domestic banks, restricting financial services, while continuing with stringent control on short term portfolio and debt flows.

In the mid-2000s Chinese authorities parted from the “easy in, difficult out” policy they had practiced since the early 1980s. Instead they began experimenting with lowering the barriers to entry into the domestic equity markets for foreign participants (Chinn and Ito 2011; Hu 2005; Yongding 2009). In 2002, the qualified foreign institutional investors (QFII) program was launched, which allowed foreign entities to purchase A-shares with certain restrictions. This was part of a transition towards a “difficult in and easy out” approach, “with the aim of reducing upward pressure on the RMB” (Yongding 2009, 1). These were the first “cautious experiments” following the AFC, which had made the regime apprehensive about further financial openness. According to Hu, “the decision, jointly made by the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE), followed a two-year period of careful study and consultation” (2006, 360). A new four-tier classification of industries where foreigners can invest was introduced, most consequentially opening the services industry to foreign investment. The government withdrew the requirement to register with SAFE to borrow foreign exchange from domestic banks in 2003 (Prasad and Wei 2007, 462–4). Foreign investors gained access to more than 1200 Chinese companies listed in Shanghai and Shenzhen (Hu 2005, 360).

But even in this brief episode of financial openness, the cautiousness of the Party leadership prevailed. The CSRC required QFII participants to hold their investment for a minimum of 12 months before repatriating the gains (Hu 2005, 360).

At the end of 2004, only 23 foreign investment banks received approval for a total amount of a meager \$3.2 billion (Prasad, Wang, and Rumbaugh 2005, 26). Despite the initial success of the program, “the authorities temporarily stopped approving new applications... mainly to limit further portfolio investment inflows” (Hu 2005, 357). Ultimately, the impact of QFII, in terms of the total amount of inflowing fund was negligible.

Approaching the onset of the Global Financial Crisis, Chinese economic openness policies were a mix of contradictions. While the current account operations were liberalized, the capital account was subject to a litany of formal restrictions. The new foreign exchange regime of managed float that was introduced in 2005 actually required stricter scrutiny for inflows. The new requirements, such as those that prohibited foreign inflows into RMB accounts, were specifically aimed at preventing undue fluctuation of the Chinese currency (Yongding 2009, 7). As a sign of how attractive Chinese assets were to foreign money, and despite the major *de jure* restrictions on the inflows remain, large sums of money poured into the country’s real estate and equity markets through illegal schemes, especially through over and under-invoicing of current account transactions (Kar and Freitas 2011; Prasad, Wang, and Rumbaugh 2005). To lessen the pressure on the RMB, Beijing abolished several important limitations of outflows. These included new higher limits on foreign currency conversions for residents, and, more importantly, a new program introduced in 2006, called Qualified Domestic Institutions Investors (QDII), which allowed Chinese resident to invest in foreign equities for the first time. By end of 2007, \$27 billion were invested abroad – a far greater amount that was allowed under the QFII

scheme (Yongding 2009, 7).

To summarize, while many limitations on foreign inflows of investments other than FDI have been loosened during the decade that preceded the GFC, the Chinese regime continues to tightly regulate financial flows, especially portfolio investment. Despite some significant liberalization of FDI flows associated with WTO accession, foreign borrowing by local firms is subject to strict limits and foreign portfolio investors have only limited access to the domestic equity markets (Guo and Huang 2010; Prasad, Wang, and Rumbaugh 2005).⁵⁷ Access to foreign bank accounts and foreign equity markets is strictly regulated for Chinese residents, who are for the most part prohibited from investing abroad (Prasad, Wang, and Rumbaugh 2005, 26). Finally, while the unofficial speculative inflows grew significantly during this period, the official *de jure* capital controls on these types of transactions remain in place (Guo and Huang 2010; Prasad, Wang, and Rumbaugh 2005; Y. Wang 2010). As one interviewee noted, “there are ways to get around these things, but the government in principle is in position to ‘pull the plug’ on speculative inflows.”⁵⁸

1.2 Control over and the value of specific assets

The Russian regime regained control over most lucrative specific assets in the economy by the mid-2000s through market and non-market mechanisms, using growing revenues from oil and gas exports. In China, the Communist Party faced a different dilemma. The government directly owned too many severely

⁵⁷ Even on FDI picture is not as clear as it appears at first sight. Paradoxically China employs some of the more extensive incentive schemes for foreign direct investment while at the same time retaining some of the strictest limitations on FDI (Prasad and Wei 2007, 455).

⁵⁸ Interview No 19 (investment fund manager). Beijing, China, November 2011.

underperforming enterprises that were struggling to maintain profitability. SOE reforms lagged far behind other market reforms in China, in spite of the introduction of the Contract Responsibility Program (which created performance based contracts for SOE managers) and the official turn towards the “Socialist Market Economy” in 1992 (J. Lee and OECD 2009). State-owned industries faced somber, potentially politically devastating difficulties, since these industries were responsible for the employment of tens of millions of urban workers. In the course of the SOE reforms, the Party accomplished a number of important goals, including most retaining control over the most profitable and politically sensitive industries while raising their values substantially (although likely raising less than would have been the case in the absence of capital controls). In contrast to Russia however, the Chinese regime was undoubtedly aided by high rates of domestic savings, lack of investment alternatives for the household sector, severe controls on outflowing capital and a positive capital account balance. In other words, it was able to achieve these aims without outside financing.

In the early 1990s, the CCP faced the problem of deteriorating state-owned enterprises. By one estimate, the Chinese government was directly involved in 68,000 industrial SOEs, of which 53,000 were small firms (China Daily, October 30, 1997 cited in Sun and Tong 2003, 185). State and collective-owned enterprises accounted for about 90 percent of all industrial production before 1990 (Piovani and Li 2011, 79). By some estimates less than 50 percent of the SOEs were profitable at the start of 1990s. The government responded by pushing toward corporatization of SOEs, with about 30 percent of them being turned into modern corporations, creating hundreds of

newly listed companies by 2002 (Zhang 2004, 2033). A 1994 law issued specific guidelines for corporatization of the SOEs, calling for “share ownership arrangement” by means of share-issuing privatization (SIP) (Zhang 2006). As McGregor colorfully described it, the 1990s reforms allowed the Communist Party to redefine communism once again, but with an “audacious twist”:

“Instead of trying to protect the moribund state sector which was threatening to sink the economy and the political system along with it, the Party decided on a new, high-risk course of action. The Party resolved to ruthlessly streamline government enterprises, place survivors atop the commanding heights of a profitable industrial economy under its control and pilot them into the global financial arena” (2010, 37).

Between 1994 and 2001, 873 IPOs took place. 414 of those happened between 1998-2001, raising a total of \$61.6 billion (Pistor and Xu 2005, 190). According to Li, the number of unprofitable SOEs declined by about fifty percent between 1997 and 2000 (Lee 2001, cited in Sun and Tong 2003, 184). Many of the best performing businesses owned by the SOEs were restructured into separate companies that were listed on local exchanges, though the parent SOE companies retained block-holding ownership of about 40 percent, on average (Ma, Ma, and Tian 2013, 316). Despite the overall success of the corporatization initiative, the government spent far greater sums of money – on the order of hundreds of billions of RMB – in debt write-off, bailouts of state-owned banks, debt-equity swaps and preferential financing (Sun and Tong

2003, 184). In other words, control over the assets was of paramount concern to the regime, which was willing to expand enormous resources to maintain ownership and control.

Table 4.2: Role of SOEs in Chinese Economy

Year	Total # of SOEs (10,000s)	Employment in SOEs (millions)	% of total gross output	% of total fixed net asset values
1978	8.37	31.39	77.6	72.1
1985	9.37	38.15	64.9	68.7
1993	10.47	44.98	47	67.9
1994	10.22	43.69	37.3	66.4
1995	11.8	43.97	34	66.5
1997	11.38	42.78	36.3	66.3
1998	9.86	40.4	31.6	65
1999	6.47	27.21	28.2	57.2
2000	5.07	24.12	47.3	54.5
2001	5.35	20.96	44.4	51.1
2002	4.68	18.24	40.8	47.5
2003	4.11	15.46	37.5	41
2004			34.8	
2005			33.3	

- Sources: Zhang 2004, 2009; Lee and OECD 2009

The role of the state-owned sector in the overall economy declined considerably in the last 20 years (Table 4.2). SOEs were responsible for “only” about one-third of the total output in the Chinese economy in 2008, as opposed to 77 percent in 1978 (Lee and OECD 2009, 4-5; Zhang 2004, 2006). However, while state involvement in the economy declined in the 1990s, the share of the state-ownership in the top echelons of publically traded companies actually increased through the 2000s. In 2003, more than 75 percent of listed companies had some connection to the government (X. Wang, Xu, and Zhu 2004, 468). In 2001, the government owned shares in listed companies that were equivalent of 17% of the GDP (Sun and Tong 2003, 185).

Chinese authorities have been lauded for these market-oriented reforms. They

have been given credit for their flexibility and willingness to introduce “innovative” financial policies, such as the Qualified Foreign Institutional Investor (QFII) program that allowed large investment institutions with at least \$10 billion in managed assets, entry into the domestic equity market in China; or the 2005 reform of non-tradable shares, allowing the non-tradable shares (primarily owned by government entities) to be converted into tradable shares (Huang and Zhu 2011, 3). During this time, however, SOEs’ fraction of total equity market capitalization has actually *increased* from about 70 percent in the late 1990s to over 80 percent in the late 2000s (Table 4.2). The QFII legislation required a year holding period before profit repatriation (Huang and Zhu 2011, 8). When qualified foreign entities were in fact given a restricted entry into the Chinese stock markets, it was the SOEs and the regime insiders that benefited most. Finally, when the China Securities Regulatory Commission released guidelines for Chinese companies seeking foreign listings (primarily Hong Kong) in 1999, the rules were tailored for large state-owned companies (Waldmeir 2012).

Table 4.3: Capitalization of SOEs in China 1995-2007

Year	# of listed companies	Total Market Cap (100 mil RMB)	# of listed SOEs	SOEs Cap (100 mil RMB)	% share of SOEs
1995	311	3867	211	2826	73.1
1999	923	27974	626	19421	69.4
2003	1266	45255	928	37108	82
2007	1516	400409	936	332769	83.1

- Source: (J. Lee and OECD 2009)

In sum, the patterns of state control and the history of share issuing privatization in China correspond to the assumptions of the model. Authoritarian elites in China prefer to retain ownership of the most lucrative industries. Thus, even after the SOEs reforms

of the 1990s, over 60 percent of all shares were non-tradable (Pistor and Xu 2005, 188). Recent estimates suggest that various state entities own on average about 50 percent of outstanding equity, representing the largest category (K. Hess, Gunasekarage, and Hovey 2010, 269). The Party concentrates ownership in “strategic industries,” most of which (like natural resource exploration, telecommunications and heavy industry) are quintessential examples of specific assets (Evans and McMillan 2013). As the model anticipates, large government shareholding in China corresponded to companies’ valuation, especially when the SOE is affiliated with the central government (as opposed to local governments or state asset management bureaus) (G. Chen, Firth, and Xu 2009; Tian and Estrin 2008).

To sum up, despite the reduction of the state’s role in the economy over the past decade, the regime has been able to consolidate assets into several hyper-profitable corporations. Some liberalization of the capital account regulations in the 2000s went hand in hand with further corporatization of the SOEs, many of which were listed abroad and attaining record-breaking valuations. At the same time, the regime (save for the banking industry, which is a separate category worthy of its own study) has been able to shed responsibility for managing poorly performing legacy enterprises, while consolidating its hold on major specific assets.

1.3 Redistributive capacity in China

How does the Chinese regime go about calibrating political risks associated with openness? The argument developed in Chapter 2 rests on the notion that authoritarian governments rely on a mix of political repression and political exchange to navigate and assess the vulnerabilities brought about by greater openness in the

global age of economic interdependence. Historical legacies and institutional frameworks of redistributive capacity make it easier for authoritarian governments to stave off rebellion, because it resolves informational asymmetry between the rulers and the ruled. When redistributive capacity is an embedded and wide-reaching aspect of state-society relations, it allows the regime to share the proceeds of openness and protect politically restive segments of the public in times of economic downturns. Redistributive capacity (RC) includes not just the welfare state institutions, but also labor market and industrial policies related to employment, subsidies, and services delivered to the population. When RC is limited, but the economy is growing fast, nondemocratic regimes can rely on the delivery of higher incomes through aggregate economic growth. However, during economic downturns the only remaining instruments are *ad hoc* payoff schemes and repression, both of which imply greater uncertainty about the regime's political standing vis-à-vis the non-elites. My argument suggests that prior to deregulating especially the more volatile financial flows, the regime must be able to have a mechanism by which it can remove the uncertainty about its capacity to maintain order. In the absence of developed, rooted and systematically administered redistributive capabilities, authoritarian elites tend to be far more uncertain about managing political fallout generated by financial volatility, and therefore more cautious about greater financial openness. Recall, that in the model, the elites are worse off under financial openness even if they can put down a rebellion successfully.

The unparalleled scale of economic change that took place in China during the last three decades, and the sheer size of labor relocation between the rural and urban

areas have put immense pressure on Beijing to maintain political order. The implicit social contract that has sustained the rule of the CCP over the last three decades has been based on the promise of economic growth, industrial development and greater urbanization. In fact, the “Open Door” policies started by Deng Xiaoping were themselves intended as a vehicle of domestic economic and industrial transformation, a transition away from the failing, almost exclusively repression-based rule of Mao during the Cultural Revolution, towards a system that incorporated political exchange to a far greater extent.

Deng’s initial gamble and the “doubling-down” on marketization after the Tiananmen uprising proved to be wildly successful. There were 600 million fewer people living in poverty in 2005 than in 1978 (Shaohua Chen and Ravallion 2009). Per capita consumption of urban and rural residents tripled and quadrupled, respectively between 1978 and 1996 (Chow 2007, cited in Piovani and Li 2011, 81). Urban households’ incomes about doubled between 1988 and 2002 (Appleton, Song, and Xia 2010, 667). These are enormous successes, but the economic transformation also unleashed a number of governance challenges for the regime. In the cities, the richest 10 percent made 3.3 times more than the poorest households in 1992. By 2002, the ratio increased to 7.9. The Gini coefficient increased from .38 to .47 between 1988 and 2004 (Piovani and Li 2011, 81). In 2014, China surpassed the U.S. in measures of income inequality, which in certain surveys Chinese citizens rank as the top social challenge, ahead of corruption and unemployment (Woellert and Chen 2014). As this section demonstrates, the Chinese regime for the most part lacks the capacity to deal with these major social problems. Major social unrest under financial openness may

lead to massive economic turmoil, including capital flight and bank failures that would quickly spill into the real economy. Limited capacity to stabilize the economy under these conditions leads it to be cautious about greater exposure to mercurial global financial markets.

1.3.1 Social policy complications of “Socialist Market Economy”

Although the Communist rebels aimed to build Soviet-style institutions immediately following the 1949 revolution, Mao went on to denounce the Soviet “softening” of Khrushchev and Brezhnev just a decade later. If the Soviet Union, “offered all citizens a ‘blanket’ of social protection, whose thickness, however, depended on one’s professional status and industrial productivity,” the PRC left the vast majority of its population without a “blanket” of any thickness at all (Maltseva 2012, 109). While the Soviet economy underwent quick-paced urbanization and development after the Second World War, followed later by the establishment of a system of vast redistributive capacity; Mao brought devastation upon the Chinese society with the onset of the Cultural Revolution. From the days of the civil war, Chinese communist leaders have placed a premium on controlling urban areas, which in those earlier struggles for power had been dominated by Chiang Kai-shek and the Kuomintang. Between 1960 and 1978, there was essentially no rural-urban migration; in fact during the Cultural Revolution millions of urban residents were forcibly settled in the countryside (Whyte 2010, 8).

The Cultural Revolution was an economically and socially devastating experiment, but it is likely that by the onset of Deng’s reforms in 1978, China was a remarkably equal society, with little variation not only in income, but also “style of

dress, housing quality, consumer possessions, and other indicators of social inequality” (Piovani and Li 2011; Whyte 2010, 3). The initial economic reforms of the 1980s were likely “Pareto-improving,” allowing workers to take advantage of the new opportunities while still maintaining their connection to the SOEs and farm communes (Lorentzen 2013, 147). The reforms of the 1990s put an end to the “reform without losers” paradigm (Qian 2003), leading to major changes in the pre-existing state-society bargain, resulting in two major social problems. First, the export-oriented growth model was based on the use of abundant cheap labor, which implied large rural-urban population dislocations exacerbating the issue of population control. Secondly, the SOE reform of the 1990s nearly halved the state-employed labor force, which relied on these enterprises for many social benefits. In short, the turn towards the “Socialist Market Economy” in the 1990s further diminished an already limited redistributive capacity of the Chinese state, without any new welfare institutions being introduced in its stead.

The rural-urban divide and the surplus agricultural labor have been among the more pressing challenges faced by the CCP in the course of the economic transition. Before the start of Deng Xiaoping’s reforms, the urban Chinese workers were enmeshed in the “iron rice-bowl” system, whereby the state guaranteed certain protections to the industrial force, chief among them being guaranteed life-long employment (Wallace 2014a, 72). The other eighty percent of the population residing in the rural areas were subjected to what Whyte referred to as “socialist serfdom” in the agricultural sector (2010, 1). Given a relatively dormant citizenry, population control was manageable during this period. The Chinese regime has relied

on the household registration system (*hukou*) to exercise population control since 1958, but especially with the onset of the reforms of the 1990s. With the start of the reforms, Chinese authorities began implicitly allowing rural residents to move into urban centers, while denying them official status. These “floating populations” without urban *hukou* to this day continue to be denied access to government services in the cities. In fact, harassment of the internal migrants is one of most commonplace examples of human rights violations in China today (Appleton, Song, and Xia 2010, 668; Wing Chan and Buckingham 2008, 583). In some export-oriented cities, the rural migrants often constitute 30 percent of the actual population (Whyte 2010, 17). Meanwhile, while cities struggle to deal with millions of incoming peasants, as “... villages became places of concentration of the unemployed and the underemployed” (Whyte 2010, 12). Both of these features of transition have been sources of tremendous instability, leading to higher chances of protest activity. At the same time, as Wallace has argued the *hukou* system proved to be a kind of “loophole” out of the Faustian bargain of urban-biased development, allowing for greater social stability than likely would have been the case in the absence of population controls (Wallace 2014a, 73).

While the urban-rural migration is an issue an order of magnitude greater, reforms of SOEs and the accompanying labor dislocation present an important problem as well. Research from all over the developing world suggests that urban residents have an easier time organizing protests and are generally more endowed with social capital to voice their concerns (Marston 2003; Wallace 2013; Walton and Seddon 1994). The 15th National Congress of 1997 called for the restructuring of the

SOEs (many of which were facing difficult economic times), with one of the chief priorities being the reduction of the state-employed labor force. During this period, large numbers of urban SOE employees were placed on furloughs, but also continued to receive about 20 percent of their regular wage in lieu of unemployment benefits (Price and Fang 2002, 416). While this is not dissimilar from the Russian case, the sheer size of the non-SOE employed labor force in China is on a very different scale from Russia. Even during the 1990s, when the SOE-employed labor force was at its peak, it only constituted about 43 million workers. These workers accounted for about two thirds of total industrial employment in China. By the mid-2000s, the number of SOE-employed workers was down to only about 15 million (L.-Y. Zhang 2004, 2032). Overall, labor force participation in urban areas declined from 71.2 to 63 percent between 1998 and 2007 (Gustafsson and Quheng 2011, 3). Some estimates suggest in the course of the shift toward the “socialist market economy,” the number of state-employed workers was reduced by as much as 40 percent (Naughton 2007, 105).⁵⁹

These enormous societal changes have exposed the regime to acute vulnerabilities. The surplus of labor generated by the SOE reforms and fierce competition from cheap rural labor pouring in from the countryside led to increased instances of protests and social disturbances (Whyte 2010, 15). According to the numbers released by the Ministry of Public Security, incidences of popular protests

⁵⁹ Although self-defeating on the surface, the choice to reform SOEs at the expense of urban industrial workers could be a rational tactic from the standpoint of the Party. First, cities are the bedrocks of economic growth in China that perpetually experienced labor shortages, leading to (illegal) rural-urban migration. In other words, Party leaders were reasonable in thinking that laid off workers would easily find alternative employment. Second, the regime had favored urban centers at the expense of the country for decades. The SOEs reforms corresponded with a shift away from this approach – a change that included the introduction of new agricultural subsidies (Wallace 2013, 632).

have increased from 8,700 in 1993 to 87,000 in 2005 and to 180,000 in 2010 (Fewsmith 2012, 3). The rise in protest activity was directly related to serious deprivations, even “sustenance crises” among laid-off workers, pensioners and other vulnerable groups (F. Chen 2000; S. Hess 2010; Hurst and O’Brien 2002). In notable contrast to Russia, China “has no safety net for retirees,” making pensioners (individuals with lots of freed up time and a history of political activity during the Cultural Revolution) an especially potent source of protest activity in the future (Hurst and O’Brien 2002, 348, 360). At the same time, repressive mechanisms, like the *hukou* continue to be used as the main mechanism for stability maintenance in China.

Lacking stable, broadly embedded mechanisms of political exchange, the Party has been creating *ad hoc* solutions to respond to mounting social instabilities. One of them has been the decentralization of stability maintenance to the local level. The 2005 National Petition Regulation and 2008 CCP proclamation on integrated security management codified this approach in law (C. K. Lee and Zhang 2013, 1483). In the absence of a redistributive mechanism, Chinese localities have developed a system of “buying stability” or *huaqian mai pingan*, translated as “paying cash for peace.” Lee and Zhang report that the district governments in Beijing operate “stability maintenance funds” reaching into tens of millions of RMB (2013, 1485). Meanwhile, the Public Order Administration Office set up by the Ministry of Public Security revealed it spent 701.8 billion Yuan (about 111 billion USD) in 2011 to fund all the public order administration missions (*Wei wen*), exceeding the national defense spending for the first time (2011 National Public Expenditure Budget, 2011). With the rise of protest activity in China over the years a “gray market” for “petitioner-

interception, security contracts, and payoffs” has developed on the local level (Xu and Li 2011).

Given all these realities, regime stability in China largely depends on repressive tactics and economic growth to a far greater extent than Party likely prefers. This meant that the Chinese elites had fewer mechanisms to signal regime strength, leaving it in a weaker position if financial openness policies were to be implemented in full. According to one Beijing-based analyst, “controls are an extension of the Party’s approach towards managing domestic political life. They avoided political crises by means of political repression, and economic crises by means of financial repression.”⁶⁰ It is clear, however, that the Party has started to recognize the limitations of repression-based approach. Starting in the early 2000s, Beijing began implementing new social welfare reforms, expanding the reach of its redistributive capacity at about the same time as it began experimenting with the more volatile forms of financial flows.⁶¹ Still, these changes have been relatively modest, largely because economic growth has been so robust. However, there are limits to stimulative macro policy and top-line growth as mechanisms of maintaining the social pact. Navigating welfare and foreign financial policies in the future will require elaborate political maneuvering made even more difficult by the fact that the two policy realms are intricately connected.

2. CONTRASTING KAZAKHSTAN AND RUSSIA

This section contrasts the history of financial openness of Russia and

⁶⁰ Interview No 20 (financial analyst). Beijing, China, November 2011.

⁶¹ I review some of these more recent developments in the concluding chapter.

Kazakhstan since the break-up of the Soviet Union. Equally endowed in specific assets and having inherited identical redistributive capacity,⁶² the two states nevertheless differed in patterns of regime control over specific assets. The Kazakhstani regime did not give up control to domestic actors, as was the case in Russia. This, I argue, allowed the leadership of Kazakhstan to move towards financial openness quicker, opting for a higher-risk strategy of exposure toward global financial markets. The difference in levels of regime control was largely accidental, having to do with Kazakhstan's previously underdeveloped mineral base. In Kazakhstan, state-owned corporate structures partnered with transnational oil companies (TOCs) to develop these resources. Subsequently, the regime put in place openness policies that allowed for asset exchange and diversification. Because the economy of Kazakhstan is comparatively small and its financial markets underdeveloped, the regime made special accommodations for the leading state-owned companies to list on foreign exchanges, to make site-specific assets under the regime's control more mobile and hence raise their valuations.

Kazakhstan's political regime – having been able to combine openness and integration into the global financial markets with “political stability” maintained by means of continued dominance of a small elite – is a quintessential example of an “open economy, closed polity” model. President Nursultan Nazarbayev has been leading Kazakhstan for nearly 30 years. He became the Chairman of the Council of Ministers in 1984, First Secretary in 1989 and was elected President by the Supreme

⁶² The two countries also had roughly similar industrial profiles at the start of the transition. Industry accounted for 28% in Kazakhstan and 39% in Russia; while services made up 43% of Kazakhstani and 47% of Russian GDP (Aslund 2001, 37).

Soviet in April of 1990. Nazarbayev was supportive of the continuation of the Soviet Union in the form of a loose federation. In fact, Kazakhstan was the last among the republics to declare independence (Elliot 1993, 1245–46). In 1992, Nazarbayev was elected president by a popular vote while running unopposed, a pattern that has repeated itself during the last two decades. Kazakhstan has been consistently classified as an authoritarian regime since the early 1990s, nearly a decade before Russia made its authoritarian turn.⁶³ In April of 2011, with 95 percent of the vote Nazarbayev was re-elected for yet another 5-year term (IMF 2011, 4).

Similar to Russia, Kazakhstan retained an industrial economic profile, redistributive capacity and a legacy of state-run enterprises. However, in contrast to Russia, which was mired in political crises and conflicts over asset-ownership throughout the 1990s, the Kazakhstani regime was able to deliver a stable political environment almost immediately after independence. During this time, the government implemented several important reforms, emerging as one of the more open economies in Central Asia, while earning high praise from international financial institutions, global credit rating agencies and pro-free market think tanks. Kazakhstani companies were among the first to take advantage of foreign listings, while this Central Asian economy became the undisputed regional leader in attracting foreign direct investment in the extractive industries and debt financing in the banking sector (Kasera and Katz 2007). As I show, the Nazarbayev regime adopted a liberal approach

⁶³ Voice and Accountability has ranked it on par with Iran and Cameroon (Kaufmann, Kraay, and Mastruzzi 2009). Polity project has ranked Kazakhstan at -3, -4 and since 2002 -6 on the scale of -10 to +10, which the score it has assigned to China for the past two decades (M. Marshall, Gurr, and Jagers 2010).

towards financial regulation, especially after the state consolidated extractive industry holdings in the late 1990s and early 2000s. Furthermore, significant redistributive capacity allowed the regime to maintain political stability and push towards greater financial openness in spite of two distressing financial crises of 1998 and 2007-09.⁶⁴

2.1 Financial openness in Kazakhstan

As I mentioned in section 3.5 of Chapter 2, due to limitations in data coverage and varying country-contexts, I craft approaches to measurement specific to each case. Standardized quantitative indices that include Kazakhstan paint a conflicting picture. The KAOPEN index by Chinn and Ito (2008) and CAPITAL index by Quinn and Toyoda (2008) display no changes in capital account openness in Kazakhstan since independence until late 2000s, ranking it as a relatively financially closed economy, on par with countries like Laos, Equatorial Guinea and not at all different from neighboring Uzbekistan and Turkmenistan.⁶⁵

However, even a cursory examination of the area-studies literature, World Bank and IMF reports from the last twenty years shows that these rankings fail to capture changes in Kazakhstan's financial policies, and how significantly they diverged from other post-Soviet republics. Kazakhstan's approach to economic reform, foreign economic policies and development of its industry differed unambiguously from the reform paths taken by Russia, and certainly in Uzbekistan and Turkmenistan. In fact, regional specialists have developed a small literature

⁶⁴ The crisis in Kazakhstan commenced in late 2007, well before the Lehman Brothers bankruptcy in the United States and the onset of the Global Financial Crisis in the fall of 2008.

⁶⁵ CAPITAL ranks Kazakhstan consistently at 25/100 (1992-2006) and KAOPEN at -1.14 (1996-2008). Heritage Foundation, however, ranks Kazakhstan as one of the regional leaders, ahead of Russia on the attributes of financial, investment and business freedom (Heritage Foundation 2007).

favorably comparing reform outcomes and policymaking in Kazakhstan against its Central Asian neighbors and Russia (Blackmon 2007; Cook 2013; Domjan and Stone 2010; Kalyuzhnova and Nygaard 2008; Luong and Weinthal 2010; Maltseva 2012). Unequivocally, this literature sees Kazakhstan as having adopted a more open framework towards investment, tax and banking legislation than did Russia or other Central Asian states.⁶⁶

More specifically, qualitative evidence collected from interviews and reports in the local press during my fieldwork contradict the picture painted by the quantitative indices of financial openness that include data on Kazakhstan. Interviewees consistently reported that Kazakhstan “took a quicker and more decisive approach towards financial reforms than Russia,” especially with the goal of accommodating foreign investors.⁶⁷ To that effect, one interviewee pointed out that the “banking and financial system more broadly, developed earlier and faster [in Kazakhstan] than, say, in Russia. Local banks began adhering to international practices, like the Basel I and II accords, far ahead of Russia.”⁶⁸ At minimum, the extent to which these field reports contradict cross-national indices calls for a more careful examination of financial openness policies in Kazakhstan. In reality, as I demonstrate in this section, Kazakhstan deregulated financial flows a few years ahead of Russia.

⁶⁶ For example, in describing Uzbekistan’s policies Barisitz notes: “Whereas other CIS countries, notably neighboring Kazakhstan, continued to broadly liberalize their economies... Uzbek authorities have not relinquished some essential remnants of the old...” (2007, 146).

⁶⁷ Interview No 13 (financial industry professional). Almaty, Kazakhstan, September 2011.

⁶⁸ Interview No 16 (former government official with experience in regulatory oversight). Almaty, Kazakhstan, September 2011.

Finally, even though Kazakhstan is a sizable regional economy, its GDP is less than one-tenth the size of Russia's and one-fiftieth of China's economies respectively. The degree of financial development tends to be limited by the size of the domestic markets and is especially difficult under the conditions of high inflation (Boyd, Levine, and Smith 2001; Claessens, Djankov, and Klingebiel 2001). For these reasons, financialization of specific assets at first took place through a different path, which nevertheless demonstrates that the Kazakhstani regime was able to open the economy earlier and more decisively than Russia for reasons having to do with its ability to maintain political stability through redistribution and its approach to diversifying and raising the value of specific economic assets.

Consequently, in evaluating financial openness policies in Kazakhstan over the last two decades, like in other cases I look at the government-sanctioned *de jure* policies towards the more volatile flows of capital. In the case of Kazakhstan, where the local stock market until very recently lacked liquidity, I focus especially on regulations on foreign borrowing, including rules for debt issuance listing of Kazakh companies on foreign exchanges – the two primary means by which foreign capital entered the Kazakhstani economy for the past 20 years.

Like other post-Soviet transition economies, Kazakhstan at first struggled to develop a robust financial system. Between 1992 and 1995, Kazakhstan's economy went through a period of hyperinflation that at one point reached 3,000 percent, while the country's GDP declined by as much as 35 percent. This initial period of contraction was characterized by the emergence of the so-called "pocket-banks" (numbering 179 in 1994) that profited from lax regulatory framework and economic

instability, chiefly taking advantage of currency fluctuations (Uyanik and Segni 2001, 101). During this three year period, more than a quarter of existing banks (45) went into bankruptcy (Durand and Fonteyne 2001, 208).

The Banking Act, Act on Securities Trading and the Decree on Insurance were passed as early as 1993. The national currency, the *tenge*, was introduced in the fall of that year. Interbank market began functioning in 1995. Although the National Bank of Kazakhstan (nation's Central Bank or NBK) had formal institutional independence starting in 1996, Nazarbayev made its personnel accountable directly to the office of the executive.⁶⁹ Substantial trade liberalization was accomplished by the first half of 1995, when all export quotas and import licenses were abolished (Akimov and Dollery 2008, 83). Kazakhstan was among the first post-Soviet republics to do so (Blackmon 2007). By 1998 inflation and the dollar exchange rate were stabilized (Barisitz 2007, 68).

After the initial tumultuous transition period, the government focused on establishing an attractive regulatory framework to bring foreign financing in order to develop the oil and gas industry. For example, the 1994 foreign investment law established “national treatment” of investors, creating “one of the most favorable conditions for FDI in the former Soviet Union” (Meyer and Pind 1998, 8). The law included unusually specific clauses for investment protection and dispute arbitration (OECD 1998). The Tax Code passed in July 1995 was deemed “among the most

⁶⁹ Similarly, when in 2004 banking supervision was transferred to a newly created Agency on Regulation and supervision of Financial Markets and Organizations (FSA) – it was also made accountable directly to the President (Barisitz 2007, 144). Reading of secondary literature and interview data suggest that the regime prioritized financial regulatory policy from the transition's start.

comprehensive pieces of tax legislation in the former Soviet Union” by the Center for International Private Enterprise (Suhir and Kovach 2003, 4). According to the legislation, the number of taxes collected was reduced from 49 to 11 (Blackmon 2007, 361). The “Law on Oil” (1995) and the “Subsoil Code” (1996) specifically aimed to attract investment in this sector (OECD 1998, 117). The *tenge* became fully convertible on the current account in 1996 (Blackmon 2007, 356).

The Russian financial crisis of 1998 produced significant spillover effects for the Kazakhstani economy, but the consequences were not as devastating as some would have predicted. As one observer put it “the Kazakhstani banking system was relatively resilient [in the face of the Russian crisis]. Enterprises’ competitiveness was adversely affected by the devaluation of the ruble, but banks’ portfolios did not immediately suffer an appreciable impact” (Barisitz 2007, 70). In marked contrast to Russia, where nearly all major private banks went bankrupt, the previously fragile Kazakhstani financial system successfully survived the crisis. The economy likely benefited from a series of timely banking regulations that were put in place in the mid-1990s, in large part as a response to the proliferation of banking failures earlier in the decade (Akimov and Dollery 2008; Uyanik and Segni 2001).

After the crisis, the Kazakhstani government managed to introduce new prudential regulations, including a high risk-weighted asset ratio of 12 percent. This reduced the number from a relatively low of 71 in 1998, to 48 in 2000.⁷⁰ Although

⁷⁰ One interviewee noted: “In Russia the financial system at least makes some money from the oil sector, whereas in Kazakhstan proceeds from oil go straight into the budget, so the financial system in Kazakhstan doesn’t benefit from the oil money” (Interview No 4). This could have been an early blessing for the economy, since the financial sector did not expand quick enough in the early years, so the consequences of the Russian financial crises were not felt as devastating as they could have been.

foreign banks were not allowed to open direct branches in the country, about one-third of all Kazakhstani banks in 2000 were foreign-owned (Barisitz 2007, 69; Durand and Fonteyne 2001, 210; Uyanik and Segni 2001, 101). In fact, the high market share of foreign banks made Kazakhstan an outlier among a group of “slow-reforming” FSU countries, like Russia, Ukraine, Belarus and Uzbekistan. Foreign-operated banks like ABN-AMRO and Almaty Merchant Bank boasted some of the best reputations in the country (Barisitz 2007, 38, 157). At the same time, according to an assessment by the World Bank, loose regulation on foreign borrowing and high dollarization of the economy put the economy at a “risk of external shocks,” as local banks had come to rely on foreign financing to fund a local credit boom, largely fueled by rising oil and gas revenues (Uyanik and Segni 2001, 102). As it would turn out, these warnings proved to be prescient.

The initial legislation of securities’ markets regulation was introduced in 1993, although trading did not commence in full until 1997, when the Kazakhstan Stock Exchange (KASE) opened. According to Akimov and Sollery, subsequent development of the KASE was directly connected with the so-called “Blue Chip Program” – a government program that aimed to privatize and list state-owned companies locally (2008, 86). In the midst of the fiscal crisis of the mid-1990s, the government with the encouragement of the IMF committed to restructuring 32 state-owned companies, but the program stumbled out of the gate. Lack of demand from local institutional investors and a slow pace of privatization, led firms – especially in the extractive industry – to exit the local market and opt for bond-issuance and/or list (or cross-list) abroad (IMF 2001, 25–26). By the year 2000, by one measure

Kazakhstan had the highest market capitalization of companies listed abroad in the CIS, measured as a percentage of domestic capitalization. Kazakhstan's ratio was .62, or more than 3 times the average of .18 for other transition economies. In contrast, Russia's ratio of this measure at this time was only .12 (Claessens, Djankov, and Klingebiel 2001, 116). The regime also began slowing the pace of privatization, as oil revenues increased in the late 1990s, alleviating the fiscal crisis and reducing the need for additional financing.

However, after the initial setback, the development of local pension funds and "increased interest from foreign investors" improved the liquidity of KASE and raised valuations. Between 2004 and 2006, "the volume of transactions and capitalization of the stock exchange skyrocketed, by seven- and twenty-five-fold, respectively" (Akimov and Dollery 2008, 86). Inflows of portfolio investment, however, were outpaced by debt flows. The Kazakhstani banking system in 2003 received better credit ratings from global rating agencies than did by-then recovering Russian banks. In fact, Kazakhstan's financial reforms of the 1990s resulted in it being the first among the CIS countries to receive investment grade ratings in 2002 (Akimov and Dollery 2008, 85). Kazakhstani banks began attracting foreign financing at a breathtaking pace. "By 2004, foreign liabilities accounted for 40 percent of total liabilities of the banking sector" (Barisitz 2007, 145). Cross-border lending tripped from 2003 to 2004, and then doubled again by 2005 (Barisitz 2007, 146). Higher financial openness in this earlier period would lead the regime to have an experience with a "downside" of openness in the form of the 2007 financial crisis. However, the bottom line is that on measures of control of risky inflows Kazakhstan was more lax and quicker to

deregulate than Russia, leading to increased valuation of specific assets controlled by the regime. According to one interview, although formal restrictions remained on the books, in practice full financial deregulation was complete by 2004.⁷¹

2.2 Control and value of assets

As a newly independent country, Kazakhstan came into possession of a huge, but underdeveloped natural resources base, including some of the largest deposits of oil, gas, chromium, uranium, iron ore and copper in the world (World Bank 1993, 130). In contrast to Russia, where oil and gas fields had been operational for several decades prior to the Soviet dissolution, Kazakhstan's asset-specific industry was in its infancy. The most promising deposits of oil and gas in the Caspian Sea were in need of enormous investments, due to outdated or lacking exploration and transportation infrastructure, extreme climate conditions and geography, as well as the high sulfur content of Kazakh oil (Palazuelos and Fernández 2012, fn. 2; World Bank 1993, 8). On the one hand, this placed the regime in a weak bargaining position vis-à-vis the transnational oil companies, leading the government to sign initially disadvantageous contracts, including full sale of development rights to major projects to foreigners. An ongoing fiscal crisis, falling oil production, low global prices of commodities and lack of financing alternatives led the regime to "assume a subordinate role in exchange for monetary contributions, including bribes and back payments" (Palazuelos and Fernández 2012, 29).⁷²

⁷¹ Interview No 14 (bond trader). Almaty, Kazakhstan, September 2011. By 2004 "capital movements were only being tracked for statistical purposes."

⁷² Indeed between 1991 and 1995, the oil production rate decreased from 570 to 430 thousand barrels/day (Palazuelos and Fernández 2012, 29).

On the other hand, as one of my interviewees suggested, counter-intuitively Kazakhstan may have gained from its lack of "technological expertise in developing, marketing and exporting."⁷³ A weak initial bargaining position incentivized the regime to develop a legal and tax infrastructure conducive to foreign direct investment. Laws on Investment, Government Procurement, Customs and Tax Code were all highly evaluated by international observers in the 1990s (Meyer and Pind 1998; OECD 1998; Suhir and Kovach 2003). By the late 1990s Kazakhstan would become a leading importer of FDI on per capita basis among the post-Soviet republics (Kalyuzhnova 2006).

Still, the initial approach to specific-asset base development taken by the Kazakhstani regime is unusual in the post-Soviet space (Luong and Weinthal 2010, see especially Ch. 8). By the early 2000s, foreign companies accounted for 75 and 79 percent of oil and gas reserves respectively and 80 percent of exporting capacity (Luong and Weinthal 2010, 265). However, with rising oil revenues and a more stable fiscal forecast, Astana began implementing a more onerous tax regime, as well as asserting an aggressive role to promote the state-owned KazMunaiGas (KMG). In an approach that would only later be adopted by Putin's regime, Astana made use of regulatory policies to pressure foreign companies to sell their holdings. In 2002, after being accused of environmental damage, Chevron (largest individual TOC-investor in Kazakhstan), agreed to pay a \$600 million fine. In 2004, environmental fines increased by 400 percent (Najman, Pomfret, and Raballand 2007). New revisions on the production-sharing agreements were passed, annulling previous tax exemptions on

⁷³ Interview No 17.

PSAs. A law passed in 2004 stipulated that KMG will assume at least a 50 percent stake in all future joint development projects with foreign companies. In 2005, KMG pressured the consortium exploring the Kashagan field to sell a 8.3% stake to the state-owned company. In 2007, through a similar maneuver KMG acquired another stake from Agip, creating a leading role for KMG in the Kashagan field development (Campaner and Yenikayeff 2008; Palazuelos and Fernández 2012, 32–3).

The Kazakhstani regime does not have as dominant a position over the extractive industry as does the Russian government today. However, unlike Putin, Nazarbayev had no *local* competitors for ownership, who could become political challengers. Instead, foreign companies were natural partners in maintaining political stability through a close relationship with the Nazarbayev regime. And while the regime initially had a minor position in the oil and gas industry, its ownership share has been rising steadily. Finally, Astana has maintained vast holdings in nearly all other major industries. By 2007, according to IMF's estimate the National Welfare Fund of Kazakhstan Samruk-Kazyna controlled nearly 45 percent of GDP, including holdings in mining, finance, energy, transportation, property and construction. By 2010 the share of state-controlled assets as a percentage of GDP rose to 56 percent (IMF 2011, 18). By contrast, state ownership in industries outside of the energy, banking and defense sectors have only been a recent phenomenon in Russia.

In 2006, KMG Exploration Production (subsidiary of KMG) was double-listed on KASE and the London Stock Exchange, floating about 40 percent of its shares and raising over \$2 billion, "making it the largest IPO in Kazakhstan's history" (White & Case 2006). During the boom years of 2005-07, Kazakhstani IPOs raised \$9.5 billion

on London Stock Exchange in contrast to Russian firms that raised over \$40 billion during this period (Kim 2013, 159). Considering that Kazakhstan's GDP is only about 7-8 percent of Russia's, fund-raising activities of the Kazakhstani firms on the global financial markets have to be considered impressive. The government also announced plans for the "People's IPO," that would give ordinary citizens a chance to purchase shares in state-controlled companies. The regime however plans to retain control over the most lucrative industries including the KMG and uranium miner Kazatomprom, only expecting to float 5-15 percent of the shares (Nurshayeva 2011). As interviewee noted, "the People's IPO is largely a boutique project to gain political support for the state's position against foreign companies."⁷⁴ In sum, the absence of local competitors for control throughout the whole transition process, and the gradual increase in regime ownership in the economy through the years, has gone hand-in-hand with financial openness policies.

2.3 Redistributive capacity

As former Soviet republics, Kazakhstan and Russia share the same legacy of redistributive capacity. This is a variable that does not "vary" between these two cases. In this section, I provide some background on the relationship between regime politics, economic stability and redistributive capacity in order to trace the argument again in a single illustrative case.

Kazakhstan succeeded in restructuring its welfare system by 1997, long before Putin initiated a similar reform in 2004. These efforts included monetization of in-kind benefits and a shift toward mandatory savings managed by pension funds. At the same

⁷⁴ Interview No 14.

time the regime determinedly increased social protections to the most vulnerable segments of society (Akimov and Dollery 2008, 85; Cook 2013, 8; Maltseva 2012). While there were initial declines in social protection payments (associated with the fiscal crisis and market reforms of the early 1990s), Kazakhstan's improving fiscal health and access to considerable redistributive capacity led to a massive spike in payments. To remedy the consequences of economic crisis of 1998, the government raised social expenditures to 7.9 percent of the GDP (compared to just .8 in 1995). Social spending remained high consequently, as unemployment peaked at 13.5 percent in 1999, but subsided to about 6 percent by 2007 as the Kazakhstani GDP steadily grew at about 10 percent per year (Akimov and Dollery 2008, 91; World Bank 2012). Remarkably, between 1998 and 2004, Kazakhstani social protections to the most vulnerable sectors of society became more generous than those delivered under the USSR (Makhmutova 2007, 110 cited in Maltseva 2012, 9). The United Nations Development Program singled out Kazakhstan as one of the most successful cases of poverty reduction (UNDP 2010). Between 1996 and 2004, the percentage of the population with consumption income below subsistence minimum was reduced from 34.6 to 16.1 percent.⁷⁵ The UNDP report however noted that "earned income remains at a level insufficient for a decent income," suggesting that most of poverty reduction came through redistributionist policies of the government (UNDP 2010, 11, 18). In other words, because of inherited redistributionist capacity, successful reform efforts and smaller population size, Kazakhstan today boasts an even more powerful system

⁷⁵ Similar sentiment expressed about quality of basic services in Interviews 13, 14, 17.

of redistributive capacity than Russia.⁷⁶

The Kazakhstani regime, in addition to being known as one of the more economically open in the region, is also widely recognized by the academic and policy observers as an example of what might be called “welfare authoritarianism.” Jones Luong and Weinthal show that Kazakhstan “has managed both to redistribute the benefits of foreign investment from the petroleum-rich to the petroleum-poor regions and to institutionalize limits on expenditures” (Luong and Weinthal 2010, 261). Kalyuzhnova notes that especially in the 2000s, the regime was eager to “pass the benefits of the oil boom to the population, [which] can be explained in part by a pre-emptive effort to defuse potential popular discontent” (Kalyuzhnova 2006, 597). Indeed, between 1999 and 2007, Astana increased public expenditures for social services, housing, transportation, and state employment from \$4 billion to \$25 billion. According to Palazuelos and Fernández:

“This extended network of territorial and social clientilism, very much favored by the country’s small population, at 15.5 million, increased the power stability of the elite led by Nazarbayev” (2012, 30).

In 2000, the Nazarbayev regime established the National Fund for the Republic of Kazakhstan (NFRK), which was based on proceeds from corporate taxes, royalties, and revenues from production-sharing agreements. Although three quarters of the Fund’s resources were appropriated for long-term investment, 25 percent was

⁷⁶ In 2014, Nazarbayev announced an initiative to partner with UN, World Bank and other international organizations to create a roadmap for poverty alleviation around the world, because “Kazakhstan needs to share its experience with others in the region” (TengriNews 2014a).

explicitly appropriated for economic stabilization (Kalyuzhnova 2006, 600). This planning proved to be prescient, as Kazakhstan was able to take advantage of the vast redistributive capacity and the accumulated “bonus of openness” to quickly respond to the financial crisis of the late 2000s.

The financial crisis in Kazakhstan began in 2007, a year before the shockwaves of the Lehman Brothers bankruptcy reverberated through the global financial system. Large inflows of foreign money fed a growing asset bubble, especially in the housing and construction sectors. As one regional specialist put it, the “country’s achievements in attracting foreign capital and developing its financial sector are now seen as a mixed blessing” (Bissenova 2009). By 2007, local banks accrued about \$40 billion in dollar denominated debt with a significant portion of it being in need of urgent refinancing (Laruelle 2008). With interest rates rising, the banks found themselves in double trouble, since they lent money to both the housing construction companies and financed mortgages of individual consumers.⁷⁷ In October of 2007, S&P downgraded Kazakhstan’s rating to minimum investment grade of BBB, due to high external private debt and excessive lending (Akimov and Dollery 2008, 85). With non-performing loans amounting for nearly one-third of all outstanding debt, the government was forced to issue a massive bailout of the banking system (Gorst 2013; IMF 2011).

As one financial industry professional told me in an interview, “one would have to reluctantly admit that financial openness has exacerbated the effects of the

⁷⁷ Interview No 14.

crisis.”⁷⁸ However, the regime was quick to use accumulated resources and broader redistributive capacity to mitigate the effects of the crisis. While the GDP declined by 13 percent in 2008, unemployment remained at 6.6 percent and declined further to 5.3 percent in 2012, after the public works programs were speedily implemented (World Bank 2012). An IFI official acknowledged in an interview, “the government is thought of as having done quite well in the aftermath of the crisis.”⁷⁹ All of this to is to suggest, that the Nazarbayev regime is clearly interested in using and maintaining redistributive capacity, in large part in order to continue to signal a willingness to share wealth and to stave off any potential challengers.

In short, while Kazakhstan was overexposed to global financial markets, which exacerbated the crisis, the regime quickly and effectively managed to mitigate any political destabilizing consequences of openness. Following a brief installation of capital controls following the crisis, Kazakhstan restored financial openness regime and has recently announced plans for additional IPOs of 103 state-owned companies during 2014-16. With exception of a few smaller assets, most IPOs will only float under 50 percent of the stake, retaining government control in many important industries (TengriNews 2014b).

3. ALTERNATIVE EXPLANATIONS

Authoritarian leaders sometimes choose to pursue international financial openness while maintaining a closed political and tightly controlled economic system

⁷⁸ Interview No 14. This particular individual was “reluctant” in admitting this, since he personally benefited from openness.

⁷⁹ Interview No 17.

at home. Clearly they do not do this out of an ideological affinity for liberal principles. In some cases, authoritarian regimes can be cajoled into capital account deregulation by international financial organizations that promise to provide temporary debt assistance, but this has not been the case for most emerging market economies at least since the early 2000s.

Instead, in order to address this question, I developed a risk-reward model of financial openness under authoritarianism. I have argued that even in the absence of domestic challengers for control over specific assets, authoritarian leaders see financial openness as a double-edged sword. On the one hand, with greater openness to inflows, state-owned assets become more tradable and therefore more valuable. On the other hand, financial openness exposes the economy to significant downside risks, which – most pertinently for the regime – would only be exacerbated by political instability. My aim has been to demonstrate that autocrats with access to extensive redistributive capacity are more likely to deregulate capital flows. As I showed in Chapter 3, this is what occurred in Russia after the regime gained control over asset-specific industries.

Conversely, as I demonstrate in this chapter, limited redistributive capacity prevents the Chinese regime from being able to assure political stability into the future, relying instead on *ad-hoc* payoffs and repressive tactics. The regime rationally calculated that an outbreak of political instability under financial openness would produce more damaging consequences than whatever gains greater inflows might promise. In Kazakhstan, the ruling elites are not as worried about the downsides of openness, because through highly developed and deeply-embedded RC they can

maintain political stability well into the future.

By situating the policymaking calculus of the elites within a set of international and domestic opportunities and constraints, my theory offers a new perspective on comparative political economy of authoritarianism. This approach provides a more elegant view of authoritarian politics by focusing less on political structures, like parties, parliaments or patrimonial networks and more on state capacities that allow for stable modes of political exchange between the regime and citizenry. In fact, the nature and extent of these domestic structures and capacities inform the decisions of authoritarian leaders with respect to engagement with the global economy. In the following pages, I address several alternative explanations of financial openness policies in authoritarian regimes.⁸⁰

3.1 Role of ideas and norms

IPE scholarship on financial globalization has identified a variety of channels through which processes of construction and socialization of norms as ideas influence politics and policymaking (for review see Rawi Abdelal 2009; Chwieroth and Sinclair 2013; Nelson 2014). This is an important and influential school of thought. However, it is difficult to construe predictions about the timing and the extent of financial openness policies from approaches that emphasize the role of ideas and norms.

Consider the Chinese case.⁸¹ Some scholars argue that China practices a

⁸⁰ I focus especially on the Chinese case here, which due to the size of its economy and attendant implications for broader international order has attracted an outsized amount of scholarly attention. Alternative explanations specific to the Russian case are addressed in the Conclusion of Chapter 3.

⁸¹ I am not aware of scholarship that directly tackles the relatively narrow research question of this dissertation from a constructivist angle, so I mostly infer from related work on trade, currency internationalization and systemic implications of China's economic rise.

unique and independent approach to foreign policymaking, because of its “strong national identity” and self-image of a civilization with a special place in the international system (Carlson 2008; Wang 2010).⁸² Other constructivist scholars argue that China’s approach towards foreign economic policymaking has changed significantly since Mao, and they attribute these changes to a process of socialization occurring through both domestic and international channels (Chin 2012; see review by Q. K. Wang and Blyth 2013 for a thorough discussion). But China’s approach towards international economic integration has not been consistent through time or across policy arenas. Beijing has been reluctant to embrace financial openness, but quite eager to facilitate trade openness. China’s quick accession to WTO makes little sense, if Beijing indeed paved a special and unique approach to international development that is based on prudent caution and a “long view” of history.

Similarly, scholarship that has argued in favor of the “personnel is policy” approach (Chwieroth and Sinclair 2013; Nelson 2014) cannot explain variation in outcomes among China, Kazakhstan and Russia. Since the 1990s, Nursultan Nazarbayev has been able to simultaneously advance a pan-Eurasianist agenda, pro-Western foreign investment policies and fund one of the most generous stipend programs for Kazakhstanis interested in pursuing Western education (Cummings 2003). Among the Russian technocratic elites, there are almost no Western-educated policymakers – a fact that did not lessen the regime’s resolve to pursue “liberal” financial openness policies (Gabuev and Nikol’skaya 2014). At the same time,

⁸² Of course, Russian elites subscribe to their own version of unique “Eurasianist” civilizational identity that purports manifest destiny (Tsygankov 2007).

Western-educated policymakers are well-represented in the higher echelons of Chinese technocratic elite (C. Li 2005).⁸³ If graduate training in economics in the West makes one an unabashed fan of deregulated finance, Chinese authorities ought to have removed controls on cross-border flows long ago.

Undoubtedly, even a cursory look at the history of Chinese politics over the last thirty years suggests that ideas have played a key role in informing policy debates inside the Politburo (Huang 2008; McGregor 2010). However, we still lack a deeper understanding of exactly how social construction affects outcomes or sustains old paradigms in China. In part, this is because scholars do not have an accepted baseline model against which constructivist theories might be evaluated. My theory provides a streamlined model of policymaking under authoritarianism, based in materialist interests and institutional constraints. This approach can serve as a starting point of a basic theoretical framework against which the role of ideas in authoritarian politics can be further explored.

3.2 Financial openness, regime type and political institutions

Scholarship that focuses on the role and consequences of political institutions for the capital account policies in the developing countries is vast, and I do not have the space here to address all its variants. In fact, my theory is largely about institutional constraints in authoritarian settings, as my focus on inherited redistributive capacity places my explanation squarely within this school of thought. I

⁸³ Examples include Yi Gang (Ph.D. University of Illinois in economics) and Liu Mingkang (MBA, London University, 1987). Mr. Yi is the director of the State Administration of Foreign Exchange and Deputy Governor of the People's Bank of China. Mr. Liu is the Chairman of the China Banking Regulatory Commission (See, Li (2005) for further discussion).

am not aware of other work that directly enlists expressly institutionalist explanations to account for variation in openness policies *among* non-democratic regime. Scholars who have studied other aspects of policymaking under authoritarianism have often emphasized the role of institutional constraints and, relatedly, of authoritarian time horizons (Bayulgen 2010; Hankla and Kuthy 2013; Q. Li 2009; Joseph Wright 2008a, 2008b). In fact, differences in institutionalization of power have been shown to have an inverted U-shaped relationship with policy uncertainty (Kenyon and Naoi 2010). Can differences in authoritarian institutions other than patterns of state control and redistributive capacity explain the variance in financial openness policies of China, Russia and Kazakhstan?

As Gehlbach and Keefer point out, “institutions in non-democracies vary in the extent to which they prevent power from being concentrated in the hands of a single individual or ruling clique” (2011, 1). Several studies, in fact have found that political parties and legislatures can be helpful in constraining the authoritarian rulers (Gandhi and Przeworski 2006; Gehlbach and Keefer 2011; Joseph Wright 2008a), which instills confidence in both domestic and foreign investors. One study, in fact, specifically attributed successful development of local stock markets in China to administrative governance structure of the Communist Party that provided continued incentives for local competition (Pistor and Xu 2005).

Yet, if more politically institutionalized authoritarian regimes produce greater confidence in both domestic and foreign investors, we ought to expect elites in these polities to be less concerned with managing volatility associated with capital account deregulation. For example, a long-standing authoritarian regime like China would be

expected to be less concerned with sudden stops of short-term flows, while the Putin led regime – presumably operating under far shorter time horizons – would be expected to be more cautious about economic volatility produced by greater exposure to globalized finance.

Another important shortcoming of the extant institutionalist theories of authoritarianism is their exclusive focus on institutions as mechanisms of intra-elite bargaining, at the expense of institutions as instruments for political exchange with the broader citizenry. Undoubtedly legislatures and parties play a crucial role in mediating bargaining between different interest groups with varying preferences over policy outcomes. However, once the intra-elite coordination problems are resolved, the regime still has to worry about threats it faces from the broader population. In other words, authoritarian rulers still have to rule. My research adds to efforts to delve into the problem of political exchange in non-democracies (Dimitrov 2009; Li, Liu, and O'Brien 2012; Lorentzen 2013). Redistributive capacity, when available, can play a key role in allowing the wealthy elites to signal their willingness to share the proceeds of openness during good times and to mitigate economic downturns.

Undoubtedly, the focus on “the regime” or “the wealthy elites” is a way to usefully simplify complex political realities, and in doing so my model overlooks intra-elite politics. However, there is also substantial evidence that in all three cases – despite the differences in political institutions – the elites can be thought of as a group of actors with similar economic and political interests. For example, with the development of new private wealth in China, the Party began making efforts to coopt the *nouveau riche* into the existing political fray, strengthening the “party-state-

business” nexus (Breslin 2012; A. Walter 2014, 169). In 2002, the CCP opened membership to private entrepreneurs, ostensibly to give people with business experience a chance to advance political careers (Ma, Ma, and Tian 2013, 320). In 2004, the PRC formally recognized private property rights in its constitution for the first time in over half a century (Xu and Pistor 2005, 190). Other scholars have noted this trend. In their influential analysis of corporate policies in emerging markets, Gourevitch and Shinn see China as a “striking case of the state as oligarch” or, perhaps, “edging towards” an investor model in which the state plays a role of the dominant blockholder of “corporatized” SOEs (Gourevitch and Shinn 2005, 192). All of this suggests that the CCP has adopted characteristics of an oligarchic authoritarian regime that will make decisions about further financial opening based on the anticipated values of assets under its ownership and its calibration of political risks associated greater exposure to global economic volatilities.

It is also undeniable that the Kazakhstani political system is far more patrimonial, informal and patronage-based than either the Russian or the Chinese regimes. The very top of Kazakhstan’s elite structure is based on family connections to President Nazarbayev.⁸⁴ Especially powerful is the current favorite son-in-law, Timur Kulibayev who at various points headed state-owned entities, including KazMunaiGaz and later the parent structure Samruk-Kazyna.⁸⁵ As one specialist put in, “in Kazakhstan, ‘state run’ is somewhat synonymous with ‘owned by the family’”

⁸⁴ As one informant put it: The general shape of the economic system is that of a ‘holding’ system, with powerful groups usually oriented around specific families or ‘clans’” (Interview No 17).

⁸⁵ The previous favorite son-in-law was Rakhat Aliyev, who has been in exile in Europe since 2007.

(Marat 2007; O'Neill 2014, 5). Conversely, even efforts to sell state assets to foreigners were also described by one interviewee as being about “keeping it all in the family.”⁸⁶

In fact, the initial sale of oil rights likely involved large private payouts to Nazarbayev and his family members. In 2002, the Kazakhstani leadership admitted the President diverted “\$1 billion to a secret Swiss bank account in 1996... from the sale that year of a 20 percent stake in the Tengiz offshore oil fields to Chevron” (Baker 2002). In the 2000s, former state leaders of the United States and Greater Britain were implicated in nefarious lobbying of the Nazarbayev regime (Becker and Van Natta 2008). However, in recent years the blatantly corrupt dealing between the Kazakhstani government and foreign investors gradually evolved into more official and above-board business transactions between large global corporations, including all the proper trappings of credit ratings, foreign listings and annual shareholder reports. In the meantime, incidences of massive corruption in the top echelons of both the Russian and Chinese elites have been just as common (Barboza and Lafraniere 2012; Belton 2012). In all three countries, the lines between the interests of the elites, ruling party, and leading state corporations are becoming increasingly blurred. Despite their differences, the three regimes are far more alike than most political scientists believe.

3.3 Fragility of the Chinese banking sector

China's fragile banking system is said to be the Achilles' heel of the Chinese growth model (Walter and Howie 2012). State-owned banks dominate the financial system controlling over three quarters of all lending, with the bulk of these funds

⁸⁶ Interview No 15 (financial industry professional). Almaty, Kazakhstan, September 2011.

being directed to other state-owned entities through preferential arrangement (Shih 2004, 924). Coupled with the Party's policy of rewarding local officials for high growth, this has produced a massive problem of non-performing loans (NPLs). Beijing had to issue several rounds of bank bailouts since the mid-1990s. The true scope of the NPL problem is unknown, but according to one conservative estimate of China's own National Audit Office, local governments alone have amassed debt equivalent to about 27 percent of China's GDP by the end of 2010. Chinese policymakers have been keenly aware of the problem of non-performing loans for many years. Is it possible that the Party's concern about the fragility of the Chinese banking system cautions it against greater financial openness?

Before proceeding further, it is important to point out that even if the fragility of the banking sector is responsible for the slow pace of capital account deregulation in China, this alternative explanation is not generalizable. The Russian banking system was almost entirely wiped out during the crisis in 1998, and the Kazakhstani banking system was bailed out wholesale by the government after the Global Financial Crisis. Fragility of these banking systems did not prevent the respective governments from introducing and retaining financial openness. Furthermore, after a round of renationalization, the Russian banking system under Putin has been widely perceived as "backtracking towards a state-run credit system," with all the attendant consequences of credit misallocation (Vernikov 2009). But even focusing solely on the Chinese case, there are reasons to be dubious about the "fragile banking system" hypothesis.

First, it is not obvious that additional inflows of funds would be bad for the

Chinese banks. Foreign financing could ease the NPL problem, at least in the short term. Shifting from domestic to external lending would not resolve the fundamental problems within the system, such as the lack of competitors for the state-controlled banks (Pettis 2014; Prasad and Wei 2007, 445). But it would create an immediate solution that would work just as well if not better than other short-term patches, such as periodic bailouts. After all, Chinese banks continue to be considered as extremely attractive investment by foreigners. Troubles in the Chinese banking sector that persisted since at least the late 1990s, did not detract from record breaking IPOs of state-owned banks on the Hong Kong Stock Exchange (Yongding 2009).

Secondly, restrictions on capital flows and foreign ownership of domestic banking sector do not have to go hand-in-hand (Pepinsky 2013a). If the GFC and the Eurozone crisis produced any universally accepted lesson, it is that the dangers of poorly supervised direct branching ought to be taken very seriously (Hoffmann and Stewen 2012). In fact, if the Chinese authorities were concerned with the fragility of the banking system, they would be far more reticent to allow direct branches of foreign banks. Instead, since the end of the crisis, China has had fewer restrictions on foreign participation in the banking sector than Russia, having abolished restrictions on foreign branching in 2009 (Claessens and Marchetti 2013).⁸⁷

Thirdly and most importantly, even if the fragility of the banking system is what leads the regime to be reticent about financial openness, the underlying worry,

⁸⁷ Admittedly, foreign banks operating in China face various administrative hurdles, extended approval processes and license requirements.

presumably, has to do with the Party's inability to handle the consequences of a banking collapse. It is these second-order worries about the weakness of the banking sector that fundamentally underscore the regime's weakness in handling the consequences of economic downturn through the mechanisms of political exchange. The regime's reaction to the Asian Financial Crisis is illustrative in this respect. In the aftermath of the crisis, Beijing specifically feared capital flight, which put at risk its unstable banking system – by then already beleaguered by non-performing loans. Although *de jure* controls remained on the books, authorities went even further, sending “tens of thousands of auditors into enterprises and financial institutions” to track down illegal capital transfers abroad (Yongding 2009, 5). Later in 1998, strapped for liquidity, the four major state-owned banks received capital injections of RMB 270 million (Yongding 2009, 13-14). This two-pronged approach of using repressive mechanisms and massive bailouts only demonstrated the extent to which the regime lacks confidence about its ability to respond to economic downturns through political exchange. Counterfactually, were a robust redistributive mechanism to exist, the Chinese authorities would open fully, because it would insulate them from financial volatility.

3.4 Peculiarities of the Chinese development model

An important alternative explanation to the Chinese approach to the management of capital flows points to the importance of China's relative backwardness at the start of the transition. Perhaps the most prominent strain of arguments has suggested that the export-orientation of its development policies has required capital controls on short-term flows, and wide-ranging incentives for FDI

(Steinberg and Shih 2012). While this is certainly a key strain in Beijing's approach, it by no means has been the only source of the blend of Chinese financial openness policies. China indeed has some of most extensive legal incentives for foreign direct investment. But it also ranks at the top of the list of countries with the largest number of FDI *restrictions*, including limits on ownership and exclusion from many sectors and categories of assets. Additionally, there have been instances where the Chinese could have acted to support exporters, but did not, especially during the Asian Financial Crisis, when Beijing chose against devaluing the RMB. Finally, the size of domestic savings (approximately half a trillion dollars) is perhaps ten times larger than annual FDI inflows. If the Chinese were solely driven by a developmentalist agenda, they should have welcomed competition from foreign financial institutions that would incentivize the domestic financial industry to become more efficient and productive about allocating capital (Prasad and Wei 2007, 454-56). Emphasis on the development of exporting industries and promotion of foreign direct investment at the expense of other types of flows are important pieces of the puzzle. However, the focus on the benefits being accrued to the business-party elite, and the political risks associated with greater openness have come to play a more fundamental role in explaining Chinese financial openness policies.

Finally, it would certainly be shortsighted of any researcher to dismiss some fundamental differences in economic development, population size and economic structures of Russia, China and Kazakhstan. There are a number of more distant factors that determine a country's redistributive capacity, its economic profile and experience with global economic forces. My theory, which places the authoritarian

elites' concerns about political stability at the center of analysis, merely suggests some channels through which socioeconomic development can inform decision-making of rulers. For example, some fairly basic country characteristics, such as population size, make it extremely challenging for Chinese authorities to create protective welfare and labor institutions, even if the Communist Party had actually prioritized these issues for other reasons during Mao's rule. Still, by focusing scholarly attention on the Party's capacity to engage in political exchange with the broader population, this dissertation generated fascinating insights that advance the frontiers of our knowledge of authoritarian politics.

3.5 Considerations of national security

My theory has relatively little to say about the nexus of financial openness and security. In the Russian case, it is easy to discount security considerations, since greater financial openness only exposed the Kremlin vis-à-vis Western financial sanctions, most recently in Ukraine. If the Russian leadership had been primarily preoccupied with security matters, it likely would have been more conservative in its approach towards financial opening. Recent accounts of the evolution of Chinese financial policies, however, give prominent weight to geopolitical considerations (Cohen 2014; Kirshner 2014). And while my model provides a fairly comprehensive account of Kazakhstan's financial openness policies during the last twenty years, there were other important factors that were at play. The initial approach of selling development rights to foreign investors was likely driven by incentives that underlie the model: raising the value of the payoff to the elites while maintaining local control. In the absence of a functioning financial system coupled with an inability to credibly

commit against expropriation, the regime chose to give up control— but only and exclusively to foreign-based transnational corporations. This initial approach likely included international security considerations. Nazarbayev’s foreign security policy options were rather constrained by inherited industrial interdependence with Russia. As a result, foreign economic policy-making was squarely aimed at diversification. American and British companies were the first to invest in Kazakhstan, and to this day, the United States, the UK and Netherlands are the top three largest sources of investment (The Embassy of the Republic of Kazakhstan the UK 2014). Still, while security-based explanations add more insight into the Chinese case, it is difficult to see how these theories can be applied across a larger set of cases.

4. CONCLUSION

The theory that I have advanced in this dissertation, and applied to the financial openness strategies pursued by the Chinese or the Kazakhstani regimes in this chapter, suggests that authoritarian elites weigh the *pros* and *cons* of greater financial integration. On the one hand, authoritarian leaders aim to time the policies in such a way as to make sure they are the chief beneficiaries of openness. This makes control over specific assets crucially important. On the other hand, they are also mindful of potential downsides of greater openness. They calibrate changes in exposure to external financial risks with their capacities to deal with the political consequences of economic crises. Although my argument takes into account global market forces *and* dynamics of domestic politics, the bulk of the explanation traffics in the realm of politics determined by domestic power struggles over assets and redistributive institutions. At the same time, this approach adds a new perspective on

the internal politics of authoritarianism and their impact on foreign economic policymaking under the conditions of intensifying financial globalization.

This account of Beijing's reluctance to deregulate financial moves beyond the arguments that suggest that domestic political interests drive financial policy (Jiang 2014; V. C. Shih 2008; Steinberg 2014). My claim is that regime's structural constraints given its control over fixed assets and its redistributive capacity largely drive its approach to international financial integration. In this chapter I have argued that in the course of the transition, the Chinese leadership has weighed political stability against the interests of state-owned enterprises and private interests of Chinese officialdom – the so-called “business-party-state” nexus (Lardy and Borst 2013; Pettis 2013; Hongying Wang 2014). The record of foreign economic policymaking demonstrates that regime elites in China, just like their counterparts in Russia and Kazakhstan, were interested in retaining control over specific assets, preferring to raise their valuation through block-holding corporatization (L.-Y. Zhang 2006, 10). However, they abstained from full-scale openness to external portfolio investors because of concerns about maintaining political stability. Although I provide largely circumstantial evidence that connects domestic redistribute capacity and risk tolerance vis-à-vis external financial openness, it is an explanation that is certainly worthy of further study, since many competing hypotheses do not provide a fully satisfactory account. As two of the most astute observers of Chinese financial policymaking put it, “further research [is] needed to disentangle the competing explanation for this phenomenon” (Prasad and Wei 2007, 458). Financial openness is risky business, and we have to account not only for the interests of powerful interest

groups, but also understand the broader implications for political stability and durability of existing power structures.

The Kazakhstani regime opted for financial openness earlier than Russia because the gains from openness were vast; there were essentially no domestic actors who could use these gains to challenge the regime; and Kazakhstan maintained and even improved its already extensive capacity to redistribute wealth. In pursuing the openness policies the Nazarbayev regime was clearly concerned about maintaining domestic political stability through generous welfare policies, as the experiences of 1998 and 2007-09 crises attest. As one interviewee pointed out, so successful was the regime in combining redistribution with openness, that “if the Soviet Union was successful in integrating into the global economy, it would look like Kazakhstan today.”⁸⁸ Kazakhstan today represents a durable model of an economically open authoritarian state with a generous welfare system.

The next chapter concludes the dissertation by offering a summary of the argument and empirical findings. It also covers limitations and extensions, theoretical implications and avenues for future research. Additionally, it outlines several policy implications that could be useful for policymakers aiming to understand external financial policies in authoritarian settings more generally, and specifically with respect to the cases of Russia, Kazakhstan and China.

⁸⁸ Interview No 17.

CHAPTER 5

DISCUSSION AND CONCLUSION

The purpose of this dissertation was to explore the politics of financial openness in authoritarian regimes, both theoretically and empirically. During the last quarter-century, increasingly restive publics and globalized financial markets have made the task of governing authoritarian regimes far more complicated than ever before. Intensified international mobility of capital created immense opportunities for enrichment and further power consolidation, but it also made authoritarian elites more vulnerable to political challenges that some among them were better equipped to handle than others. Given these challenges, I set out to explore the answers to the following questions: Why do some authoritarian regimes opt for financial openness while others maintain financial closure? How are these decisions related to the tactics these regimes employ to remain in power? How does the nature of the asset base in the economy impact these decisions?

In the preceding chapters I developed a theoretical argument that endogenizes financial openness policies in a model that accounts for the profit opportunities of openness and the risks associated with increased economic volatility for the authoritarian elites. I argued that rulers evaluate the pros and cons of financial openness, weighing the potential increase in the value of specific assets they control against their capacity to maintain political stability. Greater financial openness is a “double-edged sword:” it can increase the value of specific assets, but it can also make the economy more susceptible to external crises. Regimes that are able to maintain political stability through redistributive policies in the face of financial volatility are

more likely to choose financial openness. I have argued theoretically, and demonstrated in the case studies of Russia, China and Kazakhstan, that once regimes control specific assets and possess redistributive capacity to maintain political stability, they will deregulate financial flows.

1. SUMMARY

I began developing my argument by building a theoretical model that allowed me to specify the relationship between asset specificity, financial openness and redistributive capacity. My approach was based on four theoretical “building blocks” from recent scholarship on international capital mobility and the political economy of authoritarianism:

1. Regimes are equilibria outcomes of struggles over economic assets.
2. Greater financial openness alters the nature and value of those assets.
3. Financial openness multiplies the potential for both gains and losses for the regime.
4. Redistributive politics plays an important role in authoritarian regimes.

First, the model incorporated the idea that political regimes are defined by a struggle over the distribution and control of economic assets between two sets of actors: the wealthy and the poor. In authoritarian regimes, the leadership represents the preferences of the elite and excludes the poor from influencing their decisions over the distribution of assets. In this simple two-actor model, the “wealthy” and the authoritarian leadership constitute the same player, controlling the preponderance of assets in the economy.

Second, the theory posited that financial openness changes the value of assets

controlled by the regime. Building on tenets of transaction cost economics and recent scholarship by Freeman and Quinn (2012), I argued that financial openness could be used as a governance solution to the problem of site-specificity in authoritarian settings. By liberalizing the rules that govern the cross-border movement of capital, the elites are able to reduce site-specificity of assets they control and therefore increase their value.

Third, while greater financial openness can increase the value of assets controlled by the regime, it also exposes the economy to greater volatility of global financial markets – volatility, which the regime cannot control. Lessons of financial crises in Latin America, Asia and Russia in the 1990s demonstrated that exposure to the internationally mobile capital could reveal deep domestic political vulnerabilities of governments in the developing world. Financial openness, then, is a gamble on the part of the regime.

Fourth and finally, I have argued that autocracies will deregulate financial flows in the face of these downside risks when they possess significant redistributive capacity (RC). Nondemocratic regimes “preside” over states with varying RCs. “Redistributive capacity” is the capability of the state to use labor market and welfare institutions to provide employment, social benefits, subsidies and welfare services to the population. Greater RC allows the regime to rely more on instruments of “political exchange” as opposed to repressive tactics. RC is not the same as the total *size* of government spending, but rather it reflects the *capability* of the state to deploy its resources to deliver social protections, including employment, in-kind benefits and pensions to the population, including the most vulnerable and politically engaged

groups, such as pensioners, students and the urban industrial workforce.

Before proceeding to summarize the results of the empirical work, I'd like to first assess the theoretical assumptions upon which the theory was constructed. How useful were these simplified postulates of how authoritarian politics work? In the course of my research, I found these simplifications to be both useful and most of the time, quite accurate. I found qualified support for the first postulate of my theory, and a great deal of support for the latter three. In Russia and Kazakhstan, greater financial openness raised valuations of state-owned companies to unprecedented levels. Both regimes also saw the values of flagship enterprises plummet, and broader economies thrown into deep recessions, during the most recent global financial crisis.

Authoritarian regimes with sizable redistributive capacities were less concerned with political instability under financial openness – and these expectations proved to be correct. In the aftermath of the Global Financial Crisis, both Russia and Kazakhstan were able to respond quickly to share broadly some of the resources accumulated during the years of high global commodity prices and thereby preserve political stability. Neither Kazakhstan nor Russia faced large scale political instability directly related to the crisis. The experience of the crisis did not lead either regime to reintroduce controls on capital flows. In fact, both took steps to further deregulate financial flows in the years following the GFC. The Chinese leadership, lacking in redistributive capacity, relied instead on the repressive *hukou* system to expel tens of millions of unemployed workers in the urban centers following the crisis (Wallace 2014b).

The notion that authoritarian elites control the preponderance of assets in the

economy was a crucial part of my argument. In my study of Russia, China and Kazakhstan, however, I did not find evidence in support of the notion that authoritarian elites fear democracy, or any other alternative political regime, out of a concern about higher tax rates or fear of giving up control of assets to the poor. In the short term, struggle for control over assets is an intra-elite affair. In post-2003 Russia, Kazakhstan since its independence and China since 1978, the political elite (be they Nazarbayev's family, Putin's "silovarchs" or the top echelons of the CCP) had a firm grip over large portions of the economy. Whatever changes and perturbations occurred *within* the elite, the fact of their control over assets did not change. The politics of the 1990s Russia were to a great extent defined by struggles over assets among the elite, and it is one of the reasons that many specialists resisted classifying this period as properly autocratic, despite Yeltsin's blatant usurpation of power. The state was a prized possession that various factions used to advance their interests. However, once Putin and a small trusted cadre of his associates excluded private asset holders from politics in 2003-04, Russia became a fully consolidated authoritarian regime that followed the predictions of the model in its external financial policymaking.

Instead, insofar as the conflict between the rich and the poor matters for politics in nondemocracies, it is manifested in the regime's fear of political instability. Political instability can severely degrade the value of regime-controlled assets under the conditions of financial openness. In the worst-case scenario, it can result in far more fatal consequences for the elites than merely higher taxes. My theory, then, is most applicable to cases of robust authoritarian regimes, where "the rich" have already won the conflict, and where they have the means to prevent a successful revolution,

but their ability to maintain political order is not ironclad.

The fourth building block of my theory, concerning redistributive capacity under authoritarianism, yielded the most promising theoretical insights. What matters is not *whether* a regime can maintain political stability, but the *means* through which they are able to do it. Fundamentally, dictators are politicians. In the short term, they rely on a variety of mechanisms to maintain political order; to manage, give support, repress and persuade the average citizen. Dictators care about preserving political stability and expanding the reach of their power. To this end, they employ a variety of tactics, including holding façade elections, constructing dominant parties, and grooming semi-independent courts and other institutions to gather information, signal willingness to compromise with opponents, and to control mid-level bureaucracy.

My contention is that redistributive capacity can give the regime a stabilizing apparatus unlike any other. The advantage of redistributive capacity lies in the fact that its reach and magnitude is *common knowledge* among the population and the elites, which means that it affords a level of predictability. RC, by its very nature, is a mechanism that assures stability. The elites can actually take credit for uninterrupted social services and stable employment. It is a way by which a nondemocratic regime can credibly commit to sharing wealth, something that scholars of political economy of authoritarianism and democratization have often overlooked.

The elites are always interested in keeping the population quiescent, but this is especially true in financially open autocracies. In these regimes, the elites have to not only survive a rebellion, but they also have to prevent one from even commencing to begin with. In the model, if the Poor rebel, the Wealthy are worse off under the

conditions of financial openness than under the *status quo* of closure. Because of informational asymmetry in the game, the Wealthy have to devise ways to signal strength in order to preclude the Poor from rebelling. The size and reach of RC is common knowledge among the population, a deeply embedded part in the social pact between the government and the governed. It is rooted in long-standing historical legacies, and experienced by the population continually through regularized welfare payments, industrial and employment practices. In the model, RC represents a mechanism that removes information asymmetry in the game, which uniquely differentiates it from other means of keeping order, such as repression, *ad hoc* payouts or xenophobic rhetoric. Informational asymmetry is problematic for even a “strong” regime, flush with money and supported by well-trained security services and the military. In the presence of high value of specific assets controlled by the regime, RC becomes indispensable in signaling the regime’s willingness to “share” the proceeds of openness and therefore mitigate potential political instability.

The model yielded this primary “umbrella” proposition, which was supported by the bulk of evidence presented in Chapters 3 and 4:

Hypothesis 1: High value of specific assets controlled by the regime (“bonus of openness”) and redistributive capacity are both necessary for an authoritarian regime to initiate policies of financial openness.

This umbrella proposition yielded three more specific hypotheses about the behavior of authoritarian regimes with respect to financial openness.

Hypothesis 2: If the “bonus of openness” is low, high capacity for redistribution is not sufficient for openness.

I did not find a great deal of support for the hypothesis that the size of the “bonus of openness” bears a major influence on the decision-making of the elites. This condition only applied to pre-2003 Russia. In Yeltsin’s Russia, low valuations of specific assets played an important role in domestic politics, but this influence was likely channeled through other avenues. Had greater financial openness been introduced in the mid-1990s, it would have raised the value of specific assets, even under the conditions of relatively low global prices of commodities. The regime itself, however, would not have been the primary beneficiary at that time. I found only tenuous support for the notion that the size of the “bonus of openness” drove the policies in the 1990s in Russia. Rather, the politics of control over assets between the state and private economic actors had more influence on the external financial policymaking.

Hypothesis 2: Conversely, even if the “bonus of openness” is high, low capacity for redistribution will prevent openness policies.

My research found support for this hypothesis. The condition of low RC applied to the Chinese case study. The first part of Chapter 4 underscored the extent to which domestic vulnerabilities constrain Beijing’s foreign financial policies, even when there is considerable potential to raise valuations of state-owned companies. Underdeveloped redistributive capacity restricts Beijing’s policies in many important ways, and it is likely to play an even more important role as the Chinese population on

average continues to get older. As I identified in the discussion of alternative explanations in Chapter 4, there are a number of more immediate surface problems in the Chinese economy, including continued implicit transfers to state-owned enterprises, lagging growth in household consumption, and a fragile banking system. However, at bottom the CCP is concerned with these issues because – were they to unravel – the Party would be in a worse position to deal with the political fallout under the conditions of openness. Greater financial openness may increase the value of state-owned assets, and it may even be helpful in reducing domestic debt misallocation. However, it would also vastly increase economic volatility. My research suggests that the Chinese leadership, as of yet, has not developed mechanisms to peacefully resolve or prevent instances of instability through credible political exchange.

Hypothesis 3: When the regime's control over the assets is tenuous, policies of financial openness are less likely to be instituted.

The post-Soviet cases of Russia (both under Yeltsin and Putin) and Kazakhstan confirmed the importance of control over assets. My research on Kazakhstan led me to conclude that an authoritarian regime may be jealous in guarding control over assets from domestic rivals, but quite eager to allow foreign corporation to own enormous stakes in the asset specific economy. Even though the Nazarbayev regime sold majority stakes in large development projects to foreign investors, Astana faced virtually no domestic competitors for asset ownership. Across the case studies, greater financial openness accompanied the increasing role of the state in the asset-specific economy.

2. LIMITATIONS AND EXTENSIONS

While the dissertation makes important contributions to several literatures, my research also has a number of limitations. Financial, organizational and temporal constraints always force researchers to make difficult choices – choices that open some avenues for inquiry, while closing others. My work is not an exception to this rule. In this section, I outline some of the major shortcomings of the project, and offer extensions and suggestions for future research that could remedy these limitations.

2.1 Generalizability

My empirical research was limited to four cases: pre-2003 Russia, post-2003 Russia, China and Kazakhstan. While these are important countries in their own right, further work will be required to test the generalizability of my claims to a larger set of countries. It is also important to note that while the cases varied on the parameters of interest, case selection was biased towards countries that (1) share a state-socialist past; (2) have no prior experience with financial openness; (3) are fairly developed; (4) are fiscally solvent; (5) do not require assistance from the IFIs; (6) are not part of Western international security institutions. For instance, all three countries share histories of total governmental control over all economic assets. Future research should explore to extent to which this unique “Second World” legacy of the determined the patterns and outcomes observed in these cases.

One of the advantages of qualitative research is the relative flexibility it offers to deeply explore many dimensions of a given concept within a case. This is especially useful in the development of a new theory, as case studies provide an opportunity to sharpen conceptual definitions and to “reformulate our explanations of previously

studied events” (McKeown 1999, 174). This approach allowed me to conduct an initial exploration of the role of redistributive capacity in its relation to financial integration.

Although the argument was evaluated using only four cases, it could be extended to all on nondemocracies from 1991 until 2008, where the regime has some control over the specific assets. I identified about 37 low- and middle-income nondemocracies with an average polity score of 5 or less for which the CAPITAL measure is available (Quinn and Toyoda 2008). In future work, I hope to test my argument quantitatively across this larger set of cases.

Table 5.1: Larger Set of Cases for a Future Study

<i>Algeria</i>	<i>Malaysia</i>
<i>Azerbaijan</i>	<i>Morocco</i>
<i>Bahrain</i>	<i>Mozambique</i>
<i>Bangladesh</i>	<i>Nepal</i>
<i>Belarus</i>	<i>Nigeria</i>
<i>Cambodia</i>	<i>Pakistan</i>
<i>Cameroon</i>	<i>Russia</i>
<i>China</i>	<i>Saudi Arabia</i>
<i>Ecuador</i>	<i>Sri Lanka</i>
<i>Egypt</i>	<i>Sudan</i>
<i>Equatorial Guinea</i>	<i>Syria</i>
<i>Gabon</i>	<i>Tanzania</i>
<i>Georgia</i>	<i>Thailand</i>
<i>Iran</i>	<i>Tunisia</i>
<i>Jordan</i>	<i>Uzbekistan</i>
<i>Kenya</i>	<i>Venezuela</i>
<i>Kazakhstan</i>	<i>Vietnam</i>
<i>Kyrgyz Republic</i>	<i>Zambia</i>
<i>Libya</i>	<i>Zimbabwe</i>

The most pressing problem in such an endeavor would be to develop a reliable and uniform measure of redistributive capacity across a larger set of cases.⁸⁹ Researchers have only recently begun to identify differences in welfare states among the low and middle income states (Rudra 2007; Sharkh and Gough 2010). Higher spending might be directed to regime supporters, such as the military or co-ethnic groups, and therefore be a sign of a different political process. As Gough correctly points out, “welfare states may not be a necessary or sufficient condition for improved social welfare” (Gough 2001, 165). Conversely, as Nita Rudra notes, “leaders may very well engage in low (or decreasing) social spending while promoting illiberal welfare measures, such as public employment or labor market protections” (Rudra 2007, 380). Simply put, a measure of the *size* of government spending may not tell us much about its capacity to redistribute to the poorest segments of the population. These conceptual and measurement problems have so far prevented researchers from moving beyond the development of typologies of welfare states in the developing world. Instead of focusing on the “supply” side of redistributive policies, future work may profit from developing uniform measures of public attitudes about social services and labor protections across a wide range of low and middle-income countries. Further research on the role of domestic institutional constraints, like the extent of redistributive capacity, would give us a new insight into what Freeman and Quinn called the “the problem of authoritarian mass control” (2012, 75).

2.2 Sole focus on *de jure* policies

⁸⁹ Although there still exist significant gaps in data coverage of financial openness across the developing world, indices of capital account openness are abundant (D. P. Quinn, Schindler, and Toyoda 2011).

In designing and conducting research for this dissertation, I made a deliberate choice to focus on the *de jure* dimension of financial openness, and especially the regulation of short-term inflows. After all, the best way to understand how authoritarian regimes acclimate to the condition of globalized finance is to actually observe what they do, which means analyzing their policies. However, the extent to which financial policymaking can be effective in preventing or attracting capital flows remains a point of disagreement in the academic literature, and a source of controversy in policy circles (Binici, Hutchison, and Schindler 2010; Edwards 2007; B. Eichengreen 2001; Quinn, Schindler, and Toyoda 2010).⁹⁰ To what extent do the financial openness policies of authoritarian regimes actually affect the composition of flows?

My research has shown that both in Russia and Kazakhstan, greater financial openness led to higher inflows of short-term capital, which raised the value of specific assets in both economies. As I have demonstrated with the case study of Russia, in addition to raising the value of regime-controlled assets, official policies of financial openness served an important role in legitimizing leading state-owned enterprises like Gazprom or Rosneft on the global stage. At the same time, despite restrictions, Chinese markets experienced significant inflows of “hot” capital in the form of illicit flows in the year preceding the financial crisis of 2008-9. This only goes to show that a government could place tight restrictions on capital movements and attract more capital than even the most open economy during periods of explosive growth. High

⁹⁰ Recently, the IMF has come out in favor of using capital controls under limited circumstances (IMF 2012).

rates of return to capital can lure financial inflows despite the strictest official regulations.

However, enough preliminary evidence is available to suggest that capital account deregulation in Russia in 2006 had profound consequences for the composition of flows. Paramount among them has been the significant *legalization* of capital flight. According to data collected by Global Financial Integrity, during the 1990s and the early Putin years, illicit outflows constituted a sizable share of total capital flight. From 1995 to 2005 illegal outflows averaged 3 percent of GDP on annualized basis, but from 2006 to 2011 that number plummeted to less than one percent of GDP. Half of all capital flight in 2001 was unaccounted in official statistics, but only 10 percent of it was unrecorded a decade later (Kar and Freitas 2013; Logvinenko 2013). In future work, I plan to explore in greater detail the connection between illicit flows and regulation on capital movements in emerging markets.

2.3 Role of the middle class

Beginning with the model and continuing in the empirical chapters, this dissertation tracked the interaction of only two actors, the wealthy elites and the poor non-elites, leaving out the middle class. However, studies of political and economic development have long emphasized a crucial role of the middle class in bringing about and sustaining democracy (Moore 1993; Rueschemeyer, Stephens, and Stephens 1992). Financial openness policies do not have a clear and obvious influence on the political orientation and behavior of the middle classes (Gourinchas and Jeanne 2005). On the one hand, the ability to purchase foreign assets or to borrow at cheaper rates would be to their benefit. On the other hand, if the ruling elites can manage to

diversify their holdings away from country-specific risks, the potential of the middle class to influence politics in the future diminishes. This can make the elites more inclined to expropriate the assets of the middle class or use other means of repression (Dadasov, Harms, and Lorz 2013).

Following through with the logic of this argument those in the middle of the income strata appear to emerge as the biggest losers from greater financial openness in an autocracy with high redistributive capacity, like Russia. The elites can benefit from financial openness and the very poor can be placated with redistributive payments. Stability of this “pact” between the economically vulnerable lower classes and the top echelons of the ruling elites, can lead the regime to become more brazenly authoritarian. In some ways, this describes the motivating factors behind the middle class-based protest movement of the failed “Snow Revolution” in Russia in 2011-12 (Kramer and Herszenhorn 2011).

In the absence of the ability to “voice” their concerns, financial integration of autocracies like Russia can leave the members of the middle class (who are uninterested in being loyal to the regime) with few political options other than “exit.” This may have important implications for cross-national mobility of skilled labor. One of the more intriguing developments in emerging markets in recent years has been the growing popularity of the so-called “citizenship for sale” schemes. Many advanced Western democracies have initiated programs that allow foreigners to receive expedited residency in exchange for either direct payment or sizable investment (Bilefsky 2014). The list of countries offering such programs goes far beyond the small islands of the Anglophone Caribbean. It now includes the United States, Canada,

Malta, Spain, New Zealand, Ireland and a number of other countries. The cost to participate, while substantial, is often less than a price tag for an average apartment in Moscow, Tehran, Shanghai or New Delhi. It is possible that in the future, stable property rights regimes in Western democracies will emerge as their main global advantage. Exploring this topic further will make for a fascinating research project.

3. THEORETICAL IMPLICATIONS

Despite the many limitations, this project yielded a number of rich theoretical insights. The key takeaway of the model was that policy decisions with respect to openness, when considered endogenously, are informed by domestic considerations of authoritarian rulers, including most prominently, their capacity to use distributive policies to deal with political instability resulting from greater exposure to global financial markets. In developing this argument, this project offers a fresh look at authoritarian policymaking with useful implications for several literatures in comparative and international political economy.

3.1 Financial globalization and authoritarian rule

In a comprehensive review of this literature, Milner and Mukherjee acknowledged a lack of a theoretical framework by which scholars can analyze the effects of economic globalization on regime dynamics in developing countries. They called on scholars to develop new theories in order to address a need “to better understand the distributive consequences of international financial market liberalization” (2009, 176). This project is in part a response to this call to improve on existing theoretical paradigms.

As David Andrews argued in an influential 1994 paper, “the degree of

international capital mobility systematically constrains state behavior by rewarding some actions and punishing others” (1994, 197). International capital mobility (ICM) as a systemic force has only intensified since the early 1990. According to most *de jure* measures there has been a clear secular trend towards greater openness in most of the developing world (Kose et al. 2009; D. P. Quinn, Schindler, and Toyoda 2011, 500). Similarly, although the timing of the *de jure* policies differed among my cases in significant ways, in the longer term, the financial policies of China, Kazakhstan and Russia are trending towards openness. The destination appears to be the same, even the pace of openness varies and the routes taken differ.

Once their financial accounts are fully liberalized, these autocracies will confront significant additional constraints on their policymaking both in the domestic and foreign economic arenas. These developments will create conflicting policy agendas between the political aims of the leadership, and increased pressures of ICM. My research suggests that authoritarian governments are keenly aware of the limitations that the international financial system imposes on them, but some are better equipped to handle these challenges than others. The most recent financial crisis only reaffirmed this point.

So far, the benefits of openness have outweighed the costs, certainly in Russia and Kazakhstan, but increasingly in China, as well. However, as these economies become more financially integrated, the costs of reversing these policies will increase. If during the last two decades, governments were able to affect the timing of their policies or limit the types of flows that enter their economy, in the future the policy space in the realm of monetary and external financial policies will be much narrower.

This will have important ramifications for inter-state politics among the great powers, most notably between China, its immediate neighbors and the United States (B. Cohen 2014; Kirshner 2014). However, in a larger set of authoritarian polities this will have first and foremost domestic implications.

These implications are numerous, but the most consequential one have to do with the inherent conflict between macroeconomic policy choices and the use of political exchange and repression. Greater financial integration significantly limits both macroeconomic policy options and dictators' use of outright repression. A battery of studies has found that imprudent management of debt or interest rates can result in significant capital outflows (Collier, Hoeffler, and Pattillo 2001; Cuddington 1987; Dooley 1988; Mikkelsen 1991). Similarly, various measures of political instability are negatively associated with financial turmoil and capital flight (Cerra, Rishi, and Saxena 2008; Le and Zak 2006). Leaders of financially open autocracies that are limited both in their capacity to use repression and employ expansionary macroeconomic policies, would have to find other means to assure political stability. My research suggests that redistributive capacity can aid the perseverance of a financially integrated regime facing this "double bind" of ICM. In the absence of RC in places like China, we are likely to see greater instability and/or new efforts to develop new social welfare programs.

3.2 Political economy of authoritarianism and redistributive capacity

My argument is based in the rationalist theories of authoritarianism. This line of scholarship suggests that regime outcomes "hinge on the distribution and nature of assets among individuals and on the political resources people bring to bear in the

solution of domestic conflicts” (Boix 2003, 235). My main contribution to this literature is to shift focus onto an overlooked “political resource” available to some authoritarian regimes: redistributive capacity, which in a counterintuitive twist, can serve to protect the rich from the poor.

This dissertation did not explain the origins of varying redistributive capacities among authoritarian regimes. In fact, I have treated it as a genuinely exogenous variable in the theoretical and empirical chapters.⁹¹ However, my work has established that (a) redistributive capacities matter for politics in autocracies, and (b) levels of RC vary across cases in meaningful ways. The redistributive models of authoritarianism and democratization are based on the premise that authoritarian regimes cannot credibly commit to redistribution in the future (Acemoglu and Robinson 2006; Boix 2003). In these models, democracy itself is seen as “a credible commitment to future redistribution, [in cases] when the promise of redistribution is not sufficient to stave off the threat of revolution” (Acemoglu and Robinson 2006, 36).

Building on the work of Ronald Wintrobe (1990, 2007) and others, my research suggests that redistributive capacity is key to the preservation of political stability in many important authoritarian regimes, precisely because it can serve as a mechanism by which the elites commit to redistribution without being subject to democratic accountability. Specialists on redistributive models of authoritarianism tend to think of redistribution in terms of overall government spending. I’ve suggested

⁹¹ One of the advantages of my approach is that redistributive capacity is fundamentally exogenous in all three cases: all three regimes inherited RC and limitations from a prior epoch. However, future research would do well to explore the sources and origins of varying redistributive capacities among authoritarian states.

instead, that a focus on institutional *capacity* could yield productive insights, since autocracies have maintained such capacities without necessarily expanding or abiding by full democratic franchise.

Findings reported in this dissertation also call for a renewed attention to what used to be known as the “Second World” of the state-socialist states. In a recent exchange in *Comparative Democratization*, Haggard, Kaufman, and Teo criticized Acemoglu and Robinson’s explanation of Bismarckian redistributive state. Acemoglu and Robinson suggested that redistributive policies in Germany could be attributed to the frequency and persistence of revolutionary threat from socialist movements. Haggard *et al* wrote in response that they were “hard pressed... to think of contemporary examples in which high capacity for collective action on the part of the poor was responsible for stable, redistributive authoritarian rule” (Haggard, Kaufman, and Teo 2013, 5). My research has identified Russia and Kazakhstan as potentially important examples of stable redistributive authoritarian rule. In fact, studying these cases further should help scholars of authoritarianism to gain better insights into why the poor might be considered a greater threat to the regime in some nondemocratic settings and not others.

Developed redistributive capacity, while requiring greater redistribution of wealth than the elites prefer, can be a force that stabilizes a regime. Contrast redistribution with another tactic that could be deemed a type of “political exchange” between the rulers and the ruled: nationalism. Authoritarian regimes (certainly, in the cases I studied, but also more broadly) frequently use nationalist rhetoric and xenophobic ideologies to retain popular support, weed out opponents and pursue

foreign policy goals (Cannady and Kubicek 2014; Weiss 2013; Zhao 2004). However, as all studies on nationalism and authoritarianism point out, the “nationalist card” is a dangerous one to play. First, when leaders call upon nationalist symbols, they necessarily *borrow* those signifiers from some episodes in the country’s past. These memories are important only so long they are shared and therefore cannot be attributed directly to the leadership. Secondly, patriotic fervor also has a short shelf life. Therefore, it cannot be a consistent source of regime support. Thirdly, and most importantly, nationalist protests are dangerous to the regime. Even when they are useful in achieving certain goals, they work for reasons having to do with their potential to generate *instability* (Weiss 2013, 2014). As my model suggests and numerous empirical studies confirm, financial openness only strengthens the already strong association between political uncertainty and capital flight (Cerra, Rishi, and Saxena 2008; Le and Zak 2006; Lensink, Hermes, and Murinde 2000). Greater financial integration only exacerbates the dangers of using nationalist protests or stoking xenophobia as a political device.

Still, it is important to remember that in studying nondemocracies, researchers should be wary of the “tendency to focus on the democratic-looking features of authoritarian regimes at the expense of, ironically, their authoritarian ones” (Art 2012, 369). Redistributive capacity is an institution useful only insofar as it helps to generate political stability and social compliance. Welfare and labor protection, in a country like Russia, while substantial, are still considerably less extensive than those available

even in the weakest Western welfare models like the United States.⁹² Additionally, while I have suggested that financial integration makes redistribution preferable to repression, this does not preclude the possibility of other ways to maintain political stability working better under different conditions. The extent to which financial integration influences the policy mix of political exchange and repression in autocracies will continue to be a fascinating topic for years to come.

3.3 Research on policymaking under authoritarianism

Scholars have written voluminously on a wide spectrum of topics ranging from the origins of authoritarianism (Acemoglu and Robinson 2006; Moore 1993; Mancur Olson 1993); categorization of its variants (Arendt 1986; Geddes 2003; Levitsky and Way 2010; Linz 2000; Schedler 2006) and the role of institutions - such as elections and courts - in the process of authoritarian longevity and downfall (Bunce 1999; Gandhi 2008; Hale 2005; B. Magaloni 2006; Smith 2005; Solomon 2007; Svobik 2011). These advances in the study of authoritarian politics have allowed us to look inside the “black box” of authoritarianism, producing new and important insights. However, many of these studies, willingly or unwillingly, adopted a teleological bias – even if for perfectly understandable reasons. Scholars have been most interested in figuring out either what makes dictatorships last or the reverse: what causes their breakdown. However, as Pepinsky put it, “authoritarian regimes do many things besides grow/stagnate and survive/collapse” (2013b, 20).

Moreover, we have learned from this literature that (a) most fallen

⁹² While the Russian welfare state is far less generous than any Western variant, it is one of the most generous in the FSU. For example, the promise of higher social payments likely won over the support of most Crimeans during the 2014 referendum to join Russia (Kramer 2014).

authoritarian governments tend to be replaced not by a democracy but by another autocrat; (b) single-party authoritarian regimes, like China, tend to be among the most long-lasting (Brownlee 2007; Geddes 1999; Hadenius and Teorell 2007). In other words, authoritarianism is here to stay for the foreseeable future, so more scholarly attention could be usefully diverted to the study of topics more seemingly pedestrian like the politics of redistributive and financial policymaking. This dissertation is an effort to do just that.

4. POLICY IMPLICATIONS

The findings of this dissertation point to at least two significant policy implications for governmental and non-governmental entities that are interested in gaining a better understanding of authoritarian politics in the context of globalized financial markets. First, the dissertation shed new light on the connection between the regulation of capital flows and the interests of the power-wielding elites in countries like Russia and China. For example, my research suggests that the United States' unique position at the center of the global financial system endows it with immense influence vis-à-vis autocracies, especially as they become more financially integrated.

While the rise of new economic powers poses new challenges for the West, the dynamism of the emerging market economies in the last decade depended on a functioning global financial system that is based primarily in the United States and Western Europe. Ironically, the Global Financial Crisis that originated in the United States, only increased the American financial power advantage (Eric Helleiner 2014). According to one recent estimate, United States, Europe and Japan account for about \$102 trillion of globally traded securities, while Chinese assets make up only about

\$0.3 trillion (The Economist 2014). State-owned and private companies from the rest of the world overwhelmingly prefer to do business, to raise capital, and to access the financial and legal institutions of the Western world. According to the calculations of Freeman and Quinn, as of 2008, “of the \$6.5 trillion in market capitalization value for the top 15 emerging markets, nearly 25% [were] traded in New York and not in the home market” (Freeman and Quinn 2012, 62). The American position at the center of global financial infrastructure has given Washington immense leverage in advancing its security objectives. It’s not surprising that according to recent reports, it was the U.S. Treasury Department, and not the Pentagon, that played the most pivotal role in the American response to the Russian annexation of Crimea (L. Goodman and Browning 2014).⁹³

The second important implication concerns the importance of the institutions of political exchange (as opposed the repressive apparatus) in nondemocracies, including mechanisms of redistribution. A deeper knowledge about redistributive capacity, for example, can be helpful in anticipating future challenges facing Communist Party of China, as it responds to the aging of the Chinese population. According to the United Nations data and KPMG projections, the working-age population of China will decline by about 20 percent between 2020 and 2050 (KPMG 2013). As growth rates continue to slow down, underdeveloped capacity to protect vulnerable segments of the population (the dislocated labor force and the elderly) will force the regime to make unpopular decisions. Even as I am writing these words, there

⁹³ Western officials are certainly not immune from influence of large corporations and individuals be their domestic or foreign, as recent scandals in the United Kingdom suggest (Hopkin and Blyth 2014; Shaxson 2011).

are new reports of increasing protest activity in China due to the economic slow down (China Labour Bulletin 2014). *Ad hoc* payoff schemes and repression can serve only as temporary patches. Inability to deal with these issues more systematically will only contribute to the uncertainty about the regime's political standing vis-à-vis the agitated public.

Chinese officials have been aware of these mounting problems at least since the late 1990s. State sector reforms of that era led to new job insecurities in the cities and deterioration of access to services and education previously provided through communes (Cook 2002; Li and Zhu 2004). The Chinese state was so inadequate in certain aspects of governance that official unemployment statistics from that period were completely unreliable (Solinger 2001). Inability to account for the unemployed has even been cited among the reasons for the state's inability to institute an unemployment insurance scheme (Cai, Park, and Zhao 2008; Lorentzen 2013, 148). All of these major social issues have led the regime to pronounce (at least rhetorically) in 2003 a new strategy of development to "tackle China's social, ecological, and macroeconomic imbalances," by shifting attention towards social equity, with the aim of achieving "common prosperity" and a "harmonious society" (Piovani and Li 2011, 80). Just like rulers in other contemporary nondemocracies, the CCP uses a mix of repression and political exchange to stay in power. While early in the transition period the regime relied more heavily on repression, in recent years it has begun experimenting with a political exchange tactic of "social management" (C. K. Lee and Zhang 2013, 1483). Still, these efforts, when contrasted against the scope of the

overall problem, appear to be woefully inadequate.⁹⁴ My research suggests that China-watchers would be well advised to pay attention to the development of redistributive capacity in the coming decade.

5. FINAL THOUGHTS

While it is the folly of each new generation of scholars to describe the state of world affairs to which it is a witness as unique and unprecedented, there are good reasons to believe that the quarter-century that followed the end of the Cold War has rearranged world politics in a truly extraordinary way. Among the cataclysmic changes that occurred during this time, none has been more significant than the total triumph of capitalism over the competing forms of organizing economic production. Deng Xiaoping may have been right in saying that "it doesn't matter if a cat is black or white, so long as it catches mice." However, it is undeniable that that it is the "capitalism-colored cat" that almost exclusively "caught mice" in recent decades.

While the tide of economic globalization, especially in the Global East and South, has been the locomotive of change in world affairs in recent decades, progress in the political sphere has not kept pace. In fact, some of the greatest economic success stories of late have come from economies overseen by authoritarian governments. This is why some surveys show considerable support among, for example, many Indian and Thai citizens for more "decisive" policies practiced in neighboring China (Mishra 2012; Thomas 2014). Russians overwhelmingly prefer Putin's heavy hand to the chaos

⁹⁴ For example, Beijing has vastly expanded the provision of *Di Bao*, or the minimum living standard guarantee. Although initiated in Shanghai in 1993, the *Di Bao* system of social assistance did not get instituted in the majority of urban centers until 1999, when the number of recipients stood at only about 3 million. Between 1999 and 2008, the number of persons living in households receiving *Di Bao* increased from 2.66 million to 23.35 million (Gustafsson and Quheng 2011, 3–6).

of Yeltsin's democratization (Ostalki 2007). Since the onset of the Arab Spring uprisings in the Middle East and North Africa, the revolutions disappointed even the grimmest pessimists. All of this suggests that scholars of political economics have a lot of work ahead of us.

The stakes are only rising. If we can arrive at a better understanding of the interplay between global economic forces and political development in low and middle-income states, there is chance that we can avoid big mistakes in the future. If we fail, our discipline will further cede the stage to populist fervor. Globalization has been a force for good, but it has also served to advance the agenda of dictators. We especially have to be on guard against the danger that the rise of multinational, but state-controlled corporations would further strengthen regimes with open economies and closed polities, and produce a bifurcated system in which – to paraphrase William Easterly (2006, 165) – the rich have markets and the poor have authoritarianism.

APPENDIX

1. MODEL BACKGROUND AND PROOFS

1.1 Background on the Boix (2003) model

Levels of inequality are exogenously determined at the start of the game. Let α be the fraction of the population that is poor, $(1-\alpha)$ - fraction representing the wealthy ($\alpha > 1/2$), and K be the total capital stock in the economy:⁹⁵

$$K_p + K_w = K,$$

$$k_p = K_p/K,$$

$$k_w = K_w/K,$$

$$k_p + k_w = 1;$$

Hence, the capital held by a Poor citizen:

$$k_p^i = k_p/\alpha;$$

While a Wealthy citizen holds:

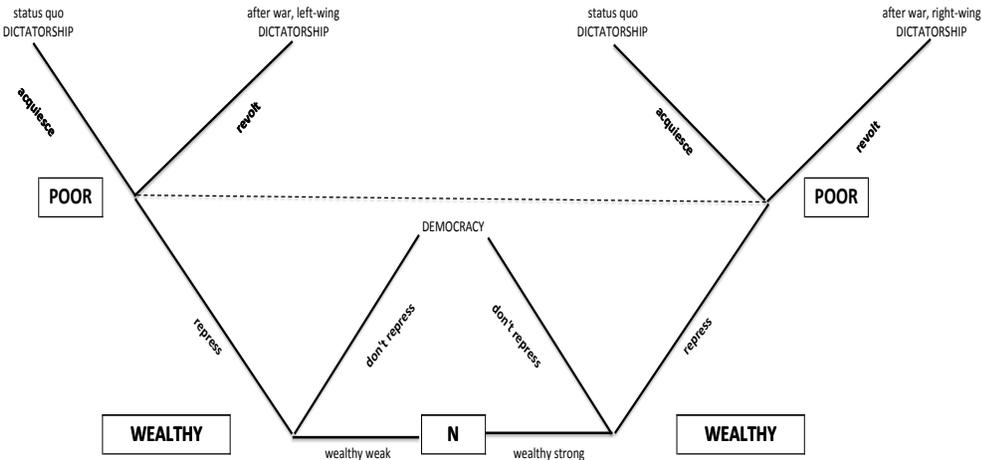
$$k_w^i = k_w/(1-\alpha).$$

The income of each individual is determined by capital endowment with constant returns alone, so that $y_j = k_j$ where $j = w, p$. Asset specificity is determined by the value of assets when they are transferred abroad. When capital is moved, it loses σ -portion of its value, so that capital k_h at home is worth $k_a = (1 - \sigma) * k_h$ abroad. The more “specific” are the predominant economic assets in the economy, the larger is the value of σ . For example, the economy of Saudi Arabia has a very high overall σ , and the Swiss economy has a very low σ .

⁹⁵ This set up follows Boix (2003), and by extension Meltzer and Richard’s (1981) theory of redistribution based on the positioning of the median voter.

Boix allows for four political states: authoritarianism (the wealthy exclude the poor from rule), communism (the poor rule, expropriating all assets of the wealthy), democracy (the median voter sets the tax rate), or revolutionary war (both parties incur costs, and the wealth they obtain depends on their respective strengths). Maintenance of an authoritarian regime requires expenditure on repression ρ , which is determined by “Nature” to be either high or low. The magnitude of ρ depends on the “organizational and technical means” of the Wealthy (Boix 2003, 26). When the cost of repression is low, the Wealthy are able to easily suppress an uprising by the Poor. The Boix model in extensive form is presented in Fig. 2.5 below.

Figure 6.1: Boix (2003) Model in Extensive Form



The game begins in the state of dictatorship, and the Wealthy make the first move after observing the levels of k_p^i and σ , and whether they are “strong” or “weak.” The median voter in a democracy sets the tax rate. The democratic regime taxes economic agents with linear tax τ , then it redistributes the revenue across all individuals equally, less the distortionary losses from taxation denoted by $\tau^2/2$

(Meltzer and Richard 1981, 916). The median voter maximizes the following income function:

$$y_p^i = (1-\tau) k_p^i + \tau - \tau^2 / 2;$$

Solving the maximization problem:⁹⁶

$$dy_p/d\tau = -k_p^i + 1 + \tau;$$

$$\text{Setting } dy_p/d\tau = 0;$$

$$\tau = 1 - k_p^i.$$

The “redistributive threat of democracy” drives the decision-making of the poor. For example, if the tax rate under democracy is low due to relatively moderate levels of inequality, and the cost of repression under dictatorship is high, the Wealthy will not repress the Poor, allowing for the emergence of democracy.

However, the decisions of the Wealthy are also subject to the capital mobility constraint. If they are better off transferring their wealthy abroad even accounting for losses due to the specificity of assets, the Poor will not be able to tax them under democracy:

$$(1-\tau) * k_w^i \leq (1-\sigma) * k_w^i;$$

$$\tau \geq \sigma.$$

The Wealthy are indifferent between paying taxes preferred by the median voter and moving capital abroad when $\sigma = 1 - k_p^i$. In order to keep the wealthy from moving capital abroad, the median voter in a democracy chooses tax rate:

$$\tau^* = \min\{1 - k_p^i, \sigma\};$$

⁹⁶ Second derivative $(dy_p/d\tau)^2 = -1$, so that in fact $dy_p/d\tau = 0$ solves for max.

When $\sigma < (1 - k_p^i)$, the redistributive threat of democratic tax rates is not menacing for the Wealthy, so they choose to not continue authoritarian rule, knowing that the Poor would have to choose σ as the tax rate under democracy anyway. If σ and $(1 - k_p^i)$ are equally high (as is the case in most modern authoritarian regimes where inequality is high and asset mobility is low), the Wealthy are compelled to repress the poor, generally leading toward dictatorial equilibria. In other words, when asset base of the economy is very country-specific, and inequality is high, the redistributive threat of democratic rule is credible, so the wealthy choose to expend resources on repression.

1.2 Democratization and Financial Openness

The model has novel implications, when lowering of asset specificity parameter binds the taxation decisions of the poor under democracy ($\sigma_N < 1 - k_p^i$); in other words, only when asset inequality is high. How plausible is this assumption? In authoritarian regimes with fairly high levels of inequality and country-specific wealth, even relatively small change in asset specificity $\Delta\sigma$ can alter the calculations of the poor. In an economy with high σ_I (assume $\sigma_I = .69$), the offer of $\Delta\sigma = .1$ from the wealthy may be binding on the tax rate under democracy. Let's consider an economy where "the poor" constitute 80% of the population and control 32% of the wealth.⁹⁷

$$k_p^i = k_p / \alpha = .32 / .8 = .4,$$

$$\tau^* = 1 - k_p^i = 1 - .4 = .6 \text{ (democratic tax rate);}$$

The income of the wealthy is $k_w^i = (1 - k_p)/(1 - \alpha) = .68/.2 = 3.4$, and so the democratic tax rate under this scenario would yield $\hat{y}_p^{\text{dem}} = .58$ and $\hat{y}_w^{\text{dem}} = 1.78$, implying a 45% boost for the poor and a 47% loss for the wealthy when the transitional regime is introduced (less the costs p of putting down the rebellion for the wealthy).

An offer of financial openness $\Delta\sigma = .1$ (given the initial overall openness of the economy of $\sigma_1 = .69$ and natural level of asset specificity $\sigma_N = .59$) would actually affect the democratic tax rate by 1%, lowering real after-tax income of the poor in a democracy from $\tau = .60$ to $\tau = \sigma_N = .59$. In other words, the wealthy elites in charge of an economy composed mostly of immobile assets would benefit from greater financial openness, because this would lower the redistributive threat of democracy.

Under a democratic tax rate $\tau = .60$, the wealthy will receive $\hat{y}_w^{\text{dem}}1 = 1.78$ and the poor $\hat{y}_p^{\text{dem}}1 = .58$. However, a tax rate just one percent lower: $\tau = \sigma_N = .59$, would yield the wealthy $\hat{y}_w^{\text{dem}}2 = 1.8$ (a 1.1% bump in income), while the Poor's income would be reduced to $\hat{y}_p^{\text{dem}}2 = .579$ (.16% loss). In other words, greater financial openness lessens the democratic threat for the Wealthy, making the hypothetical democracy more acceptable to them. Notably, changes in after-tax income with lower rates have disproportionate consequences for the Wealthy and the Poor.

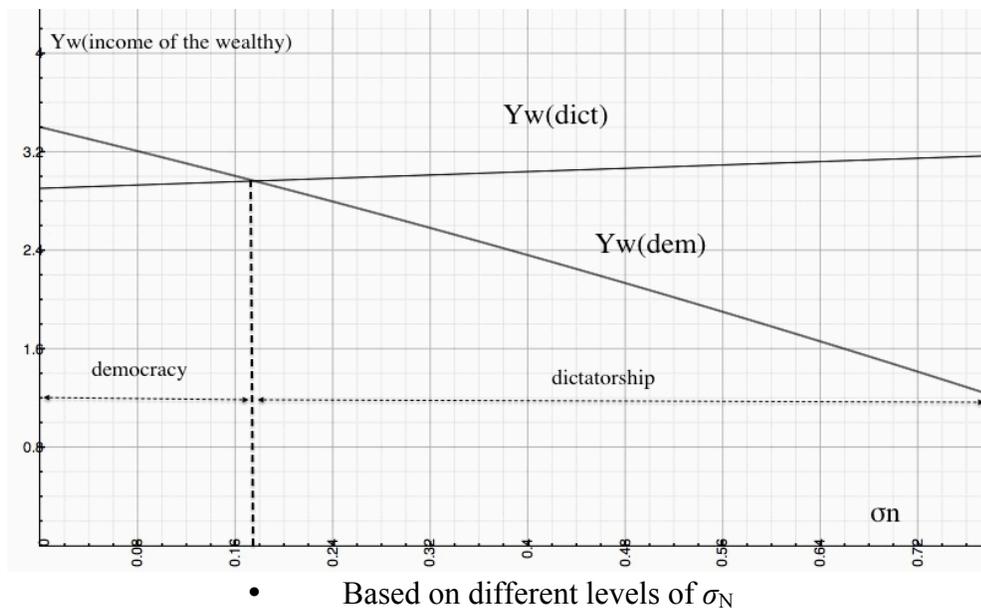
⁹⁷ The concept of inequality used here captures *asset* as opposed to *income* inequality. Countries where bottom 80% of the population controls only 32% of all *income* are essentially non-existent. Even in the most income-unequal countries, like Brazil, CAR, Honduras, Panama, Colombia bottom 80% of the population controls close to 40% of income. In China and Russia this number is in the range of 50-55%. However, we can be safe in assuming that levels of *asset* or *wealthy* inequality far exceed those of *income* inequality, suggesting $k_p^i < .5$ to be plausible. For the discussion of wealth vs. income inequality see especially Piketty 2014, who calculates that even in the industrialized economy

Still, a transition to democracy can only happen when levels of “given” asset specificity σ_N are very low. As Figure 2.6 demonstrates, the Wealthy will choose to “not repress” and therefore allow democracy when the following condition holds:

$$\hat{y}_w^{\text{dem}} > \hat{y}_w^{\text{dict}}; \text{ or}$$

$$[\hat{y}_w^{\text{dem}} | \tau^* = \sigma_N] > (1 + \Delta\sigma) * k_w^i - \rho;$$

Figure 6.2: Democratization Choice for the Wealthy



For what values of σ_N does the above condition hold? Consider the illustration in Figure 2.4 with the parameters I just described above ($k_w^i = .68/.2 = 3.4$; $\rho = .5$; $\Delta\sigma = .1 * \sigma_N$).⁹⁸

The comparative statics make clear that the wealthy will only select democracy when σ_N is low (in this case $\sigma_N < .17$). Doubling the costs of repression ρ from .5 to 1

the wealthiest 10 percent of the population control close to 95 percent of wealth.

⁹⁸ $\Delta\sigma = .1 * \sigma_N$ means the *de jure* change in asset specificity $\Delta\sigma$ is equivalent to a 10 percent change in the natural level of asset specificity σ_N

will move the intercept to only .34, suggesting that even when the costs of suppressing the poor become very high, in economies heavily endowed in specific assets, the wealthy will have an incentive to continue authoritarian rule (with or without financial openness).

1.3 Low redistributive capacity

Proposition 2

*A weak sequential “pooling” equilibrium with both types of wealthy picking FO and the poor choosing to “Acquiesce” occurs when the poor assign a belief that the wealthy are “strong” with probability $\pi > 1 - (k_p^i) / ([\hat{y}_p^{dem} | \tau = \sigma_N] - k_p^i * \phi * \sigma_N - \omega)$ ⁹⁹; and “weak” with probability $q > 1 - (k_p^i) / ([\hat{y}_p^{dem} | \tau = 1 - k_p^i] - k_p^i * \phi * \sigma_N - \omega)$ when they offer Status Quo and the poor Acquiesce.*

Consider the expected payoffs facing the poor, given that the nature picks the wealthy to be **strong** with probability π and **weak** with probability $1-\pi$.

When they *Acquiesce*:

$$EV_p (\text{Acquiesce}) = \pi * k_p^i + (1-\pi) * k_p^i * (1 + \phi * \sigma_N);$$

$$EV_p (A) = k_p^i + k_p^i * \phi * \sigma_N * (1 - \pi)$$

When they *Rebel*:

$$EV_p (\text{Revolt}) = (1-\pi) * (\hat{y}_p^{dem} - \omega) + \pi * (0);$$

Consequently *Acquiesce* is optimal for the poor when,

⁹⁹ They are indifferent when $\pi = 1 - k_p^i / (\hat{y}_p^{dem} - \omega)$, and prefer “rebel” when $\pi < 1 - k_p^i / (\hat{y}_p^{dem} - \omega)$.

$$EV_p (A) > EV_p (R),$$

$$k_p^i + k_p^i * \phi * \sigma_N * (1 - \pi) > (1 - \pi) * (\hat{y}_p^{dem} - \omega) - \pi * 0.$$

Solving for π , we have:

$$\pi > 1 - (k_p^i) / ([\hat{y}_p^{dem} | \tau = \sigma_N] - k_p^i * \phi * \sigma_N - \omega)$$

Otherwise, “Rebel” is optimal.

When do the wealthy choose *FO* given the poor’s estimate of π ? First, the payoff of the wealthy (weak or strong) after *FO*, *Acquiesce* exceeds any payoff for the wealthy of in sub-history *Weak, Status Quo*. When the wealthy are strong, they prefer *SQ* to *FO* if the poor rebel. Therefore, we need to make sure the poor *Acquiesce* instead of *Rebel* to offer of *SQ*, keeping in mind that in this scenario the democratic tax rate is $\tau = 1 - k_p^i$ (tax scenario 1, in Table 2). When do the poor acquiesce in *SQ*? Let’s assume the poor assign probability q to wealthy being strong, and $(1 - q)$ to them being weak. The poor acquiesce when $EV(A) > EV(R)$.

$$EV_p (\text{Acquiesce}) = q * k_p^i + (1 - q) * (k_p^i + \phi * \sigma_N);$$

$$EV_p (A) = k_p^i + k_p^i * \phi * \sigma_N * (1 - q)$$

$$EV_p (\text{Revolt}) = (1 - q) * ([\hat{y}_p^{dem} | \tau = 1 - k_p^i] - \omega).$$

“Acquiesce” is optimal for the poor when,

$$q > 1 - (k_p^i) / ([\hat{y}_p^{dem} | \tau = 1 - k_p^i] - k_p^i * \phi * \sigma_N - \omega).$$

1.4 No separating equilibrium

Proposition: *The game has no pure-strategy weak sequential “separating” equilibrium where the wealthy pick “openness” when strong, “status quo” when weak; and the poor believe with probability = 1 that they are in history*

“strong” when the signal is “FO,” so they “acquiesce;”
 and believe with probability = 1 that they are in history
 “weak” when the offer is “SQ,” so they “rebel.”

The Wealthy prefer *FO* to *SQ* when strong, only if the Poor acquiesce. If the Poor were to rebel, the Wealthy would prefer *SQ* outcome, since $\sigma_N * k_w^i < \sigma_1 * k_w^i$ (given that $\sigma_1 > \sigma_N$ by assumption). In other words, even if the Wealthy are strong, it doesn't follow they would opt for greater openness. Similarly, the wealthy do not necessarily prefer status quo when weak, since they actually pay lower taxes under the transitional regime after sub-history *Openness* ($\tau = \sigma_N$) than under sub-history *Status Quo* (tax scenario (2), where $\tau = 1 - k_p^i$). For a separating equilibrium to be sustained, the wealthy cannot be tempted to select openness when they are in fact weak.

2. TIMELINE OF IMPORTANT CHANGES IN FINANCIAL REGULATIONS

2.1 RUSSIA¹⁰⁰

1993-96

Russian Central Bank allows foreigners to set up two types of ruble-denominated accounts: one (T-account) for export-import activities and (I-account) for purchasing of currency in exchange for rubles and for repatriation of ruble profits (Katsman 1993).

In 1994 the Economist Intelligence Unit ranked Russia as the second riskiest country in the world to invest (after Iraq). Nonresidents allowed to purchase up to 10% of the issue of domestic treasury bills

Duma passed a law making Central Bank independent (chairman is nominated for parliamentary approval by the president) (Treisman 2012, p. 209). Another stock trading platform, the Russian Trading System (RTS), NASDAQ-like system was created. MICEX (previously a currency trading platform) licensed for equity trades launched in October of 1996.

1997-99

In March of 1997, Duma passes a law putting restrictions on foreign ownership of shares in telecommunications and energy companies. President decrees a 9% limit on foreign ownership of Gazprom capital (which could only be done through ADRs) Foreign currency position of commercial banks were limited to 20%, and only 10% for any individual currency.

In August of 1998 financial crisis breaks out. The CBR announced a 90 day

moratorium on the repayment of foreign loans by the 20 largest Russian banks, amounting to \$3.4B during this period (Johnson 2000, p. 216). Ruble devalued by 50%, foreign exchange trading on MICEX is halted. Most private banks go bankrupt. In October of 1998, new regulations on foreign currency trading were introduced. Exporters are now required to sell 50% of proceeds on MICEX. In January of 1999, Duma passes further restrictions in foreign ownership of Gazprom shares.

2000-2003

Putin elected in March of 2000. Government announced a broad program of liberalization, including tax reform (corporate tax rate cut from 35% to 25%), investor protection, and deregulation of rail and energy monopolies, banking and reform of the pension systems. Gazprom issues ADRs. Plans for full ruble convertibility announced. Ministry of Finance lobbies for a full opening of the Russian insurance market to European competitors, angering many Russian companies. EBRD announced a plan to issue \$150M ruble-denominated bonds. Mikhail Khodorkovsky, Russia's richest person and CEO of Yukos arrested.

CBR's reserves continue to expand; foreign investment continues to increase despite the Yukos affair.

2004-2007

In December of 2004, Rosneft bought Yuganskneftegas (Yukos's most valuable asset) from an opaque "Baikalfinancegrup" which previously bought the asset in a state-controlled auction (Treisman 2012, 95-95; Woodruff 2007). In 2005, government-controlled group Rosneftegaz bought 10.74 percent of Gazprom's shares for \$7.1

¹⁰⁰ Source: Bekaert and Harvey (2002), unless noted otherwise.

billion, increasing the government's stake in the company to 50 percent plus one share. Rosneftegaz was able to qualify for a loan of \$7.4 billion from a group of foreign banks, making it to-date the largest credit received by a Russian company (Derbilova et al 2005).

Trading Gazprom shares is liberalized. "A government decision in December 2005 to lift a ban on foreigners investing in the domestically traded stock fuelled a strong surge in Gazprom's share price" (Belton 2012).

As of July 1, 2006 the government no longer maintains any controls on the borrowing of Russian companies abroad, residents' purchases of securities abroad, or the purchases of Russian securities by nonresidents (Pervyj Kanal 2006).

Rosneft goes through an IPO. 15% of shares sold for a total of \$10.7 billion. The company, which was outside of top 25 Russian companies in 2003, was the second-largest company in Russia, valued at \$71 billion as of September 2010 (Poussenkova 2007).

2012

Government announces plans to allow foreign settlement of local government bonds (OFZs). "By enabling its locally issued treasury bonds - known as OFZs - to be settled through international clearing houses, Russia is in the process of sweeping away regulatory barriers that have kept most foreign investors away. The liberalization means that Russia will belatedly tap into an international fashion for local currency debt, which has mushroomed in recent years as investors seek out alternatives to the low yields on dollar bonds" (Reuters, 2012).

2.2 CHINA

1978-1983

State Council approved an administrative procedure for foreign borrowing by provinces and enterprises, requiring a long review process by the State Planning Commission, Foreign Investment Control Commission, and State Administration of Exchange Control. All earnings in foreign exchange were required to be kept at the Bank of China.

Joint ventures with operation plans of more than 10 years or whose earnings were reinvested in China were offered significant tax exemptions. In 1982, the Bank of China adopted a program of discounted foreign currency loans for export-oriented ventures and purchases of deficit raw materials (Prasad and Wei 2007, 462–4).

1983-82

In 1983, the State Council approved a series of new tax incentives for joint ventures in agriculture, energy, communications and education, along with some minor relaxations of exchange controls for joint ventures (Prasad and Wei 2007, 462–4).

In 1982, the State Council introduced a new initiative that would expand the SEZs to fourteen coastal cities starting in 1984 (Chinn and Ito 2011, 2). Foreign investors introducing advanced technologies would be taxed 10 percent (as opposed to the national rate of 33 percent). The State Council authorized the Industrial and Commercial Bank of China to provide lending in foreign currency to domestic and conduct transactions in foreign currencies in special economic zones(Prasad and Wei 2007, 462–4).

1985-88

In 1985, the Chinese Patent Law came into effect. China joined the Paris Convention

for the Protection of Industrial Property. First foreign bank branch since 1949 is opened Shenzhen (HSBC).

In 1987, new provisions regulations permitted joint enterprises with foreign income to guarantee foreign exchange obligations of other debtors, along with a new requirement to register external borrowing activities with the State Administration of Foreign Exchange (SAFE) (Prasad and Wei 2007, 462–4).

1989-1991

In 1989, the State Council issued new limits on commercial borrowing, which is to be channeled through ten state-approved entities (the Bank of China, the Communications Bank of China, the China International Trust and Investment Corporation, the China Investment Bank, and six regional investment corporations). Most notably short-term debt as a fraction of each total borrowing entity was limited to only 20 percent. State Administration of Exchange Control also issued new strict guidelines on Chinese outgoing foreign investment, requiring government approval, deposit of 5 percent of the total investment and earnings repatriation within six months (Prasad and Wei 2007, 462–4).

In 1990, the Shanghai Securities Exchange reopened, followed by the Shenzhen's Stock Exchange in 1991. The "B" shares, which only can be owned by foreigners, were introduced. B-share owners can collect dividends, but they do not have the right to influence the operation of the company (Bekaert and Harvey 2002).

In 1991, the National People's Congress further lowered the tax rates on foreign-funded enterprises and introduced new incentives for investment in the priority industrial sectors. In 1992, new policies made it easier to invest outside of the coastal

cities and the SEZs (Prasad and Wei 2007, 462–4).

1993-94

New regulations governing domestic investors are issued, but the laws governing foreign securities firms are ambiguous. They can buy and sell B-shares (denominated in the RMB, but bought and sold with foreign currency). The four biggest “specialized” banks converted into commercial banks. New commercial banking law allowed for non-state owned banks to be set up (Bekaert and Harvey 2002). Qingdao Beer is the first Chinese firm to be listed on the Hong Kong Stock Exchange in July 1993 (C. X. Zhang and King 2010, 74).

1996

In 1996, the Chinese government became a signatory to the Article VIII of the IMF’s Articles of Agreement. As of 1996, nonresidents were not permitted to sell or issue capital market securities. Residents, except for authorized financial institutions, were not allowed to purchase, sell or issue securities abroad, unless these actions were coordinated with the People’s Bank of China, the State Administration of Foreign Exchange and the Securities Supervisory Board (Prasad and Wei 2007, 462–4). Essentially all transactions with money market instruments, collective investment securities, and derivatives were either prohibited or limited to only state-approved entities.

Resident financial institutions were not allowed to lend to nonresidents. Residents were mostly prohibited from borrowing abroad, unless authorized by the State Administration of Foreign Exchange. (Prasad and Wei 2007, 462–4).

In the same year (1996), China also formally accepted IMF Article III (sections 2,3,

and 4), which “provided for current account convertibility for the renminbi” (Hu 2005, 358). Despite these commitments China continued to employ extensive controls on capital flows and foreign exchange.

1997

The Asian Financial Crisis of 1997-98 led many among the policymaking elites to slow down the pace of capital account deregulation (Guo and Huang 2010, 454; Hu 2005, 360; Prasad and Wei 2007, 453). Continued stringent restrictions would be applied to “portfolio investment, including equities, bonds, bank loans, currencies, commodities, and derivative instruments” (Hu 2005, 360). According to an account by Eswar Prasad and Shang-Jin Wei, “The psychological impact of the Asian financial crisis may have been profound” (2007, 453)

1998

China’s first securities law was passed. Foreigners are prohibited from buying A-shares, and the amounts of B-shares purchased must be registered with the exchange. Foreigners pay .50% value transaction fee, .10% registration, \$8 clearing fee and a \$20 depositary fee. Foreigners holding more than 5 percent of the outstanding shares must report to the People’s Bank of China (Bekaert and Harvey 2002).

In the aftermath of the crisis, Beijing specifically feared capital flight, which put at risk its weak banking system – by then already plagued with non-performing loans issue. Although *de jure* controls remained on the books, Chinese authorities went even further, sending “tens of thousands of auditors for enterprises and financial institutions” to track down illegal capital transfers abroad (Yongding 2009, 5). In 1998 the four major state-owned banks received capital injections of RMB 270 million

(Yongding 2009, 13-14).

2000-2004

In 2000, the China Securities Regulatory Commission (CSRC) allowed state and listed firms to buy unlimited shares through domestic IPOs. Requirements on foreign exchange balancing for foreign investors were eliminated ((Prasad and Wei 2007, 462–4).

China officially joined WTO in 2001. According to the negotiated commitments of WTO accession, China pledged to liberalize financial services within five years (Yongding 2009, 5).

In 2001, foreign-funded firms were allowed to list on Shanghai and Shenzhen exchanges, but firms were required to have operated in China for 3 or more years, and all foreign shareholders holding more than 5% of the outstanding stock issue must report to the Chinese authorities (Bekaert and Harvey 2002). At the same time domestic investors were now allowed to purchase B-shares with new foreign currency deposits. Certain restrictions on foreign exchange purchases by domestic entities are removed ((Prasad and Wei 2007, 462–4).

New approval guidelines for domestic companies listed overseas or China-held foreign listed companies to sell shares. Permission from the China Security Regulatory Commission (CSRC) and SAFE are required (Prasad and Wei 2007, 462–4).

In October 2001, responding to over 1,000 civil law suits filed against Guangxia Company, the Chinese Supreme Peoples' Court temporarily banned all investor law suits in China (Pistor and Xu 2005, 192-93).

In 2002, the qualified foreign institutional investors (QFII) program was initiated,

which allowed foreign entities to purchase A-shares with certain restrictions. This was part of a transition to an “difficult in and easy out” approach, “with the aim of reducing upward pressure on the RMB” (Yongding 2009, 1). According to Hu, “the decision, jointly made by the China Securities Regulatory Commission (CSRC) and the State Administration of Foreign Exchange (SAFE), followed a two-year period of careful study and consultation” (2006, 360). New four-tier classification of industries where foreigners can invest is introduced, most consequentially opening the services industry to foreign investment. The government withdrew the requirement to register with SAFE to borrow foreign exchange from domestic banks in 2003 (Prasad and Wei 2007, 462–4).

QFII participants are required to hold their investment for a minimum of 12 months before repatriating the gains (Hu 2005, 360). Foreign investors gained access to more than 1200 Chinese companies listed in Shanghai and Shenzhen (Hu 2005, 360). At the end of 2004, only 23 foreign investment banks received approval for a total amount of \$3.2 billion (Prasad, Wang, and Rumbaugh 2005, 26). Despite the initial success of the program, “the authorities temporarily stopped approving new application... mainly to limit further portfolio investment inflows” (Hu 2005, 357).

In December of 2003, \$45 billion was used to bail out two of China’s largest banks, Bank of China and China Construction Bank (Hu 2005, 365).

In 2004, the PRC constitution recognized private property for the first time in over half a century (Xu an Pistor 2005, 190). In the same year new guidelines for the QFIIs were issued. QFIIs managers are required to have at least five years of management experience, and insurance companies have to have been in operation for at least 30

years. QFIIs must have at least US\$10 billion under management. QFIIs that are banks must be in the top 100 international banks in the previous year. QFIIs are prohibited from owning more than 10 percent of stock of any given company traded on the Shanghai or Shenzhen exchanges. Total shares owned by the QFII in a single company cannot exceed 30 percent. QFIIs are subject to strict foreign exchange regulations. They can only remit capital after three years of investment, and in installments of no more than 20 percent of the total at intervals of one month or longer (Prasad and Wei 2007, 462–4).

Some rules for joint-venture commercial banks between China and Hong Kong were liberalized. Foreign ownership limited in a Chinese bank was raised to 25 percent (Prasad and Wei 2007, 462–4). Transfer of personal assets by Chinese citizens emigrating abroad is permitted (Prasad, Wang, and Rumbaugh 2005, 26).

2005

In July 2005 a managed float exchange rate regime was adopted. RMB appreciated by over 20 percent in the next several years. Shanghai Stock Index gained 483% between summer of 2005 and October of 2007 (Guo and Huang 2010, 454).

2006-08

Authorities raised limits on foreign currency conversions for residents, and more importantly a new program introduced in 2006, called Qualified Domestic Institutions Investors (QDII), which allowed Chinese resident to invest into foreign equities for the first time. By end of 2007, \$27 billion were invested abroad – a far greater amount that was allowed under the QFII scheme (Yongding 2009, 7).

At the same time, a new exchange system under the regime of managed float that was

introduced before the onset of the crisis required stricter scrutiny for inflows. These new requirements, such as those that prohibited foreign inflows into RMB accounts, were specifically aimed at preventing undue fluctuation of the RMB (Yongding 2009, 7). While major *de jure* restrictions on the inflows remain, large sums of money have poured into the country's real estate and equity markets through illegal schemes, especially through over and under-invoicing of current account transactions (Yongding 2009; Prasad et al 2005).

2.3. KAZAKHSTAN

1993-96

Between 1992 and 1995, Kazakhstan went through a period of hyperinflation (reaching into the range of 3,000 percent) and the GDP declined by as much as 35 percent (Uyanik and Segni 2001, 101). The national currency tenge is introduced in the fall of 1993.

The Banking Act, Act on Securities Trading and the Decree on Insurance were passed as early as 1993. Interbank market began functioning in 1995. The President decreed an independent role for the Central Bank (National Bank of Kazakhstan) in 1996, though he also made accountable only to the office the President. Substantial trade liberalization was accomplished by the first half of 1995, when all export quotas and import licenses were abolished (Akimov and Dollery 2008, 83). Kazakhstan was among the first post-Soviet republics to do so (Blackmon 2007).

Between 1992 and 1995, there were 45 recorded bank failures in Kazakhstan (Durand and Fonteyne 2001, 208). By 1994, the number of private banks increases to 179, though by 2000 the National Bank of Kazakhstan reduces their number to 48, though

stricter prudential regulations and new liquidity requirements to maintain risk-weighted assets at 12 percent (Durand and Fonteyne 2001, 210; Uyanik and Segni 2001, 101).

1994 foreign investment law establishes “national treatment” of investors. “This legal foundation offers one of the most favorable conditions of FDI in the former Soviet Union” (Meyer and Pind 1998, 8). The law includes specific clauses for investment protection and dispute arbitration (OECD 1998).

Tax Code passed in July 1995, deemed “among the most comprehensive pieces of tax legislation in the former Soviet Union” (Suhir and Kovach 2003, 4) Number of taxes reduced from 49 to 11 (Blackmon 2007, 361).

“Law on Oil” (1995) and “Subsoil Code” (1996) are passed, specifically aimed to attract investment in this sector (OECD 1998, 117). Kazakhstan’s currency (the tenge) became fully convertible on the current account in 1996 (Blackmon 2007, 356).

1997-1998

Kazakhstan Stock Exchange (KASE) opened in 1997. Government initiated the “Blue Chip Program,” aimed to privatize and list SOEs locally (Akimov and Dollery 2008, 86).

Russian financial crisis spills over to Kazakhstan. The banking system survives the crisis in fairly good shape (Barisitz 2007, 70). By late 1990s, the Kazakhstani government managed to introduce new prudential regulations, including a high risk-weighted asset ratio of 12 percent. This reduced the number of banks to 71 in 1998 and 48 in 2000 (Barisitz 2007, 69; Durand and Fonteyne 2001, 210; Uyanik and Segni 2001, 101).

1999

Fifty percent of banking assets are denominated in USD. Investment industry concentration and dollarization place the banking system “at risk of external shocks” (Uyanik and Segni 2001, 102).

Kazakhstan achieved the highest market capitalization of companies listed abroad (measured as a percentage of domestic market capitalization) with ratio of .62 (more than 3 times the average of .18 for the transition economies) (Claessens, Djankov, and Klingebiel 2001, 116).

2001-2004

As of 2001, foreign banks are not allowed to own more than 25 percent of domestic bank’s stock (Durand and Fonteyne 2001, 211).

Between 2004 and 2006, “the volume of transactions and capitalization of the stock exchange skyrocketed, by seven- and twenty-five-fold, respectively” (Akimov and Dollery 2008, 86).

Kazakhstan is the first FSU economy to receive investment grade ratings from the S&P in 2002 (Akimov and Dollery 2008, 85). Foreign lending boom ensues. Cross-border lending trippled from 2003 to 2004, and then doubled again 2005. “By 2004, foregin liabilities accounted for 40 percent of total liabilities of the banking sector” (Barisitz 2007, 145).

In 2004 banking supervision was transferred to a newly created Agency on Regulation and supervision of Financial Markets and Organizations (FSA). The FSA reports directly to the President (Barisitz 2007, 144).

In practice full financial deregulation was complete by 2004.¹⁰¹

¹⁰¹ Interview No. 14, Almaty, Kazakhstan, September 2011.

3. LIST OF INTERVIEWS FOR CITATION

Interviews were conducted between February and November of 2011 in Moscow, Russia; Astana and Almaty, Kazakhstan; and Beijing, China. Each interviewee read and signed a consent form. Each informant was promised anonymity.

Consent Form

Dissertation Project: Financial Internationalization and Non-Democratic Politics.

You are invited to take part in a research study on global financial integration of emerging markets with non-democratic forms of government. I am asking you to take part because I have identified you through books/newspapers/websites as someone with expertise in this area.

Please read this form carefully and ask any questions you may have before agreeing to take part in the study.

What the study is about: The purpose of this study is to learn how different governments regulate the flows of money across borders, specifically short-term investments into equity markets (portfolio investments or PI) and longer-term investments into specific firms (foreign direct investment or FDI).

What I will ask you to do: Your participation in this research project will amount to one interview with me. I will ask you a series of questions related to the politics of finance, financial regulation and broader questions related to the current state of politics in country X (Russia, Kazakhstan or China). The interview will take about 60 minutes to complete.

Risks and benefits: There are no direct benefits to you as a participant in the study, but there are also no risks, apart from those encountered in everyday life.

Taking part is voluntary: Taking part in this study is completely voluntary. You may skip any questions that you do not want to answer. If you decide not to take part or to skip some of the questions, it will not affect your current or future relationship with Cornell University. If you decide to take part, you are free to withdraw at any time.

Confidentiality: I will not record your answers using any digital devices. The records of this study will be kept private. Research records will be kept in a locked file, and only the researcher will have access to the records. This interview will be anonymous and “off the record” which means that it will be confidential and you will not be named as the source of the information in my dissertation, in publications that may result from this study, and/or in presentations about this study. You may also choose to skip any question that you do not want to answer. I will make sure that in anything written or presented about this study your name and/or any information identifying you will not be associated with that information.

If you have any questions: The researcher conducting this study is Igor Logvinenko, Ph.D. Candidate, Government Department at Cornell University. Please feel free to ask me any questions you have now or later. I may be contacted at 1-312-870-0207 (USA) or iol3@cornell.edu. If you have any questions or concerns regarding your rights as a subject in this study, you may contact Cornell University’s Institutional Review Board (IRB) at (607)-255-5138 or access their website at <http://www.irb.cornell.edu>. You may also report concerns anonymously to Ethicspoint, an independent organization, at (866) 293-3077 or access their website at <http://www.ethicspoint.com>.

You will be given a copy of this form to keep for your records.

Statement of Consent: I have read the above information, and have received answers to any questions I asked. I consent to take part in the study.

Interviewee Signature _____

Date _____

Researcher Signature _____

Date _____

3.1 Interviews conducted in Moscow between February and May of 2011.

Interview No 1. Former government official.

Interview No 3. Financial industry professional.

Interview No 4. Academic economist with experience of advising government officials.

Interview No 6. Financial industry professional.

Interview No 7. Financial industry professional.

Interview No 9. Prominent academic economist.

Interview No 10. Financial industry professional.

3.2 Interviews conducted in Astana and Almaty, Kazakhstan between September and October of 2011.

Interview No 13. Finance professional specializing in brokerage, audit and compliance.

Interview No 14. Bond trader.

Interview No 17. Former financial regulatory official.

Interview No 17. Representative of an international financial institution (IFI).

3.3 Interviews conducted in Beijing, China between October and November of 2011.

Interview No 19. Fund manager.

Interview No 20. Financial analyst.

3.4 Interviews conducted in Washington, DC in March of 2012.

Interview No 18. IMF official.

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