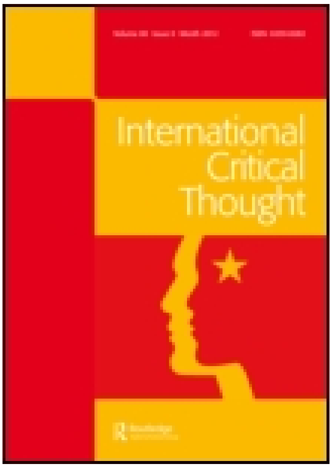

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Has Capitalism Defeated Socialism Yet?—Kornai's Turnaround on Liberalism, and the Evaporation of Myths about Eastern Europe

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The Hungarian economist Janos Kornai has warned the West of the possibility of a reversal of liberalization in Eastern Europe. He advocates a new policy of containment aimed at countries such as Russia and China. This prompts us to investigate the truth concerning the transition in Eastern Europe. After 1990 the West recalculated economic data from the former Soviet Union and Eastern Europe (FSUEE thereafter) before 1990, for creating an illusion that "shock therapy" had made progress in FSUEE. However, the Eastern Europeans including the Hungarians, who were enthusiastic for liberalization from socialism, soon discovered that joining the European Union (EU) was damaging the interests of the majority of people in Eastern Europe, while Western Europeans also came increasingly to oppose the financial burdens imposed by EU enlargement and immigration inflows. The short-sighted transition strategy carried out in Eastern Europe and the preoccupation with geopolitical interests have in fact exacerbated the EU's economic crisis, triggering a civil war in Ukraine and causing Russia to become disillusioned with the West. Kornai's theory of soft-budget constraints as well as his anti-Keynesian policies during the transition recession, is responsible for the economic downturn triggered by rapid liberalization in Eastern Europe. The reversal of the liberalization trend in Eastern Europe and the change in the mass psychology of Eastern Europeans towards the West together constitute an important rebuff to utopian capitalist thinking in China. Has capitalism defeated socialism, as Western propaganda claims? The success of China's autonomous open-door policy and the failure of Eastern Europe's unilateral opening indicate that the collapse of the FSUEE occurred mainly for political rather than economic reasons.

Keywords: Eastern Europe; transition; containment; real per capita GDP

Success of Shock Therapy and a Revival of the Washington Consensus?

On May 6, 2014, the Peterson Institute for International Relations (USA) organized an international conference entitled "Transition in Perspective: 25 Years after the Fall of Communism" (referred to hereafter as "Transition in Perspective") at the Central European University in Budapest, Hungary. The attendees included the major designers and decision-makers of the economic restructuring in Eastern Europe and the former Soviet Union. The conference was conducted amid an atmosphere of self-congratulation, and the organizers plan to publish a collection of papers under the title *The Great Rebirth: Lessons from the Victory of Capitalism over Communism* (Aslund 2014).

At the beginning of the financial crisis, on April 3, 2009, then British Prime Minister Gordon Brown (2009) declared publicly in his closing speech at the second G20 summit in London that

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the old Washington Consensus was over, and that a new world order was needed. Five years later, with the countries of the West not yet having emerged from the shadow of the financial crisis, the supporters of shock therapy have begun celebrating the success of the transition in Eastern Europe and trying to restore the credibility of the discredited Washington Consensus. The conference is like a magic show that attempts to demonstrate that the world history could be easily manipulated.

Interestingly, the keynote speech to the conference, delivered at the banquet on the first day, was presented by the Hungarian economist Janos Kornai (2014a), a professor emeritus at Harvard University and perhaps the most influential transition economist in the world. Kornai's pessimistic warning was like cold water poured on the enthusiastic conference organizers, who were trying to create an atmosphere of triumphalism. The Chinese website of the *Financial Times* on July 2 published the full text of the speech, under the title "Watch the Imminent Threats" (Kornai 2014b). Kornai warned the West of the danger of a possible reversal of liberalization and democratization throughout the world, citing the case of Hungary's "U-turn." Hungary is famous for its West-oriented rebellion in FSUEE, and its leading role in implementing market-oriented reforms as early as 1968. At the beginning of China's reform and opening up, Chinese leaders sent several high-level delegations to visit Hungary for learning the Hungarian approach in economic reform. The Hungarian turnaround, as Kornai insisted, is certainly an eye-opening development. We should appreciate the deep lesson on causes and consequences of the reverse transition in Eastern Europe, as well as the underlying forces in re-shaping the global order, which is beyond the scope of Western perspective.

Although Kornai's emotional message was clear, his distorted picture was not backed up by the historic facts and real data. His presentation even radically deviated from the objective norms of economics and science. Consequently, it does little to help readers who have not visited Eastern Europe to grasp the actual situation there. I have personally visited Eastern Europe many times since 1985, and starting at 1992, have engaged in exchanges with Jeffrey Sachs, the designer of shock therapy in Poland and Russia in 1990s (Chen 1993). I would like to share with readers some basic facts I am aware of, and discuss why Hungary, the leader of West-oriented liberalization movement, has had to undertake such a dramatic reversal of course despite a great deal of Western support over many years. Has shock therapy in Eastern Europe been a real success or tremendous failure compared with China's reform and opening up? Will the future of the Western world involve what Kornai has advocated, a "democratic coalition" designed to contain the "autocratic Russia and China"? Or do we live in "one world with different dreams"? We would investigate these issues in this article.

From a Liberal Economist to a New Cold War Geo-politician

Kornai's influence within the economic circle in China could be much greater than any Nobel laureate. During his visits to China, Kornai has been received by high-placed policy-makers and at least nine of his books have been translated and published in China. He has acted almost as a guide directing the Chinese market reform. When major policy debates have taken place at various stages of China's transition, liberal scholars have often invited Kornai to China or sought out his advice overseas.

Now 86 years old, Kornai might be well regarded as the gravedigger of the Soviet model of socialist economics, since criticism from within the system is more deadly than attacks from outside. He has made two notable turns in the course of his life: the first transformed him from a socialist economist to a liberal economist, while the second has turned him from a transition economist to a geo-politician advocating a new policy of containment. A study of these shifts by Kornai can help the Chinese people better understand the changing order of world affairs.

At an early age Kornai began a self-educated study of Marx's *Das Kapital*, and he later became an economics professor and member of the Hungarian Academy of Sciences. From 1986 to 2002 he was a professor at Harvard University, and he was also elected a fellow of the Royal Swedish Academy of Sciences. He has been considered a serious contender for the Nobel Prize, and is hailed as a leading world authority on transition economics of the socialist economic system. His major work is the book *Economics of Shortage* (Kornai 1980), published in 1980. He claims that the phenomenon of shortages in the socialist countries of Eastern Europe does not result from faulty planning or policies, but is deeply rooted in the institutional flaw of the socialist system. His theory seems to prove that capitalism is better than socialism. His model of "soft budget constraint" propounded in 1986, provides a theoretical foundation for inefficiency of state-owned enterprises (Kornai 1986). His 1990 work *The Road to a Free Economy* (Kornai 1990) puts forward the argument that market reform and the liberalization of political and economic systems are one and the same. He made clear that the goal of economic transition by means of shock therapy is total negation of the socialist system.

Today, both the world situation and the Chinese economy are at a crossroads. Kornai's demand for containment of so-called "red" countries such as China will prove enthralling to those who call for unrestricted liberalization in China.

The Overall Performance of Eastern Europe after 25 Years of Transition

Although the organizers of the "Transition in Perspective" conference announced that the "shock therapy" implemented in Eastern Europe 25 years ago represented the triumph of capitalism over communism, Kornai had serious doubt about this conclusion. Unfortunately, the participants mainly talked about their political success with few economic facts. Here, we will present main indicators from mainstream Western sources, so that our readers can draw their own conclusions.

We made a quantitative comparison of the economic performance of the countries concerned, based on data for real GDP between 1988 and 2012 published by the United Nations (UN) Statistical Office.[1] During these 24 years (22 years for Russia and Ukraine) the average annual GDP growth rates (in percentages) of major countries and regions were: China 9.7, Latin America 6.7, India 6.4, East Asia 3.8, Poland 2.9, the world average 2.8, the United States 2.5, Germany and Western Europe 1.8, Japan 1.3, Eastern Europe 1.0, Hungary 0.8, Russia 0.6, and Ukraine −1.6. Among Eastern European transitional countries, only Poland underwent growth slightly higher than the world average. At the end of this 24-year period, China's economy was 930% of its size in 1988, while the corresponding figures for other countries and regions were: the world 179%, the United States 183%, Western Europe 153%, Eastern Europe 128%, and Hungary 120%. Russia's economy was 116% of its size in 1990, and that of Ukraine only 70% as large.

It should not be forgotten that prior to the transition Eastern Europe's industrial base, technological level, human capital and natural resources, plus the natural resources of the Soviet Union, were all much greater than those of China, East Asia, and Latin America. During the transition period, the West for geopolitical reasons also waived Poland's huge foreign debt. The populations of the Eastern European countries are also smaller than those of East Asia. Hungary has only 10 million people, just a little more than China's Hainan province, and less than that of Tianjin City; Poland's population is less than 40 million, about the same size as

[1]See United Nations Statistics: National Accounts Main Aggregates Database. http://unstats.un.org/unsd/snaama/selbasicFast.asp.

that of Fujian province. According to the Central Intelligence Agency (CIA) data, the per capita foreign direct investment (FDI) received by Hungary and Poland is far greater than the figure for China or any other East Asian country. Hungary attracted a total of $46 billion, which in per capita terms is 1.7 times the figure for Poland, 11.5 times of that for Korea, and 11.5 times that for China (CIA 2014). According to mainstream Western economic theory the countries of Eastern Europe, especially Hungary, have met all the conditions for economic development, through ensuring property rights and democracy and opening their borders to foreign investment. In addition, these countries enjoy the military protection of the North Atlantic Treaty Organization (NATO), as well as the advantages of political and economic integration with the EU. According to the Washington Consensus, they should have become models of development. In terms of the conditions noted, the economic resources of East Asia and the US-aligned countries of Latin America are much less than FSUEE. Nevertheless, the results have been very different from those predicted.

After more than 20 years of transition, the population has undergone a greater decline in Eastern than in Western Europe. According to UN data, the Russian population has declined by 2%, that of Hungary by 4%, of Ukraine by 11%, and of Eastern Europe as a whole by 23%. The population decline has been due mainly to economic recession and income disparities; young people dare not get married and have children, while large numbers of young talents choose to emigrate in search of employment. Among all the socialist countries in transition, it is only in China that the economy is thriving. Vietnam initially followed China's footsteps in carrying out reform, but later experienced border disputes with China, and in recent years has faced significant economic turmoil. The transitions in the already-developed economies of Eastern Europe and the former Soviet Union have also brought significant setbacks, and in the case of the former USSR the loss inflicted by the transition has actually been greater than the total losses suffered in two world wars plus the civil war and famine in 1920s. Even in the case of Poland, which has recovered fastest from shock therapy, economic growth has lagged behind that in most countries of the developing world. Following World War II, economic growth rates in Eastern Europe were originally higher than in developed countries other than Japan. Since the 2008 financial crisis, economic growth in the United States and Europe has been slower than in developing countries, and in Eastern Europe as a whole, growth has been even slower than in Western Europe and Japan. While the organizers of the "Transition in Perspective" conference declared the victory of "shock therapy," they could take pride only in the political aspects, not in the economic outcomes. While shock therapy destroyed the economic base of socialism in Eastern Europe, it did not bring about economic prosperity as the peoples of Eastern Europe had been promised. Kornai has recognized the changing consciousness of people in Eastern Europe, and thus warns of the threat Western capitalism faces.

When Will Eastern Europe Become Developed?

Two years ago, the World Bank and the Development Research Center of the State Council in China jointly issued a report, which noted the "middle-income trap" as a major risk confronting China's economic development (see The Research Team of World Bank and the Development Research Center of the State Council 2012). The report argued in favor of the model provided by Eastern Europe and Russia for achieving the status of a "high-income country," and relaunched market liberalization in line with the Washington Consensus. The quantitative basis offered in the report for its claim that Eastern Europe and Russia had undergone a successful transition was that Hungary and Russia were categorized by the World Bank in 2006 and 2012 respectively as "high-income countries." Meanwhile China's 2012 GDP per capita, according to the United Nations Statistical Office, ranked below the figures for Hungary, Kazakhstan, Argentina, Brazil, Turkey, Mexico, Iran, and Cuba, and just above those for Thailand and Angola.[2] This is certainly a big blow to the confidence felt by the Chinese people in their path of development. China is widely known for "crossing the river through feeling for the stones," but what is actually on the other side of the river—the Eastern European model, the model of the United States and Europe, or the endlessly debated Chinese model? Does the problem have to do with whether the data used for the above categorizations are reliable?

The reliability of economic data is crucial in policy debate. Recently, French economist Thomas Piketty (2014) gave us a good example. His wealth distribution data for the major Western countries during the past 300 years revealed the fundamental problem in capitalist society. Piketty shows that the inverted U-shaped curve developed by Nobel prize-winning American economist Simon Kuznets based on the US data in the part of twentieth century does not hold for major Western countries in the past 300 years; in other words, income disparity that is increased by technological progress will not necessarily decrease later of its own accord. Piketty thus proves that unless politics intervenes, pure market mechanisms result in a trend toward widening inequality (see Chen 2014).

Kornai's warning of a U-turn in Hungary inspired me to investigate the real situation in Eastern Europe. Has the result of the transition in Eastern Europe been an upgrading of these countries to "high-income" status, or a regression to economic dependence? Comparing the economic data released by the West before and after the transition, I broke a myth created by the West concerning the performance of capitalism versus socialism.

The first categorization of "developed countries" was carried out in 1961 during the formation of the "rich country" club, the Organization for Economic Cooperation and Development (OECD).[3] The statistics from the United Nations Statistical Office and the Central Intelligence Agency for which comparisons are possible date back to 1978. If we take the per capita GDP of the United States as the reference unit, the minimum threshold for joining the OECD club can be revealed by the figures for Portugal and Turkey, whose per capita GDPs in 1978 were respectively 23% and 21% of the figure for the United States. The CIA (1980) data for 1978 show that per capita GNP in the Soviet Union at that time was already 59% of the US figure, that of Poland 32%, and that of Hungary 31%. All these figures are well above the OECD threshold, and are more than those for the United Kingdom, Portugal and Turkey.

The CIA (1987) data for 1985 show that the GNP of the Soviet Union in that year was 52% of that of the United States. The Soviet economy ranked as the second largest in the world, with per capita GNP about 44% of that of the United States.[4] Hungary's per capita GNP in 1985 was even higher than that of the Soviet Union. Obviously, both the USSR and Hungary should belong to the category of developed countries before transition. Until 1990 the data from the CIA and the *Encyclopedia Britannica* all indicated that the Soviet GDP was the second largest in the world, about half that of the United States (see Daume 1992).[5] Prior to the transition in Eastern Europe, the West thus admitted that economic development in these countries was on an advanced level.

[2]For World Bank rankings of the high-income economies, see, http://en.wikipedia.org/wiki/World_Bank_high-income_economy.

[3]For the history of OECD members joining the organization, see, http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm.

[4]The statistics published in 1987 are the actual statistics for 1985; the statistics for other years follow a similar pattern.

[5]The statistics published in 1992 are the actual statistics for 1990; the statistics for other years follow a similar pattern.

This judgment was consistent with the post-war consensus concerning the existence of two superpowers, and with the categorization of countries into three "worlds." Before the collapse of the Soviet Union, therefore, there was no myth maintaining that Western capitalism was superior to the system in the socialist camp. Huntington in his *Political Order in Changing Societies* (1969) also showed systematically that the efficiency of the Soviet system was not worse than that of the United States, with higher stability than in France.

After the Soviet Union collapsed, the Western media started downgrading the historical data of the socialist countries systematically. For example, the United Nations in 2014 issued historical statistical data for the year 1988, just before the transition in Eastern Europe; the GDP of the Soviet Union in 1988 was less than one-seventh of that of the United States, ranking seventh in the world, below that of Italy. The GDP of Russia in 1990 would amount to only one-tenth of that of the United States, slightly higher than the figures for Canada and Spain. If that were really the case, how is it possible to account for the economic power of the Soviet Union to counter the US superpower? If we accept the new United Nations data for per capita GDP in 1988, the figure for the Soviet Union is only one-seventh of that for the United States, smaller than the figure for Mexico and barely higher than the one given for Turkey. Meanwhile, the per capita GDP figures cited for the Czech Republic and Hungary are higher than those for Mexico and Turkey. According to the categorization used by the OECD, per capita GDP in the Soviet Union, the Czech Republic and Hungary was already high enough for them to be assigned the status of OECD developed countries well before the transition. Clearly, the factors bringing about the transition in Eastern Europe were mainly political rather than economic.

Interestingly, the OECD formally accepted the Czech Republic as a member in 1995, and Hungary and Poland in 1996. In 1987 the World Bank began to issue its national standards for high-income (developed) countries, with the lower limit set at the level of Saudi Arabia and Taiwan; consequently, Mexico and Turkey had not yet reached high-income status. These transition countries joined the high-income club in the following years: the Czech Republic in 2006, Slovakia and Hungary in 2007 (Hungary in 2012 fell out of the club of rich countries), Poland in 2009, and Russia in 2012.

From the above, we can see that behind the high-income standards of the World Bank is what looks suspiciously like geopolitical considerations. We should bear in mind that the evaluation of per capita GDP is not scientific, as the arithmetic average deliberately obscures the unequal distribution of the results (see the appendix). Readers should be reminded that the objectivity of economics cannot at present be compared to that of the physical sciences, a topic that merits investigation in a separate paper.

If there are as yet no alternative measures to replace those of the Western mainstream, how do we assess the authenticity and error difference levels? My experience is that the perceptions most people have of their living standards provide a more reliable guide than the judgments of ivory-tower economists.

I have visited the Eastern European transition countries a number of times both before and after the 2008 financial crisis. During the latter visits I asked friends and colleagues from Eastern European countries how people in Eastern Europe evaluate the results of the transition. I was told that older people tend to think of the past as better than now, while young people are divided roughly into two halves by their views on this topic. In other words, perhaps three-quarters of people agree that the present is worse than the past. A Polish friend quoted a popular folk saying according to which people in the past were slaves in politics but are now slaves in the economy, while to be an economic slave is worse than being a political one.

If the high-income standards set by the OECD and the World Bank reflected the true state of the economies concerned, we might have expected Hungarians and Russians to be pleased at their admission to the club of rich countries. Kornai's observations of the world situation are clearly more sophisticated than those of the conference organizers, and his warning certainly contains more real information for us.

Why Are People Disappointed with the Results of Transition?

When facing the various problems brought on by marketization, liberal economists generally offer only one answer: the marketization is incomplete. The greater the problem, the more courage is needed for the vessel of the economy to escape the shallows and reach "deep water." But the warning issued by the transition economist Kornai is different, which is why China's policy-makers need to ponder it carefully.

Kornai admits frankly that the people of Eastern Europe and the former Soviet Union are greatly dissatisfied with the results of transition. The facts he cites include massive unemployment, a widening wealth gap, rising nationalism, and increased ethnic conflicts. More importantly, Kornai's solution is not further liberalization as practiced during the early period of shock therapy, but a resumption of the Cold War policy of containment. If this is not resorted to, he argues, the West will find it difficult to protect itself.

What alarms Kornai and Western neo-conservatives most is the fact that the country now witnessing the most marked political reversal is the one that was the first to rebel against the Soviet Union and implement liberal reforms, and that later sought most actively to join NATO and the European Union. If we leave aside considerations of economic rationality and political wisdom, Hungary as a country that has received large-scale Western aid, including loans and investment, would seem an unlikely candidate for such a U-turn. Kornai's warning of an imminent threat comes as a shock to people yearning for freedom, and should also prompt Western strategists to re-evaluate their plans for engagement with China.

The political U-turn carried out by Hungary in 2010, and to which Kornai refers, arose out of the overwhelming victory by Hungary's center-right party in the 2010 national elections. The party has since sought to strengthen state intervention in the economy and to try to restore Hungary's economic sovereignty, leading the EU to issue a public warning to the Hungarian government.[6] What is the reason for the reversal of course now being seen in Eastern European politics? My view is that the economic situation has dictated this shift. The factor driving people's behavior is economic interests rather than ideology. Contrary to the belief by neoclassical economists, the people who have lost out from market competition will not accept this outcome, and collective actions are leading to the rise of political forces oriented against the market and capital. The U-turn in Hungary serves as the latest proof of Piketty's observation that politics and economics may move in opposite directions.

Transition economists in the West, including Kornai, cannot evade their responsibility for the current predicament of Eastern Europe (see Chen 2006). Since there are still scholars in China who advocate shock therapy as a means for making a transition to "a high level of human rights protection," while criticizing China's development mode as a "low level of human rights protection," it is worth making a comparison between the transition in Eastern Europe and China's reform and opening up. The standard employed here to judge the merits of these policies will not be Western values, but of longitudinal (historical) and transverse (international) comparisons of the economic effects. We divide the transition in Eastern Europe into two stages: a "shock therapy" stage lasting about 10 years, and a subsequent stage that has seen the upgrading stage following their admission to the EU.

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[6]In 2010 the Fidesz party (Hungarian Civic Alliance) came to power with Viktor Mihály Orbán as its chairman. Orbán since then has been prime minister of Hungary.

How Did Shock Therapy Destroy the Original Division of Labor and Collaborative Network of the Eastern European Countries?

The implementation of shock therapy in Eastern Europe by mainstream Western economists had both theoretical and empirical bases. First, the liberalization policy can be justified by the standard Arrow-Debreu general equilibrium model of neoclassical microeconomics. It assumed that if a variety of products engaged in perfect competition, with flexible prices, there would be only one stable equilibrium solution for the perfect competitive market, a solution that would assure optimal allocation of resources. The two founders of the model have both been awarded the Nobel Prize for economics. Second, there was a historical case in market liberalization, the so-called "Erhard miracle," which occurred in West Germany after World War II. Under the allied military occupation price controls were at first implemented, but the result was barter economy and economic depression. As Director of Economics under the occupation regime, Erhard took a bold action in June 1948; he took the opportunity offered by the introduction of the new deutsche mark to abruptly end price controls. The prosperity of the German market was quickly restored, and on the basis of this experience many Western economists speculated that the transition in Eastern Europe could repeat the so-called "Erhard miracle." However, the rapid liberalization of prices, foreign trade and exchange rates in Eastern European countries did not bring economic prosperity; instead, it resulted in huge trade deficits, inflation, currency devaluation, business failures, and massive unemployment. The harsh conditions for receiving Western aid required the Eastern European countries to raise interest rates, tighten their budgets, and sell state assets. The result was 10 years of sluggish economic performance.

Why was the 1948 Erhard miracle not repeated during the transition in Eastern Europe in the 1990s? The key reason is that West Germany in the immediate post-war years was in ruins, which reduced the level of division of labor to primitive atomic state; this is a prerequisite for the Arrow-Debreu model to work. At the beginning of the transition in Eastern Europe, the Soviet Union unilaterally dissolved the Warsaw Pact and the Council for Mutual Economic Assistance (Comecon). This had the effect of unilaterally throwing Eastern Europe open to the West, while shock therapy abruptly destroyed the existing network of division of labor by huge price fluctuations, which broke supply chains of raw materials and components. Previously, about a half of the trade of the Eastern European countries had taken place between socialist states using the mechanisms of barter or ruble exchange. However, the shock therapy imposed the Western trade standards that required all foreign trade to use Western hard currencies for settlement. The result was the immediate collapse of the old network in division of labor as well as of the Eastern European trading system. Trade liberalization thus amounted to a one-sided opening up of the Eastern European market to the West, with no equivalent on the Western side. This brought about a flood into Eastern Europe of Western products that included even such low-end, everyday items as toilet paper. Meanwhile, goods such as agricultural produce for which Eastern Europe enjoyed some price advantage had little access to Western European markets due to a lack of familiarity with Western marketing networks and quality standards. The result once again was the huge trade deficit, currency devaluation, and bankruptcy of numerous Eastern European companies. During the privatization process, Eastern European companies generally proved lacking in monetary capital, which allowed Western multinationals to acquire numerous enterprises, including the core businesses of Eastern Europe, at under-valued prices. By contrast, China at the start of its opening up set high tariffs and other trade protections, thus providing national enterprises with a certain living space. The selective opening of Special Administrative Regions (SARs) also enabled state-owned and private enterprises to gradually learn to compete with foreign enterprises. As a result, Chinese enterprises, which initially lagged behind their Eastern European counterparts in terms both of capital and technology, were able to grow quickly in the later course of the transition process.

During the first decade of transition in Eastern Europe, GDP in Hungary and Poland declined by 18%, and that of Russia by 43%. In Ukraine the drop in GDP was even 61%. Inflation reached 400–580% in Poland, 3400% in Ukraine, and 4000% in Russia, with the high inflation lasting for five to eight years. In Hungary and Poland the currency depreciated to one fourth of its original value. The Russian ruble depreciated by a factor of 5500, and the Ukrainian currency by a factor of 76000 (see Chen 2006). State-owned assets built up over many years in Eastern Europe were rapidly transferred to Western hands with fire-sell price.

In defending market liberalization, Kornai argues that shock therapy at least reduces the time people waste in queuing to buy products under the conditions of the shortage economy. This is the shallower aspect of Kornai's "shortage economy" thesis. Objectively speaking, Kornai's (1979) article that contrasts the "resource constraints" in socialist countries with the "demand constraints" in capitalist countries is more realistic. It should be noted that the "resource constraints" in socialist countries are caused mainly by the West's embargo policy, since the socialist countries cannot use their currencies to purchase resources throughout the world as Western countries do. Part of the reason for the shortages undoubtedly relates to the fact that the socialist countries maintain fixed prices for daily necessities, in order to guarantee equal distribution to the people. If floating prices were allowed, just as China has allowed some goods to sell at high prices during the early 1960s, the prices would certainly rise sharply, with the majority of people unable to buy. In a technical sense this can quickly eliminate the phenomenon of shortages of certain commodities, but the absence of queues in front of high-priced merchandise does not mean people's lives have improved, nor does it signify an increase in the international competitiveness of the economy.

In the transition process, we find three basic approaches to solve the shortage problem. The first involves stimulating consumption through debt, in order to curry favor with the public. Prior to the transition the Hungarian and Polish governments borrowed massively from the West in order to fund consumption; the effect was to raise living standards in Eastern Europe above those in the former Soviet Union. The Yeltsin government dissolved the Soviet Union in order to be rid of its financial burden overseas. In terms of economic deterioration and declining competitiveness, the results of Eastern Europe's indebtedness and the European-American debt crisis are similar. Hungary's foreign debt increased dramatically from \$1 billion in 1973 to \$15 billion in 1993. To pay off the debts, Hungary's government sold most state-owned enterprises and state-owned banks to Western transnational capital, so that these countries would have little economic instruments to cope with the financial crisis of later times. Some liberal economists advocate that China should adopt Western policies by stimulating consumption rather than investment in order to stimulate economic growth, but there are no precedents in either Eastern Europe or the West that have shown this strategy to be sustainable.

The second approach for eliminating shortages is to use imports to overcome domestic shortages through the international market. According to Western trade theory, the market will automatically reach equilibrium so long as free trade and exchange rate fluctuations are allowed without the government's interference. But the historical fact is that Eastern Europe, like the United States since the 1970s, has long suffered from chronic trade deficits, leading to deterioration of foreign exchange reserves and of fiscal revenue and expenditure. The ideal situation of equilibrium can only appear when two commodities are exchanged between two countries; it does not hold when multiple commodities are exchanged between many countries. In the first place, everyday necessities and key components cannot be replaced in the short term, so must continue to be imported even under conditions of trade deficit. Further, there is a great deal of intermediate trade in parts and components. While currency devaluation may benefit exports of end products, it may not be favorable to the procurement of raw materials and components. Consequently, volatility and depreciation of the currency will not only fail to improve the trade balance in the long term, but may actually have adverse effects on the management of production within enterprises. It took China 16 years to improve its international competitiveness to the point where it achieved trade surpluses, before going on to unify its exchange rates in 1994. It is thus clear that the Chinese government officials who did not believe Western dogma had superior intuition and a better grasp of how to improve international competitiveness than did ivory-tower Western economists.

Poland's performance since the financial crisis has been better than that of Hungary, because Poland has kept a considerable number of banks and other enterprises in state hands. Historically, Poland has been carved up repeatedly between Germany and Russia, so its leaders are reluctant to place the country's destiny in the hands of foreign capital from the United States or other foreign powers, fearing that outside companies pursuing their short term interests might promptly resell Poland's core businesses to Russia or Germany. The biggest blow suffered by Poland has been trade liberalization, which makes it hard for Polish enterprises to survive. The Gdansk shipyard, which gave birth to the well-known Solidarity, originally had 20,000 workers; now, the workforce has been cut to 2000 people, and the shipyard is unable to compete with the shipbuilding industries of South Korea and China.

The third approach to eliminating shortages is to improve the capacity to produce goods that are in short supply, and so to increase output. This has been China's consistent policy. At the beginning of the transition China also faced shortages of products, and with certain restrictions, chose to open trade gradually. Although the newly imported durable products such as color TV sets and refrigerators appealed to Chinese consumers, their high prices in the domestic market gave local enterprises an opportunity to develop. This has resulted in the emergence of brands such as Changhong, previously a military radar enterprise converted to a home appliance company, and Haier and TCL, transformed from municipal and village enterprises. These brands have emerged and now penetrated international markets. By contrast, Eastern European enterprises with levels of technology and talent much higher than those of their Chinese counterparts finished up being annihilated by foreign competitors.

Kornai's "Soft-Budget Constraints" Theory and Anti-Keynesian Transition Policy

While Kornai's concept of the shortage economy amounts merely to a superficial use of microeconomics, his "soft-budget constraints" theory provides the argument for his anti-Keynesian policies that have misdirected the response to the crisis.

I pointed out in 2006 that Kornai's soft-budget constraints theory contradicts the experience of macroeconomics (Chen 2006). If the state-owned enterprises of socialist countries were so inefficient that they could be sustained only by government subsidies, the outcome would be huge fiscal deficits. As a result, their inflation rates would be much higher than those in capitalist countries. However, we observe that high inflation is most common in Latin America, and that high deficits are more prevalent in developed countries. The main reason is that capitalist countries are more likely to resort to currency manipulations or to contract large-scale debts. In countries with a full range of credit market and varying conditions in bankruptcy laws, the situation that applies is more akin to soft-budget constraints. Kornai's ideal "hard constraints" are more evident in developing countries than in the West, because it is difficult for the poor countries to borrow money or issue corporate bonds. During the 2008 financial crisis, soft-budget constraints operated to a greater extent in the United States than in any other country, as was shown by the US government's rescue of financial oligarchs and vehicle corporations. The real problem of state-owned enterprises in socialist countries has been uneven development, but governments have feared that declaring state-owned enterprises bankrupt would lead to social instability, and inefficient enterprises have thus been subsidized by profit transferring from efficient firms. When state-owned enterprises in China have been permitted to transfer their social burdens to local governments, and to obtain new resources from better utilization of land value or increased exports, their competitiveness has improved significantly.

What is fatal has been the fact that Eastern European policy-makers and their Western advisors have been given the wrong advice by the Kornai-type transition experts. The assumption has been that the low efficiency of state-owned enterprises is not related to technology, management, marketing or other factors, but is only due to government subsidies in the term of soft-budget constraints. When state-owned enterprises have found it difficult to compete with imported goods, governments have further cut off their sustenance. Not only have opportunities to improve productivity been lost, but also the collapse of these firms has been accelerated, which made the macroeconomic situation even worse. By contrast, the Chinese government during transition implemented proper soft-budget constraints, by mainly using financial subsidies on imports of technology and equipment that are critical for improving competitiveness. Only at a minor scale, government subsidies were used to maintain social stability, such as re-training for laid-off workers. In Eastern Europe the soft-budget constraints are mainly targeted at unemployment, while those in the West are used to bail out financial oligarchies. Neither of these policies can be expected to improve international competitiveness.

Why Does the Western-Dominated Market Mechanism Exacerbate Social Unrest in Eastern Europe?

Many people find puzzling the fact that the European Union, whose welfare systems and rule of law are even more developed than those of the United States, has failed to bring prosperity to Eastern Europe. The key reason is that the accession of Eastern Europe into the EU has been accompanied by harsh unequal conditions, while the movement of Western capital into the EU faces few restrictions from sovereign states. China's market-oriented reform has seen a delegation of authority from the central to the local, in order to strengthen local initiatives, while in the EU integration involves a transferring of monetary and fiscal sovereignty from member states to the EU, in order to compete with the United States. Nevertheless the EU, with its headquarters in Brussels, serves mainly the interests of the core areas of Germany and France, rather than those of the countries on its periphery.

The unequal institutional arrangements are the result of an asymmetrical distribution of power in the global market. For Eastern European countries with disadvantaged economies, little political capital and bargaining power is available to allow them to participate in the EU under fair terms. Chinese companies operate more strongly and confidently in the international market because the Chinese government's position in international negotiations has grown stronger, and this has improved the international environment for Chinese enterprises.

After the fall of the Berlin Wall, the massive quantities of Western capital flowing into Eastern Europe were not invested in high-risk technology updates and long-cycle infrastructure development, but instead in cheap real estate, serving to inflate an Eastern European real estate bubble. The increasing price of housing has raised living costs and weakened the competitiveness of local enterprises. Young people are forced to leave their homes and move to the West to find better employment opportunities. Meanwhile, the enlargement of the EU has increased the financial burden on the rich countries of Western Europe, resulting in slowed economic growth and increased unemployment rates. Except the United Kingdom and Ireland, Germany, France and other major industrial countries do not welcome newcomers. Large numbers of Polish workers in the United Kingdom have been able to find only low-paid, dirty jobs, and jokes about

"Polish plumbers" abound. Not a few female college graduates from Eastern Europe have become prostitutes in the West. With its rapidly aging population, Western Europe is now host to an unprecedented westward migration. Ukrainians are moving to fill the labor gap in Poland's construction industry. With the unrest in Egypt just one example, much of the turmoil in the Middle East, both Eastern and Western Europe also results from discontent among unemployed young people, especially college graduates.

Why Are Eastern European Parties Abandoning Westernization in Favor of Independence?

From 1950 to 2010, Hungary was cherished in the West as a star of the "free economy." In 1956 student rebellion against the Soviet Union broke out in Hungary, triggering Soviet military intervention. In 1968 the new leadership of the Communist Party of Hungary became the first in Eastern Europe to implement market-oriented reforms. In 1990 Hungary carried out the first multi-party election in Eastern Europe. The current Hungarian president, whom Kornai tacitly criticizes, is a former student leader who fought against the Soviet Union, and who in 2001 won the "Medal of Freedom" awarded by the conservative American Enterprise Institute. But for all this, crises in Hungary have never ceased since the country entered the EU.

Before the 2008 financial crisis, the real estate bubble had been further inflated by inflows of "hot money" from foreign banks. During the crisis foreign capital was withdrawn, leading to currency depreciation and sharp fluctuations on financial markets. Real estate mortgage loans from foreign banks operating in Hungary were denominated in foreign currencies, which added to the pressures on local residents. The Hungarian government was forced to seek help from the IMF, which required the implementation of austerity policies, leading to a further deterioration of the economy. Hungary's GDP fell by 6.4%, far exceeding the losses in the United States, the birthplace of the 2008 financial crisis.

Before the transition, the Hungarian people had grown accustomed to the generous welfare provisions of socialism, including generally stable employment, universal free health care, free higher education, 24 weeks of maternity leave with full pay for women, and up to three years of maternity leave with 70% of salary guaranteed. By contrast, new mothers in the United States receive only 12 weeks of unpaid maternity leave, and career women who bear children often face the risk of being dismissed. After the transition, the Hungarian welfare state could not be sustained. As part of its attempts at reform the center-left government sought to increase medical and hospital fees, while also raising university tuition fees, privatizing pension plans, and reducing maternity subsidies. The changes met with great resistance, and taking the opportunity to oppose the welfare reform, the opposition party won the support of the popular votes. A change of government, and a reversal of policy, then took place.

Returning to power in 2010 with a majority of seats in the parliament, the center-right government set about reversing "liberalization." The new government passed legislation forcing foreign banks to allow mortgage loans denominated in foreign currency to be settled using the Hungarian currency. The privatization of the pension system had brought a drastic decline in the value of pension payments and had caused public panic; as a result, the Hungarian government was compelled to re-nationalize the pension system in order to maintain social stability. The center-right government had promised to cancel university tuition fees, but facing financial crisis, decided to cut subsidies to university students. This move triggered renewed protests. In hopes of strengthening the government, the state-controlled media publicly accused the opposition of being supported by foreign forces. After being publicly condemned by the European Parliament, the Hungarian government tried to win public support on the basis of safeguarding national interests, openly accusing the EU of moving towards an American model of federalism.

Kornai has not dared to admit that the reversal of course in Hungary is the result of Western-led liberalization, instead seeking to shift the target by arguing that Western Europe is threatened by the "red capitalist" forces of Russia and China. In the next section we will thus explore the reasons why the conflicts within the EU have led to a resurgence of nationalism.

Why Has the Enlargement of the EU Resulted in Disappointment?

Although the OECD and the World Bank began in 1995 to award the flattering title of "rich country" to Eastern European states, the actual experience of the populations of Eastern Europe has been very different. The only compensation for the Eastern European countries that transferred ownership of their core industries to international capital has been the freedom gained by their citizens to migrate to the West. When the Berlin Wall was dismantled, it was young people yearning for the West who were most joyful. The high consumption levels of Western Europe, together with the welfare provisions of the East, had once nourished the fantasy of finding a third way. The people of Eastern Europe soon found that what they received was involuntary democracy and unequal freedom. This is the reality of an international division of labor dominated by the West powers. Needless to say, textbooks of neo-classical or transition economics keep silent to geopolitical reality.

In 1993 the Copenhagen Criteria were developed, and the process that was to see the eastward expansion of the EU and NATO was launched. From 2004 Eastern European countries in transition began to be accepted as EU member states. By 2005 the regional conflicts within the EU had soon intensified, and increasingly disappointed with the results of accession, Eastern European voters were voting down the parties that had argued for it. For citizens of the wealthier countries of Northern and Western Europe, the eastward expansion has brought more costs than benefits, with the price including not only tax increases and reductions in benefits, but also increasing rates of unemployment among young people. Anger has risen at Eastern European immigrants looking for jobs. This is among the reasons for the rise of neo-Nazi parties in France and the Nordic countries.

Why Did the Money Politics of German Reunification Win the Cold War but Weaken the Euro?

The establishing of the EU and its expansion to the East were based on the economic power of Germany and the political power of France. As projected by the elites of these two countries, the EU and the euro were intended mainly to achieve the peaceful unification of the whole of Europe, including Ukraine and the European part of Russia, while resisting the hegemony of the US dollar, so that Europe could emerge as a world pole able to compete with the United States and East Asia and to win autonomy from the influence of the Soviet Union and the United States. Germany and France, however, could not compete militarily with the Soviet Union and the United States, and therefore took the path of peaceful evolution through parliamentary politics and financial incentives.

Perhaps the most effective strategy followed by West Germany involved using subsidies from other parts of its territory to create the illusion of high consumption in West Berlin. Through the mass media, this vision of consumer abundance exerted a significant influence on people in Eastern Europe. West Germany also unilaterally opened its border with East Germany, creating the façade of a "free world" to which the people of Eastern Europe were encouraged to cross. In 1985 I drove through the Czech Republic, East Germany and West Germany, and found that the East German side of the border with the West was indeed heavily guarded, with armed soldiers and trained dogs, while the West German side was more like the entrance to a park, with only one person in attendance, neither checking passports nor collecting fees. This respective "confidence in their systems" indeed had quite an effect on me.

After the reunification of East and West Germany, I was invited to give a lecture at the Free University of West Berlin. I was surprised to find that the new capital of Berlin was in a recession, with no restaurants open on weekends. Students at the university later told me the inside story. During the Cold War era, the façade of prosperity in West Berlin had been created by financial subsidies from the other regions of West Germany. After the socialist regime in East Germany was brought down, West Berlin was forced to rely on its own resources, and its underlying economic condition was exposed, since Berlin has weak industries and revenue sources.

Still worse were the democratic politics related to the monetary reunification. To win the votes of East German residents, West German president Helmut Kohl, who led the quick reunification, used his presidential prerogative to announce suddenly that the East and West German currencies would be exchanged on a one-to-one basis. This amounted to giving cash directly to the people of East Germany but not East German industries, since the real black market exchange rate at the time was about six to one. The monetary unification occurred on July 1, 1990, less than a year after the fall of the Berlin Wall. This was even more rapid than the implementation in Eastern Europe of the shock therapy policies that would have such far-reaching consequences.

As well as enjoying a standard of living much higher than that of other Soviet-bloc countries, the residents of East Germany had accumulated huge savings. Reportedly, they had needed to save for about a decade to buy cars manufactured in East Germany. Once they received large quantities of West German marks, they immediately abandoned East Germany's practical, inexpensive products and started buying fashionable, technically advanced merchandise from the West. East German enterprises lost their domestic market overnight. Previously, about a half of East German products had been exported to other Eastern European countries and to the Soviet Union, using the ruble or barter for settlement. But with the shift to the West German mark, East German enterprises found their traditional export markets also gone because their traditional trading partners were short of hard currency. The combined forces drove many East German firms soon to bankruptcy. Prior to German reunification East Germany's many famous enterprises, such as the optical firm Zeiss, had negotiated joint operations with Western counterparts on equal terms. But as soon as the East German enterprises lost their domestic and foreign markets, they ceased to be able to compete. Many core businesses of the East German economy were taken over fully by West Germany at very low or even negative prices, meaning that West German enterprises received subsidies for acquiring them, on the basis that they undertook to deal with problems such as pollution. This also led to mass lay-offs of East German management personnel, resulting in serious confrontations between East German employees and West German management teams.

The West German labor unions feared that the cheap labor of East German enterprises would put workers in the West at a significant disadvantage, so lobbied the parliament to pass legislation requiring a convergence of wages in East and West Germany. This act simply ignored the time needed for East German enterprises to improve their competitiveness, and resulted in labor costs in East Germany being higher than in the United States. East German firms were consequently unprofitable and attracted few investors, even from among patriotic West Germans. The outcome has been a long term recession in the economy of East Germany.

The cost of this decades-long recession in East Germany has actually been borne by West Germans, with about a half of East Germany's GDP effectively transferred from West Germany simply for social stability rather than infrastructure investment. While Kohl won votes and the reputation of being the "father of German reunification," Germany's competitiveness and growth have been greatly reduced. The huge financial burden caused German interest rates to rise, and the mark to strengthen. This led the United Kingdom to quit the pegged exchange rate, and has made it difficult for the euro zone to function effectively. By contrast, China's dualtracked reform and "one country, two systems" approach to reunification have provided the time and space for developing the elements of a mixed economy, so that both mainland and Hong Kong managers can learn from each other and engage in cooperative competition.

According to Western economists who defend shock therapy, the fact that Eastern Europe and China lag behind the West in technological terms implies that they will inevitably lose out in market competition. This could not be more fallacious. Even though Eastern Europe and China suffer from a technological lag, their labor costs are much lower than in the West. The factors affecting market competition are not restricted to quality, but are also closely related to costs. When China joined the WTO, its textile exports to Western countries were set for a number of years by quotas, as well as being subject to a variety of external restrictions such as quality standards, patent laws, and anti-dumping regulations. Anyone with knowledge of international trade knows that while the West requires others to implement trade liberalization, it has never imposed similar liberalization measures on developed countries. The Eastern European leaders are either deluding themselves, or are forced to deny the truth. When all is said and done, Western aid comes with political and economic conditions that suit the West; without autonomous politics, there is no way that developing countries can enjoy economic independence.

Although shock therapy and the enlargement of the EU and NATO have served politically and economically to rule out the possibility of the countries of Eastern Europe becoming competitors to the West, the economic decline of the Eastern European countries has exacerbated the regional disparities and social conflicts that the eastward expansion of the EU and NATO originally fostered. During the 2008 crisis the United States, Europe and Japan all faced huge budget deficits brought about by the high welfare costs of their aging populations, by the arms race, and by NATO's eastward expansion. Keynesian fiscal stimuli could not be implemented, and instead these countries competed to enact zero interest rate monetary policies, trying to divert the crisis to foreign states. While presenting the appearance of political unity, the world's wealthiest regions undercut one another in their economic policies.

Comparing the collapse of the Soviet Union with the rise of China, it seems to me that the shortsightedness of the Soviet leaders and Deng Xiaoping's far-sightedness reflect their different conceptions of reform and opening up, and the consequences that flowed from these distinct visions. Stalin and Khrushchev overestimated the attractiveness of the Western system to the people of Eastern Europe, and thus imposed tight controls and a closed economy in an attempt to limit "brain drain." The result was that they lost the hearts and minds of the intelligentsia. Deng Xiaoping boldly opened China's national door for students to study abroad, believing that the success of reform and opening up would eventually lead them to return; this has enabled China to acquire Western technology while retaining the allegiance of Chinese intellectuals. Together, China and Eastern Europe have a population much larger than that of the West, and have a greater potential than the West to solve the problem of employment. If the populations of China and Eastern Europe were allowed to migrate in a free and orderly way, the Western propaganda of "freedom" would emerge as a false promise where immigration and employment issues were concerned. After the dismantling of the Berlin Wall, the border of the United States with Mexico was tightened to stop illegal immigration, while other Western countries all use "work permits" to restrict the employment of foreign students. The financial crisis has intensified the tensions between immigrants and the Western countries.

Who Planted the Powder Keg of Hungarian Ethnic Conflict?

The biggest difference between the histories of Europe and China is to be found in the historical trends of integration and disintegration. China has a history of 2000 years as a unified country, because it was only through unity that it could cope with the threat presented by the nomads;

the architectural history of the Great Wall has a greater meaning for national identity than pure military defense. In addition, the floods and droughts of the Yangtze and Yellow Rivers could only be dealt with effectively by a centralized government. Throughout European history, from the Roman Empire through Napoleon and Hitler to the era of the EU, centrifugal forces have regularly proven stronger than centripetal ones. The mechanisms of the market and of democratic politics also favor disintegration over integration. Western phonetic writing further exacerbates the tendency to ethnic and cultural conflict, since it lacks the cohesive function, which the Chinese script exercises in relation to local dialects.

Hungary has a unique language, and by the sixteenth century had already begun establishing universities. In Eastern Europe, the country is well known for its science and technology. The father of American computer science John von Neumann and the father of the hydrogen bomb Edward Teller were both Hungarian by birth and education. Why is it then that Hungary's economic performance since the transition has been notably worse than those of Poland, South Korea and China? Kornai often identifies himself as a Hungarian, but does not dare point to the historical sources of Hungarian nationalism.

Historically, Hungary at several points became the most advanced and powerful country in Eastern Europe. Its national character was formed in the course of its struggle against the Mongols and Turks. The Kingdom of Hungary, established in the tenth century, at one time extended to today's Germany, Italy and Spain. The Austro-Hungarian Empire of the nineteenth century was also the political, military and cultural center of Central Europe. After World War I the empire disintegrated according to the Treaty of Trianon signed in 1920 in Versailles, France, with Hungary losing 70% of its territory, 60% of its population, and also its navy, becoming a landlocked country with no access to the sea. About 30% of Hungarians remained in Romania, the Czech Republic, Ukraine, Yugoslavia and other countries, where as ethnic minorities they often faced discriminatory treatment. After the multi-ethnic Austro-Hungarian Empire was replaced by disparate nation-states, Hungary's access to raw materials was obstructed, its manufacturing base and marketing network declined, and its economy became dependent on Western Europe. Since accession to the EU, Hungary's economy has been further marginalized due to the country's unfavorable geopolitical position. This has brought about an upsurge of nostalgic sentiment in the Hungarian people, and is a key reason why Hungary has become the first to challenge the authoritarian policies of the EU.

After World War I, John Maynard Keynes attended the Versailles Treaty negotiations as an official of the British Treasury. In 1919 he published his masterful work *The Economic Consequences of the Peace*, which sharply criticized the harsh treaty imposed on Germany by Britain and France. Keynes argued that by preparing the destruction of the German economy, the allies were creating the conditions for another war. But the parliamentary politics of Britain and France led the British and French politicians to consider only their short term electoral prospects, while ignoring the long term interests of Europe. The Versailles Peace Treaty helped open the way for the Great Depression and the emergence of German and Italian fascism. Hitler's slogan in launching World War II was to transform the pattern of inequality left by the Versailles Treaty, and the injustices of the treaty enabled him to obtain considerable support from unemployed people. Hungary's problem is similar to that of Germany in historical terms, but Hungarian strength has been much less than that of Germany, so the country has had to bear with the outcome at Trianon, Versailles until now.

Russia's Fantasy of NATO and Reality in Geopolitics

Kornai criticizes Russia for violating international law in Ukraine and using force to change the status quo, thereby threatening the democratic Western world. His attitude simply distorted the history of Eastern Europe transition.

As we all know, Soviet President Mikhail Gorbachev naively thought that the Cold War was only an ideological conflict, but the Soviet Union's unilateral dissolution of the Warsaw Pact and the withdrawal of Soviet troops from Eastern Europe did not bring equal actions from the West. Not only was NATO kept in existence, but also it was expanded eastwards to include most of the former socialist countries of Eastern Europe.

After Russia quit the Soviet Union in 1990, its foreign policy began to tilt toward the West; it even applied to join NATO, but was rejected. It seems that Russian President Boris Yeltsin failed to understand the harsh realities of geopolitics: if the superpower Russia joined NATO, how could the middle powers of the West maintain their dominant positions? After witnessing a substantial decline of the Russian economy and a swing of public opinion against him, Yeltsin finally drew the realistic lesson and engineered the promotion to power of Vladimir Putin, who has a strong sense of nationalism. Meanwhile, relations with China were improved, and Russia came out in clear opposition to NATO's eastward expansion. Similar reversals of course are occurring in Eastern Europe, as reality teaches the people of these countries that ideology does not equal national interest, and that concealed behind the banner of Western democracy is naked self-interest.

Nuclear Arms Disposal and the Cost of Splitting Ukraine

Historically, Ukraine's pursuit of its destiny has been even more tortuous. The ninth century state of Kievan Rus was the common ancestor of both Ukraine and Russia. As the terrain of the steppe provided no natural line of defense, Ukraine became a battlefield on which Mongols, Lithuanians, Poles, Germans and Russians fought for hegemony.

At the time when the Soviet Union collapsed, Ukraine's population, nuclear weapons, and arms industry were a match for those of France. Ukraine additionally is a rich agricultural country; while it lagged behind major Western states at the beginning of the 1990s in its overall productive potential, this was only due to the relatively small size of its civilian manufacturing sector. Ukraine's economy, technology and military strength at this point far exceeded those of Poland, and with political stability and economic development, the country might rapidly have become an Eastern European powerhouse. If the leaders in Kiev had been wise and capable, they could perhaps have turned Ukraine into a country that Russia and the European Union vied with one another to please. Unfortunately, the outcomes were quite different. When Western governments were eager to get rid of the huge stock of nuclear weapons in Ukraine, they promised the country massive assistance. But when Ukrainian leaders naively handed over the weapons to Russia, Ukraine lost a bargaining chip in the international negotiations, and the Western countries simply repudiated the promised assistance. With economic chaos mounting, Ukraine lost the financial capacity to buy spare parts for its agricultural machinery, largely paralyzing the rural sector and turning previously rich farming areas into wasteland. The sudden collapse of the Soviet Union left Ukraine's monetary system in disorder, and the heavy industries of the country's eastern regions, closely integrated with Russian producers, were brought largely to a standstill. Previously, Ukraine had been among the most economically advanced regions of the USSR, and more prosperous than Poland, but shock therapy led to the country suffering the worst economic decline in Eastern Europe.

Ethnic problems in Ukraine during the Soviet period were not significant, but economic decline and the East-West confrontation have seriously exacerbated a historical legacy of ethnic conflict. In western Ukraine there are numerous people of Polish and German descent, while eastern Ukraine has large numbers of Russian-born residents. The heavy industry of eastern Ukraine can find a future for itself only through integration with Russia, while the agricultural area of western Ukraine need the investment and markets of Western Europe. The enlargement of NATO and the EU, as well as the "color revolutions" in Ukraine, have drastically exacerbated divisions and civil conflicts.

Kornai's criticisms of Russia and China without historical facts in the context of the Ukraine crisis have shown that he has strong bias in international affairs. Even certain German politicians have acknowledged that the status quo was first altered by the NATO war in Kosovo, in the former Yugoslavia, where Russia was trying to maintain the original borders. Ironically, when the center-right Hungarian government—based on the same forces that earlier had pushed for joining NATO and the EU—again came to power, it performed a political U-turn, strengthening economic cooperation with Russia and China in an effort to deal with the economic decline and EU pressures. The shortsighted selfishness of the Western powers has forced Hungary to turn to the East to find more reliable partners.

Fears and Myths of a New Axis Alliance

To be fair, Kornai's fear of an alliance between Russia and China has been prompted by his Western backers. In the United States last fall I attended an international symposium on the EU debt crisis. The proceedings began with a debate on the marginalization of Southern Europe by Germany and the Nordic countries, and ended with a harangue on the marginalization of Europe and America by China. The participating Western economists and politicians agreed unanimously that the biggest mistake of the previous three decades had been to transfer technology and industry to China, a situation that had become difficult to reverse. The Trans-Pacific Partnership (TTP) and the Transatlantic Trade and Investment Partnership (TTIP) proposed by the United States are aimed at allowing the West to protect itself rather than at containing China, since the West has been unable to curb the strength of China and the emerging markets or to deflect the challenge they pose.

The new axis of international strategy advocated by Kornai is even more ambitious than the "pivot to Asia" strategy put forward by US neo-conservatives. Kornai does not mention terrorism or the unrest in the Middle East, and nor does he prescribe ways for the EU to cope with Russia. When Germany and the United Kingdom began to seek closer relations with China, he made widely reported claims that the most dangerous threat to the West came from the combination of communism with the market economy found in "authoritarian" China, Russia and Vietnam. In taking this position, Kornai inadvertently upset the hidden US agenda of inducing disputes between China and Vietnam. Russia, like Japan, faces the dilemma of whether to orient towards the West or East, but Kornai's categorization of Russia and the countries of Central Asia as "pink" and "crimson" has the effect of forcing them to move closer to China. If this occurs, it will be a nightmare for the United States. Samuel Huntington's (1996) "clash of civilizations" thesis originally contended that the threat facing Western civilization came from an alliance between Confucian and Islamic civilizations, with the Russian Orthodox and Latin American Catholic civilizations ultimately joining with the civilization of Western Christianity in a united front. Kornai, however, has turned Russia and Central Asia toward China.

To be honest, I would like to see the US attempt to carry out Kornai's containment strategy. The high point of American containment policy in the past was the Korean War, which resulted in a new China with independent industries. The withdrawal of Soviet scientists and technological experts forced China to pursue its successful development of atomic bombs and satellites. The ban placed by the United States on Israeli sales to China of aircraft radar warning systems accelerated China's development of its own weapons. The currency war initiated by the United States has led to the establishment of the BRICS development bank. Since the Middle East War and the financial crisis, the myth of universal Western values has lost a great deal of its luster. In both East and West, the new academic trend has become the replacing of Western-centric attitudes with multiculturalism. Since World War II Western Europe has lacked the courage for a hot war. Military alliances, whether NATO, the Japan-US alliance, or the Japan-Australia alliance, all rely on American soldiers. But given that the United States found itself in a quagmire in Iraq and Afghanistan, and that little in the way of military appropriations is available from the Congress, it is hard to see how a new containment could be carried out. This is something on which Kornai dares not elaborate.

In fact, the most cost-effective way to carry out a containment of China would be to brainwash the Chinese leaders through the processes of dialogue and opening up, supporting the rise to power of someone like Gorbachev, and waiting for China's Yeltsin to split China so that the threat to the West would be eradicated. If the West were now to implement a policy of containment of China, this would reduce the chances of liberal or pro-American leaders coming to power. A strong future China, whether under the banner of communism or neo-Confucianism, would be a more formidable opponent than Russia under Putin. This is perhaps the reason why the Western media, which used to favor Kornai, did not offer his views much support or coverage this time.

The Lesson of Kornai's Two Transitions

Kornai remains a prominent figure, so we should not underestimate his influence. Furthermore, China's current debate on its path of development has reached a stalemate. While we have avoided the dependency suffered by Latin America and Eastern Europe, our people on the whole lack personal experience of the shortcomings of Western democracy. Kornai's two transitions might thus provide a useful lesson, which would be more instructive than the teaching offered in politics classes in domestic universities.

Kornai's transition from a belief in socialism during his youth, to liberalism in his middle age, and more recently to neo-conservatism and to advocating a policy of containment, raises a few basic questions regarding the economics of transition.

In the first place, the transition from a planned to a market economy does not equal liberalization, privatization, and minimization of the government role in the economy as advocated by the Washington Consensus. The market instability, pressure of unemployment, income polarization, and impact of the international environment that face the market economy are all likely to result in the adjustment of government policies, whether the adjustment is to the degree of marketization, the trend of privatization or the role of government. It is not an obvious foregone conclusion that either socialism or capitalism will win out in open competition, or that the market economy and planned economy can be integrated.

Second, there is no simple link between welfare subsidies and political stability. The generous subsidies that the Soviet Union provided to the energy sector and energy consumption in Eastern Europe did not win the appreciation of the region's people, and neither could Marshall Plan aid during the Cold War ensure the loyalty of Western Europe and Japan to the United States. The generous welfare provisions of Eastern Europe, Western Europe, and the United States are all unsustainable. Once international competitiveness declines, an over-developed welfare system may well become a huge obstacle to reform and adjustment. This is the same in both East and West.

Third, globalization has reinforced rather than weakened the role of the state, because the unequal international division of labor, together with network effects, has increased the gap between the core and periphery of the world economy. The results of open competition are of two kinds: the dependent opening seen in Latin America and Eastern Europe makes it difficult for them to resist the self-interested short term behavior of international capital, while the autonomous opening characteristic of China and East Asia promises to escort them past the various pitfalls.

Fourth, marketization and democratization are not necessarily linked. If reliance is placed on market mechanisms alone to bring about economic development, without government intervention or heed for social constraints, the result will be that only a few people benefit, while the majority will eventually come to doubt and oppose the system. No matter whether those who gain from this situation are financial oligarchs, multinational enterprises, or "black gold" forces, they all need support from Western powers. The contemporary forces advocating liberalization are all supported by American hegemony at the expense of the long term interests of the majority. The question is how long America's economic, political, financial and cultural hegemony can survive in the twenty-first century. Kornai's transition from socialism to liberalism and then to neo-conservatism provides us with a vivid lesson in political economy and international politics.

The Western Capitalist Crisis and the Potential of the Chinese Path

In his memoirs Zhang Weiwei, who once served as translator to Deng Xiaoping, specifically mentioned Deng's view of the world situation following the collapse of the USSR: The Soviet Union was dissolved on December 25, 1991, and Deng's southern trip began on January 28, 1992, just 20 days later. Deng commented at length on the Soviet Union and Eastern Europe. He believed that the region would see a great deal of turmoil, and warned the West that their celebration was premature. The world, he pointed out, was at a major turning point, and this was a good opportunity for China (Zhang 2014). At a time when many people doubted that the red flag would continue flying for long after the entire Soviet bloc had collapsed, Deng in contrast saw the opportunities that had opened up. This indeed demonstrates his far-sightedness.

From a close observation of developments over the past 30 years, we can see that the decline of the West and the rise of China represent irreversible historical trends. China currently is not in a period of political reform, but rather, in one of upgrading its development. We will not only learn from the West's experience, but also avoid their failure in the past. We will develop a new path suited to China's national conditions, while joining with people and countries who have similar aspirations for reform in order to build a more fair and sustainable new world order. During the past three decades of reform we were crossing the river by feeling for the stones, and our goal was to catch up with the United States and other developed countries. Now that the West is caught in the "high-income trap" while China's economy is thriving, our prime need is to adopt an outlook of "global navigation," so that we can go beyond the Western model.

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Notes on Contributor

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Appendix: The Mathematical Measurement of Income Inequality: A Comparison of the Arithmetic Mean and Geometric Mean

The per capita GDP and other per capita economic indicators that are widely used in Western economic statistics are calculated through simple arithmetic averaging. The use of the arithmetic mean ignores the impact of income inequality. A better indicator is the geometric mean. The following numerical example shows that different income distributions lead a to different economic picture if the geometric mean is employed. If we posit three societies with the same population size and total income, so that their arithmetic mean is the same, the geometric mean is highest for the most equal society, lowest for a slave society, and somewhere in the middle for a capitalist society. Thus, the per capita GDP rankings issued by the West do not necessarily reflect the actual incomes of the majority of the people. The larger a country's income gap, the greater the difference between the geometric mean and arithmetic mean. The geometric mean is more representative of the real income of the majority of people. Consider a hypothetical community with a population of 100 and a total income of 1000 units. Here, the income unit is arbitrary. The arithmetic average of per capita income would be 10 units. Now let's consider three patterns of income distribution:

(A) Equal society: income is 10 (unit) per person; the geometric mean = arithmetic mean = 10 (unit).

(B) Slave society: 99 people have a total income of 1 (unit), while the slaveholder's income is 999. The geometric mean = 1.07 (unit), while the arithmetic mean = 10.

(C) Capitalist society: a poor class of 30 people have 1 (unit) per person; one oligarch has half of the total income, 500; and a middle class of 69 people have an income of 6.81 per person. The geometric mean = 3.998 $\sim$ 4.0 (unit), while the arithmetic mean = 10.