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Series: Country Files

Dates: 07/11/1990 - 11/27/1990

Sub-Fonds: Records of President Barber B. Conable

Fonds: Records of the Office of the President

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THE WORLD BANK

Washington, D.C.

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EXC - Country Files

U.S.S.R. - Joint Study
July 1990 - November 1990

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1779946



Jennifer

Please set up mtg + invite John + Timothy through WT's

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 27-Nov-1990 01:20am
TO: See Distribution Below
FROM: John A. Holsen, PADSS
EXT.: 33719

(JOHN A. HOLSEN) office.

Also David Back.
=> BBC + 3, not

SUBJECT: Dr. Abel Aganbegyan's Visit to the Bank

You will find a biography on Dr. Aganbegyan in the book of bio data on Soviet leaders that we provided for Mr. Conable's trip. He is close to President Gorbachev, much more of an adviser on "political economy" than a technical economist. He was the leader of the group that finally put together the "Gorbachev Plan" or Economic Reform Guidelines that were approved by the Supreme Soviet on October 19. He speaks excellent English and prides himself in his many contacts outside the Soviet Union. He is the author of "The Economic Challenge of Perestroika" which was published by Indiana University Press in 1988.

more
" Sven
11-27

Mr. Viehe is incorrect about contact between Bank staff and Aganbegyan. Gelb, Levy and I meet with him in early September when we were in Moscow on a 3-day "planning mission" for JSSE. However, we met him in a group which also included two or three people each from the Fund, OECD and EBRD -- so he has no particular reason to remember us as individuals.

Timothy King has met with one of his deputies to discuss possible cooperation between EDI and the Academy. His Academy probably is the logical counterpart for EDI.

If he is back in Moscow on December 6-7, the Personal Representatives and JSSE Team Leaders would no doubt meet with him to discuss our draft report.

Mr. Conable should certainly find time to meet with Aganbegyan when he is here on November 29 or 30. Both EDI and the JSSE team could well participate in the discussion.

THURSDAY BEFORE 9:00
ROCK - FRIDAY BEFORE 9:30

DISTRIBUTION:

TO: Jennifer Anne Volk JH -
TO: Timothy King TK -
CC: Wilfried Thalwitz Golan -
CC: Sven Sandstrom
CC: Patricia Gallagher
CC: Daphne Minott

(JENNIFER ANNE VOLK)
(TIMOTHY KING)
(WILFRIED P. THALWITZ)
(SVEN SANDSTROM)
(PATRICIA GALLAGHER)
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Record Removal Notice

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|--|-------------------------------------|---|-----------------------------------|-----------------------------------|
| File Title Country Files: Union of Soviet Socialist Republic [USSR] - Joint World Bank and IMF Study - Correspondence 01 | | Barcode No. 1779946 | | |
| Document Date [undated] | Document Type CV / Resumé | | | |
| Correspondents / Participants Aganbegyan, Abel Gezevich | | | | |
| Subject / Title | | | | |
| Exception(s) Personal Information | | | | |
| Additional Comments | | <p>The item(s) identified above has/have been removed in accordance with The World Bank Policy on Access to Information or other disclosure policies of the World Bank Group.</p> <table border="1"><tr><td>Withdrawn by Shiri Alon</td><td>Date September 05, 2019</td></tr></table> | Withdrawn by Shiri Alon | Date September 05, 2019 |
| Withdrawn by Shiri Alon | Date September 05, 2019 | | | |

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 11-Nov-1990 00:16am EST

TO: See Distribution Below

FROM: Stanley Fischer, DECVP (STANLEY FISCHER)

EXT.: 33774

SUBJECT: Meeting with Aganbegyan

Aganbegyan has been in Cambridge for the last few days. I had dinner with him tonight in a small group; before dinner I met him for a private conversation for about an hour.

I did not get much new information, but it was nonetheless interesting to hear his perspective on events.

1. He is a big fan of Gorbachev, most of the time. He admires his intellect, his ability to interact with many different types of people, his determination not to use force, etc. He said that Gorbachev had worked closely and directly with them in formulating the October 15th plan. But, he also fears that Gorbachev is not strong enough to keep the union together, and he says that his emotions register too easily for him to be as effective in domestic politics as he needs to be.

2. Pushed on the relationship among the plans, he said he couldn't figure out why Gorbachev was sticking by Ryzkov. His description of the October 15 debate is mind-boggling -- he says at the same time as Gorbachev was presenting his plan, Ryzkov was in there plugging for his plan. He also says that at the republican level, some governments have announced they will implement the Shatalin plan, some the October 15 plan, and some the Ryzkov plan. Asked what will happen, he shrugs his large frame and smiles.

3. Notwithstanding the previous comment about Gorbachev, he predicted that the USSR will stick together, with all republics remaining in. He based his argument on the economic costs of going it alone for the republics; Russia is subsidizing the others, and they're beginning to realize that, according to Aganbegyan. He also claimed that in their private conversations, all the leaders of the other republics ask Gorbachev to exercise strong central leadership -- and then turn around and complain about the center when they speak to their own people. He's the most optimistic person I've heard on the possibility that the entire union will stay together.

4. He says that some of the basic foodstuff prices are being raised now and in the next few days. He expects only 30% of prices to be freed by the end of 1991, and practically all by the

end of 1992. He recognized the dangers of hyperinflation that could occur if the process of raising controlled prices (by an average of over 50% in the next year) gets out of hand. But he was more optimistic about the budget deficit next year than the Fund is: he said 40 billion rubles, or perhaps a bit more, maybe 60 billion. He thinks the food price increases will help on the budget. When I said that JSSE research had led to much larger deficit estimates, he said that it would be hard to reach 60 billion.

5. He believes they can control inflation by adjusting prices only two or three times next year, but did agree that they'd have to control the deficit. When asked if they were considering a monetary reform, he said mysteriously that they have a set of plans to implement if things go badly wrong, and that a monetary reform is among them -- but that no details of the emergency plans are being revealed, nor even the existence of such plans.

6. The conversation was not easy, nor was there any rapid interchange. He spoke English during our pre-dinner conversation. The usual happened at dinner -- that the fellow who came along to translate knew less English than the translatee, so we had on average worse English during dinner, and certainly slower English.

Bottom line: He conveys a sense of better understanding the plan than other people we've met, or -- judging from the BTOs -- than the Fund has met. He seems reasonably confident that the latest plan will work out, again being more optimistic than anyone else.

He concluded the dinner by saying we'll have to wait and see what happens. When asked at that point what they were looking for from Western governments, it was finance plus market access (especially MFN status with the US). He said they were willing to join the FUNK (Fund and Bank) asap.

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| TO: John A. Holsen | (JOHN A. HOLSEN) |
| CC: Paul Isenman | (PAUL ISENMAN) |
| CC: Fred Levy | (FRED LEVY) |
| CC: Alan Gelb | (ALAN GELB) |
| CC: Stephen Mink | (STEPHEN MINK) |
| CC: Kate Oram | (KATE ORAM) |

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/08/10

DUE DATE : 90/08/28

LOG NUMBER : 900820013

FROM : Sylvia Jay

SUBJECT : Requesting clearance of Mr. Attali's reply to Mr. Christophersen
on the collaboration of the EC & 4 Institutions study on USSR

OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

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- _____ PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- _____ AS WE DISCUSSED
- _____ RETURN TO _____

COMMENTS :cc: Messrs. Qureshi, Stern, Fischer, Holsen, Sandstrom o/r, Khanna



10 August 1990

E.B.R.D.
28 Avenue Hoche 75008 Paris
Tel: 42 89 10 26
Fax: 42 89 34 83
42 89 35 22

To the Personal Secretary of Mr. Conable, President of the
World Bank

Mr. Christophersen, Vice-President of the Commission of the European Communities wrote to the President designate of the European Bank for Reconstruction and Development on 17 July (copy attached) about collaboration on the EC and the Four Institutions studies on the Soviet Union. At the end of his letter Mr. Christophersen says that he intends to write to Mr. Conable, Mr. Camdessus and Mr. Paye along the same lines.

Mr. Attali would like to reply positively in the draft attached but he would like to be sure that his three colleagues in the study have no objections before he does.

Would you be kind enough to let me know as soon as possible whether Mr. Conable has any objections to the draft reply?

Many thanks

Sylvia Jay

Mrs. Sylvia Jay
Directeur Adjoint
of the Cabinet of
the President Designate

Secretary of Mr. Conable
1818 H. Street N.W.
Washington DC.
20433 USA

Jacques ATTALI

S. JAY

EBRD

28, Avenue Hoche

75008 PARIS

Tel. 42.89.10.26

Fax 42.89.35.22

3 August 1990

Thank you for your letter of 17 July with your helpful suggestions for collaboration on the two studies of the Soviet Union. These seem to me to be very sensible and I shall be glad to cooperate in the ways you suggest.

Jacques ATTALI

Mr. HENNING CHRISTOPHERSEN
Vice-President of the Commission
of the European Communities
Rue de la Loi
B1049 Brussels
Belgium



HENNING CHRISTOPHERSEN
VICE PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

Brussels

17 July 1990

633

Dear Mr. Jacques Attali

The European Council at its meeting in Dublin on 25 and 26 June requested the Commission, in consultation as appropriate with the international financial institutions, to analyze the possibility and desirability of extending short-term credits and longer-term support for structural reform in the Soviet Union. These proposals will be based mainly on an economic report by the Commission services. Also, the Houston G-7 summit of 9-11 July has asked the IMF, the World Bank, the OECD and the EBRD to undertake a detailed study of the Soviet economy, in close consultation with the Commission.

It is clear that in dealing with the Soviet Union our approach will be different from the one used in our work on Eastern Europe. It rather needs to be along the lines of how the Soviet Union can be integrated into the world economy. The Soviet Union and the West would have to work closely together. In this way discussions on internal reforms in the Soviet Union and on how possible assistance can be provided most effectively could go hand in hand.

We would plan to use the same network for the purposes of our consultations as is already in place for Eastern Europe, linking the Commission with the EIB, the IMF, the OECD and the World Bank, to which will be added the EBRD.

We have drawn up provisional plans which include a mission to Moscow in late August and the preparation of our economic report by the end of September. In the work of our respective organisations on the USSR we should like to exchange information and data resources. We would also hope that the meeting of our network of correspondents scheduled to take place in Washington in mid-

Mr Jacques Attali
Président
BERD
28, avenue Hoche
Paris 8ème
FRANCE

September could be the occasion not only for our usual exchanges on Eastern Europe, but also for a discussion of the main issues concerning the Soviet Union. I would also suggest that we meet in the margin of the annual meetings of the IMF and the World Bank in Washington.

The economic analysis of the Commission services will be carried out by the Director-General for Economic and Financial Affairs, Mr Giovanni Ravasio.

I am writing in the same terms to Mr Broeder, Mr Camdessus, Mr Conable and Mr Paye.

Yours sincerely

Harry Christophersen

1) BBC
2) LM



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

August 21, 1990

Dear Barber:

I would like to invite you to join me for lunch in my Dining Room at the IMF at 1:00 p.m. on September 21, together with the heads of the other institutions participating in the study of the U.S.S.R. economy. We would then meet (together with personal representatives and study leaders) at 3:00 p.m. in my Conference Room.

I would like to suggest that during that meeting, among other matters, we could discuss the time and venue of a possible meeting with Henning Christophersen.

Sincerely yours,

A handwritten signature in dark ink, appearing to read "Michel Camdessus".

Michel Camdessus

Mr. Barber Conable
President
The World Bank
Washington, D.C. 20433

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

AK
SS

MONETARY FUND
WASHINGTON, D.C. 20447

CORRESPONDENCE DATE : 90/08/21 DUE DATE : 00/00/00
LOG NUMBER : 900822008 FROM : Michel Camdessus
SUBJECT : Inv. - luncheon meeting with heads of other institutions partici-
pating in the study of the U.S.S.R. economy: Sept. 21 at 1pm
OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)


ACTION:

- APPROVED
- PLEASE HANDLE
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- PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- AS WE DISCUSSED
- RETURN TO _____

COMMENTS :cc: Mr. Conable, Mr. Qureshi, Mr. Stern

JVoelk (schedule)

Sincerely yours,



Michel Camdessus

Mr. Robert D. ...
President
The World Bank
Washington, D.C. 20447

THE WORLD BANK

ROUTING SLIP

DATE
8.28.90

**FROM THE SENIOR VICE PRESIDENT,
POLICY, RESEARCH AND EXTERNAL AFFAIRS**

NAME

ROOM NO.

Mr. Khanna

| | | |
|---|-------------------------|----------------------|
| | APPROPRIATE DISPOSITION | NOTE AND RETURN |
| | APPROVAL | NOTE AND SEND ON |
| | COMMENT | PER OUR CONVERSATION |
| | FOR ACTION | PER YOUR REQUEST |
| X | INFORMATION | PREPARE REPLY |
| | INITIAL | RECOMMENDATION |
| | NOTE AND FILE | SIGNATURE |

REMARKS

FROM:


Wilfried P. Thalwitz

-----Facsimile Transmittal from-----
THE WORLD BANK
Office of the Vice President, Development Economics

-----Telefax 1 (202) 477-0549-----

Date: 24 August 1990

To: Mr. Thalwitz
Faxphone x-71775


From: John A. Holsen, DECVP 

Subject: Recommendation on Reply to Attali-to-Conable Letter

I attach (i) the reply we made to an identical letter from Mr. Christophersen (signed by D.C. Rao as Acting Vice President) and (ii) the package sent me. (Originals are being sent back by regular office mail.)

Mr. Attali's two sentence reply seems totally innocuous to me. I don't see any hidden traps or hidden meanings. It is not clear to me why Mr. Attali makes so much of it. He was present at JFK when Mr. Lamy and the four "HOs" agreed on full cooperation, full exchange of information.

As your blue sheet asked for "review and recommendation to EXC (A. Khanna)," I have already called him and told him the above. He said he had sent it to you only because of worries about hidden traps. I believe he wanted me to discuss the matter with you and then hear directly from your office before taking action. So, will your office please call him to make it official. Thanks.

*Mr. Khanna
The road is clear*


WORLD BANK OTS SYSTEM
Office of the SVPPR

CORRESPONDENCE DATE : 90/08/10 DUE DATE : 90/08/28
LOG NUMBER : 900824002 FROM : JAY: SYLVIA(MRS), DI
SUBJECT : L - REQUESTING CLEARANCE OF MR ATTALI'S REPLY/MR CHRISTOPHERSEN
ON THE COLLABORATION OF EC & 4 INSTITU. STUDY ON USSR
OFFICE ASSIGNED TO FOR ACTION : Stanley Fischer/Holsen

ACTION:

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COMMENTS :

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/08/10

DUE DATE : 90/08/28

LOG NUMBER : 900820013

FROM : Sylvia Jay

SUBJECT : Requesting clearance of Mr. Attali's reply to Mr. Christophersen
on the collaboration of the EC & 4 Institutions study on USSR

OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

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COMMENTS :cc: Messrs. Qureshi, Stern, Fischer, Holsen, Sandstrom o/r, Khanna

1

URGENT

10 August 1990

E.B.R.D.
28 Avenue Hoche 75008 Paris
Tel: 42 89 10 26
Fax: 42 89 34 83
42 89 35 22

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Sylvia Jay

Mrs. Sylvia Jay
Directeur Adjoint
of the Cabinet of
the President Designate

Secretary of Mr. Conable
1818 H. Street N.W.
Washington DC.
20433 USA

Jacques ATTALI

S. JAY

EBRD

28, Avenue Hoche

75008 PARIS

Tel. 42.89.10.26

Fax 42.89.35.22

3 August 1990

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Mr. HENNING CHRISTOPHERSEN
Vice-President of the Commission
of the European Communities
Rue de la Loi
B1049 Brussels
Belgium



HENNING CHRISTOPHERSEN
VICE PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

Brussels

17 July 1990

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Mr Jacques Attali
Président
BERD
28, avenue Hoche
Paris 8ème
FRANCE

- 2 -

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I am writing in the same terms to Mr Broeder, Mr Camdessus, Mr Conable and Mr Paye.

Yours sincerely

Henning Christophersen

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

AK
SS
JWS

CORRESPONDENCE DATE : 90/09/10 DUE DATE : 00/00/00
LOG NUMBER : 900910004 FROM : John Holsen
SUBJECT : Fax msg: Joint Study of Soviet Economy (JSSE)

OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

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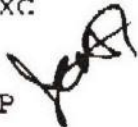
COMMENTS :cc: Mr. Stanton, Mr. Sandstrom, Mr. Khanna

Facsimile Transmittal from
THE WORLD BANK
Office of the Vice President, Development Economics

-----Telefax 1 (202) 477-0549-----

Date: 10 September 1990

To: Mr. Anupam Khanna, EXC
Faxphone x-71305

From: John A. Holsen, DECVP 

Subject: Joint Study of Soviet Economy (JSSE)

I attach a copy of the background note I have faxed to Mr. Thalwitz for possible use at the G-7 Deputy Finance Ministers breakfast meeting in Paris tomorrow.

I have spoken to Mr. Thalwitz a few minutes ago and he tells me that the main subject of the meeting will be G-7 views on the terms of reference for the study. Apparently the U.S. Treasury has prepared an outline for the JSSE report. The Fund (Mr. Whittome) has a copy, but we have not yet seen it. We are told, however, that it calls for a report which makes no mention of financial requirements.

Mr. Thalwitz passed along word that Mr. Sitarian (Deputy Chairman of the Council of Ministers and the senior USSR official directly concerned with relations with the Fund and Bank) is coming to Washington this week and will be seeing Mr. Camdessus on Wednesday. The purpose is to discuss the USSR's need for financial support during the balance of 1990. (As my note indicates, I believe that the consumer goods situation is critical in the Soviet Union and that prompt financial assistance from the West could be crucial to the outcome.)

I believe Mr. Thalwitz spoke by phone with Mr. Conable earlier this morning, so I believe the latter is aware of these issues.

This transmission consists of 6 pages including this page.
[S0091001.DOC]

The Soviet Economic Reform Program

[Comments based upon the meetings of JSSE task force leaders during their Sept. 3-4 meetings in Moscow.]

1. The on-going debate on the Soviet Economic Reform Program should come to a head within a very few days -- in the limited sense that there is to be a single plan (acceptable to both Mr. Gorbachev and Mr. Yeltsin) which will then be considered by the legislatures of the 15 republics and by the Supreme Soviet. There now exist two programs. They are (i) the Ryzhkov/Abalkin program and the (ii) Shatalin program. On Tuesday, September 4, Mr. Abalkin told us that the differences between them would be resolved within a week or ten days; he told the JSSE (Joint Study of the Soviet Economy) task force leaders that, "We have to compromise ... and, if we can't reach a compromise, we have to choose."

2. Once a compromise is reached, the long process of legislative review will begin. The final plan must have the approval of the soviets of all of the republics and, finally, of the Supreme Soviet (federal legislature). We were told that final approval was hoped for by October 1, but it might well be November 1 before it was obtained.

3. In a situation already dominated by uncertainty and inaction, further delays in clarifying policy directions will have a cost. However, given the limited effective authority of the central government, the federal authorities have no

alternative but to seek a consensus. The chairman of Gosbank noted that, while the newly empowered legislatures all wanted a voice, in practice they tended to avoid making decisions.

4. The Ryzhkov/Abalkin plan represents a relatively gradualist approach. It begins by emphasizing financial stabilization (budgetary expenditure policies, tax and subsidy reforms, interest rate reform) and then moves to major organizational ("systemic") change in the second phase. The government would start by improving the structure of relative prices through regulation, only going to price liberalization in a subsequent step (and always keeping prices of basic foods under controls). There would be some form of compensation for the elimination of subsidies and some indexing to protect people from inflation. Although new private sector activities would be encouraged, progress toward the "destatization" and privatization of existing SOEs would be slower. Rather than breaking up the largest enterprises ("demonopolization"), regulation would be used to limit the exercise of monopoly power. Privatization, probably beginning with housing, would be undertaken in part as a way of absorbing the large "monetary overhang" (that now makes the authorities fear the consequences of any rapid move toward price liberalization.) The Abalkin program sees convertibility as a long-term process.

5. The Shatalin "500 day" program is summarized in the most recent issue (September 8-14) of The Economist; a copy of this article is attached. While the Shatalin program moves much more rapidly on micro policy (particularly price liberalization)

and on systemic reforms (particularly privatization), it seems to give little attention to the need for economic and financial stabilization. While the Shatalin program contains a provision that neither the governments of the republics nor the federal government will finance their deficits by borrowing from the banking system, the realism of such an injunction, especially when it is unsupported by specific major fiscal reforms, must be doubted.

6. The compromise program is to include a "Union Compact" that would deal with the major issues of (i) what level of government now owns both state enterprises and natural resources and (ii) the extent of the taxation authority of the federal government. In both of these areas the Shatalin program comes close to reducing the federal government to an empty shell. Both enterprises and natural resources would belong to the republic in which they happened to be located. Taxation levels would be fixed by the parliaments of the republics; agreements would have to be negotiated between the republics and the center on the amounts and uses of transfers from the republics to the center. (We were told that Mr. Shatalin's economist soul worried about this provision, but that he didn't want to come out against any of the major republics.)

7. The senior officials and advisers with whom we met (including Mr. Abalkin, head of the State Commission on Economic Reform; Mr. Geraschenko, Chairman of Gosbank; and Academician Aganbeyyan, head of the Committee on Alternative Options) all emphasized the dominance of political factors in the present

environment. There are two aspects to this.

(1) The passing of power from the center to the republics. We were told that there is little, if any, confidence and trust in the central government (including in President Gorbachev). Consequently reform cannot come from the center, but must have the full consent of the republics. This implies that an acceptable program will involve a large transfer of power and economic resources to the republics.

(2) The unwillingness of the population to accept significant sacrifices (e.g., higher food prices or unemployment from industrial restructuring) combined with the very limited ability of the central government -- and unwillingness of the republic governments -- to impose such sacrifices on an unwilling population.

8. - The Abalkin program attempts to keep, to the extent its authors believe consistent with political realities, major responsibility and authority for overall economic management at the center. The Shatalin program basically moves most of such power to the republics. The latter would raise worries about the economic fragmentation of the country, except for the larger republics (mainly, Russia and the Ukraine).

9. The Abalkin program also makes a very conscious effort to "make haste slowly." It seeks to avoid (or compensate for) measures that the general population would see as worsening their already difficult situation. The supply of food and other

consumer goods has been increasingly disrupted, and we were told that it is getting worse rapidly. A program that fails, in one way or another, to improve matters in this respect is unlikely to maintain the support of the population.

10. Supporters of both the Abalkin and the Shatalin programs say that the decision to move to a market economy with a major role for the private sector is unshakable, and that the differences between them are more matters of tactics ("timing and sequencing") rather than basic objectives. But there is more to it than this. The Abalkin program is more sensitive to both the need for macroeconomic stability and the possible negative socio-economic consequences of reform. The Shatalin program is more in line with "economic liberalism" and combines this with a politically popular "all power to the republics" approach. Given the political constraints, it remains to be seen whether any compromise between these two approaches will prove to be an effective way out of a deteriorating situation.

11. Unless some improvement in supplies of consumer goods can be brought about soon, one cannot rule out the possibility of a socio-economic collapse and general breakdown of authority -- one consequence of which might be military intervention and a return to an oppressive rule in an effort to salvage something of the past power and position of the USSR. In this sense glasnost depends upon the success of perestrojka.

Draft: John A. Holsen (September 9, 1990)

[S0090901.DOC]

Talking Points

I understand that consideration is being given to a proposal by Messrs. Mitterand and Kohl to make available \$2-3 billion to the Soviet Union either by the EEC or the EEC in collaboration with other countries.

Interest has also been expressed in having the international community support a policy-oriented study of the scope and sequencing of structural change in the Soviet Union to move to a more market-oriented economy. The IMF and the World Bank might be asked to participate in such a study. I believe that it will take the better part of a year to prepare such a study, given the scale of the economy, the absence of adequate data, and the major transformation which is already in progress.

Moreover, such a study can only be undertaken at the request, and full collaboration, of the Soviet authorities. What their view may be is as yet unknown.

If the Mitterand/Kohl proposal implies early financial support to the Soviet Union, it should be considered separately from the study of longer-term structural changes. In our view, a quick study of the Soviet economy is not professionally possible. It would make us party to a false attempt to define conditions for what would be an emergency assistance to the Soviet Union.

My position would be that we are fully prepared to join with other institutions to undertake a study of the structural changes in the Soviet Union needed to move them to a more market-oriented economy; that to do this to acceptable standards would take about a year; that such a study would provide a useful basis for all sources of investment capital to judge whether there is a program to be supported and whether progress is being made. However, such a study would not be a suitable vehicle to provide assurance to donor countries, which might wish to make funds available in the near-term, that the money will be used effectively to support structural change.

USSR

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

DATE: September 21, 1990

TO: Mr. Barber B. Conable

FROM: Wilfried P. Thalwitz

*Pet rubor
situation*

EXTENSION: 80121

SUBJECT: USSR Study: Briefing for Heads of Agency Lunch

Lunch has been arranged for September 21, at 1:00 pm in the IMF Managing Director's Dining Room, to bring together the four heads of agencies involved in the G-7 Study on the USSR. They will be joined by their PRs who will continue meeting after lunch. As you know, Mr. Attali will just have returned from his first visit to Moscow; he will take up some space reporting on the political situation and impressions of the economic crisis. Our task force led by John Holsen arrived in Moscow just last Sunday and we have, of course, no findings from them on the items they cover: (i) economic organization (ownership, resource allocation, price system, financial sector; and (ii) industry, agriculture and housing sectors. Mr. Fischer participated in a Moscow visit as part of the Soros advisory group. The IMF is, after two substantial missions, ahead of everybody else.

The agenda is rather loose (see attachment). Mr. Fischer and I will brief you verbally at noon. Following are some of the salient points that will come up.

i) Political Situation

The USSR may well break up. The centrifugal forces are strong and the quest for independence remains in some republics. Even if the Union stays together, the nature of the relations between the Republics and the Union will certainly change with questions of taxing authority, central banking system and internal tariffs at stake. We need to recognize that we will have to prepare a report for the central government while these constitutional questions may still be under debate.

ii) Economic Situation

The G-7 asked for a report that would establish the criteria under which external assistance can effectively be provided. Forecasts of financial assistance will therefore be imperative; you should test whether all Heads of Agencies (HOs) share that view. The IMF is putting together the first numbers on the balance-of-payments. We should hear from Mr.

Whittome where they stand at the moment on balance-of-payments figures for this year. There will be much reference to signs of crisis such as declining output, supply rigidities, foreign exchange scarcity, monetary overhang and queues, bottlenecks in non-oil exports, continuing budget deficit, open and hidden unemployment, excessive wage growth, etc.

iii) USSR Reform Plans

We continue working with the Abalkin group set up by Prime Minister Ryshkov. However, the Shatalin plan, supported by Yeltsin, has in essence now been accepted by Gorbachev and some of our counterparts in the Prime Minister's retinue may be out by the time the report nears completion. We cannot simply put on the table an abstract blueprint for reform, but have to take cognizance and criticize the many shortcomings of the plans (ownership, price decontrol, external trade, privatization, and compensation during the stabilization phase). We should obtain agreement during lunch that we will indeed face the debate over Soviet economic plans head on.

iv) Outline of the Report

We now have a first draft of an outline for the report which needs much additional work. I do not think that during lunch we should head into the details of the construction of the report. That should be taken up by the PRs and their colleagues after lunch.

v) Calendar

| | |
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| October 19 | Team leaders meet in Paris |
| November 9 | First draft PRs |
| November 14 | Revised draft PRs |
| November 19-23 | High level discussion with Soviets (probably in Europe) |

Potential visit by HOs soon thereafter.

Still open, and to be discussed at lunch:

Discussion with G-7 before report is finally delivered.

vi) HO visit. I continue to think that a joint discussion of all four HOs with the Soviet authorities on the substance of the report is inappropriate. However, after the visits by Messrs. Camdessus and Attali (Mr. Paye may not be far behind), you would be the only HO that has not visited the Soviet Union and you may consider a separate visit after discussion with the other HOs.

JHolsen/SFischer/WThaliwitz

BBC meets Attali
at 6 p.m. today

ATTACHMENTDRAFT

Agenda items to be covered in:

1. HO's lunch, 1.00 p.m., Friday, September 21
Managing Director's Dining Room, IMF
2. PR's meeting, 3.00 p.m., Friday, September 21
Deputy Managing Director's Conference Room, IMF
1. The work schedule, including the timing of a possible
visit of HOs to Moscow
2. Relations with the EC
3. Report on the second factfinding mission to Moscow,
September 3-10
4. A possible draft outline of the summary report
5. Any other business

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Office Memorandum

To: Mr. Flemming
Mr. Thalwitz
Mr. Zecchini

November 2, 1990

From: L.A. Whittome *LAW*

Subject: USSR

I attach a copy of Mrs. Ter-Minassian's back-to-office report on her recent mission to the USSR. The minutes are also ready: we will send them by hand to Mr. Thalwitz and by courier to Messrs. Flemming (and Fitoussi) and Zecchini. We expect to send you the first two chapters of our background chapter on Monday.

Attachment

cc: Mr. Fitoussi



Office Memorandum

To: The Managing Director
The Deputy Managing Director

November 1, 1990

From: Teresa Ter-Minassian *T.T.M.*

Subject: Staff Visit to the USSR

A staff team 1/ visited Moscow on October 17-26, 1990 to discuss the "Guidelines for transition to the market economy," just presented by President Gorbachev, and the outlook for the economy for the rest of this year and 1991. The discussions with the Soviet authorities were generally cordial and open; however, it is apparent that the authorities are weary of the demands posed by numerous and sometimes overlapping teams (including those of the EC) on the time of already overstretched officials. It is also apparent that they are anxious to learn the conclusions being reached by the various organizations. They stressed their wish to receive a written summary of these conclusions prior to the joint visit of PRs and task force leaders to Moscow, currently planned for end-November or beginning of December.

The following sections summarize the main findings of the mission.

1. The political context

The last few weeks have witnessed a (last ditch?) effort by President Gorbachev to reassert a measure of authority of the union over centrifugal forces at the republican and local levels, and to control the disruptions in production and interregional trade, which have proliferated following the breakdown of traditional command mechanisms.

On the strength of emergency powers voted a month ago by the Supreme Soviet, the President recently issued a decree ordering enterprises to honor existing contracts and maintain established supply links through the end of 1991. At the same time, Mr. Gorbachev has attempted to secure a compromise with the republics, through the presentation of a framework for the transition to a market economy which leaves considerable scope to individual republics to determine the content and pace of reforms. Even so, the announcement of the program was greeted with sharp criticism by the President of the Russian republic, Mr. Yeltsin, who accused Gorbachev of reneging on the spirit of the agreement underlying the Shatalin plan.

1/ The team consisted of Messrs. Calvo (RES), Blejer (EUR), Flickenschild (ETR), Kopits (FAD), Wolf (EUR), DeMilner (WHD), Mmes. Christensen (ETR), Cheasty (FAD), Mr. Renfield (translator, BLS), Ms. Nguyen (administrative assistant, FAD) and myself. Mr. Lindgren (CBD) joined the mission at the request of Gosbank to discuss with the authorities, including representatives of the Russian republic, the draft central bank law. Messrs. Shafer and Hagemann (OECD) participated in some of the meetings.

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Although close advisers to Mr. Gorbachev, such as academician Aganbegyan, a main author of the presidential program, discount Yeltsin's pronouncements as political posturing, it remains unclear at the present time whether the President will succeed in arresting the threatened breakdown of the Union. A major test is to be faced over the next fortnight or so, when union and republican officials are scheduled to discuss the respective economic plans and budgets for 1991, and in particular, to confront such sensitive issues as the sharing of tax revenues and foreign exchange receipts, and the determination of subsidy and price policies.

2. Overview of the presidential reform program

Mr. Gorbachev's program is aptly named "guidelines for transition to a market economy" since it presents a broad framework rather than a blueprint for such transition. Indeed, many aspects of the program are left deliberately vague, with a view to allowing both scope for differentiation of approaches among the republics in the aspects of policy left to their determination, and flexibility of manoeuvre to the Union (i.e., the President) to rule by decree, in line with evolving circumstances. It is not surprising, therefore, that different officials to whom the mission talked put forward significantly different views on such crucial aspects of the program as: the foreseeable pace of price liberalization; the extent and timing of increases in those prices which will remain controlled, and of attendant compensation to wage earners; and the sharing, among different levels of government, of revenues, expenditure responsibilities and powers in the monetary, credit and foreign exchange areas. It is also not surprising that, given the lingering policy uncertainties, the authorities were generally not prepared to put forward macroeconomic forecasts for next year. 1/ Even attempts by the mission to make the discussions more specific by putting forward tentative scenarios (e.g., for the balance of payments) received only limited feedback. The authorities showed, however, keen interest in the mission's preliminary reactions to various aspects of the program, particularly in the fiscal and monetary areas, and requested an early aide-memoire to outline possible measures to contain the prospective budget deficit for 1991.

The main features of the presidential program can be summarized as follows:

a. Broad strategy and sequencing

The rhetoric of the program follows closely that of the "Shatalin plan" presented by the joint Gorbachev-Yeltsin group in September. Like that plan, the presidential program reaffirms "an irreversible choice" to move to a market-type economy, with right to private ownership of means of

1/ Gosplan provided the mission some summary projections for output and demand but was not prepared to release the more detailed forecasts presented to the Council of Ministers on October 15, citing the very preliminary and tentative nature of the projections which did not incorporate the plans for individual republics currently being discussed with the latter.

- 3 -

production, extensive privatization of state property and demonopolization of large industrial complexes. It also reaffirms the sovereignty of the republics and their basic autonomy in the conduct of economic policies, except in areas delegated to the Union. Finally, like the Shatalin plan, the program outlines a broad sequencing of measures, whereby financial stabilization is to precede--and create the conditions for--price liberalization.

In fact, however, the presidential program differs from the Shatalin plan in a number of important respects. First, it does not contain a specific timetable for the various phases of the transition period--although it makes reference to the likelihood (based on the experiences of other countries) that stabilization would take one and a half to two years. Also, the Shatalin plan contained more specific (albeit probably not very realistic) targets for privatization and price decontrol. On the whole, the heavy reliance in the presidential program on traditional command mechanisms ^{1/} at least through the next year, in combination with the lack of a specific timetable for its various phases, suggests that the actual pace of liberalization, especially if mainly controlled from the center, is likely to remain slow. If, then, some of the republics decide to move faster in areas left to their jurisdictions, tensions may well increase, leading to a further proliferation of disruptions in interrepublican trade.

b. Systemic and structural reforms

(1) Privatization and demonopolization. Although the program calls for legislation to establish private property rights and to promote privatization of state property, it is rather unspecific as to the modalities and timing of these actions. It advocates the creation of State Property Funds, at both the union and the republic levels, to oversee the sale of public properties, the privatization of small business in the industrial and tertiary sectors, the transformation of large industrial complexes into joint stock companies and the distribution/sale of their shares to private investors (with preference to be given to the workers in the firm). While no specific time horizon is indicated, the document suggests that the privatization process is likely to take a long time, given the large book value of state property. The program also calls for the creation of antimonopoly committees at various governmental levels, but does not specify their functions, powers or timetables for action. No mention is made of the potential roles of elimination of product "profile restrictions" or of import liberalization in promoting competition.

(2) Industrial restructuring and military conversion program. The program calls for a major redirection of resources and investment towards industries producing consumer goods. It envisages that certain ongoing investment projects in non-priority sectors may be reconverted if possible,

^{1/} The maintenance of a large role for state orders and of existing contracts among enterprises; the use of administratively set price lists as guidelines for contractual wholesale prices; and the persistence of direct controls over the bulk of retail prices (see below for further details).

- 4 -

or altogether halted, and unfinished construction sold off to the extent possible. The restructuring effort is to be fostered through some tightening of budget constraints on enterprises, increases in interest rates on investment loans (to 15 percent) and the closing of nonviable firms (these are estimated to be several hundred). The program envisages the creation of an enterprise restructuring fund ("stabilization fund"), probably financed through a special levy on enterprises' investment or depreciation funds, to provide temporary support during the restructuring period to loss-making firms deemed economically viable. It says little on the criteria for distribution of these funds or the duration of the proposed support. Indeed, one cannot but wonder about how sound any assessment of an enterprise's long-term viability can be at this time, given the magnitude of existing distortions in the economy and in particular in the price structure.

Although the program is vague on the content of military conversion plans, the mission was told by Gosplan that the target is to increase production of civilian goods by defense industries by 30 percent over the period 1989-91; as a result, the share of civilian goods production in total output of defense industries would rise by over 10 percentage points (to 52 1/2 percent) from 1988 to 1991. The military conversion process is to be primarily guided by state orders rather than by market instruments.

(3) Land reform. In meeting with the mission, Mr. Shatalin noted that an important positive feature of the presidential program (and the main reason why he decided to support it) is its recognition of different forms of land ownership, so that private farms could coexist with the traditional state and collective ones. In Mr. Shatalin's view, it was especially important that the President had agreed to proposing this reform, without resorting to the referendum which he had initially called for. The program remains, however, once again unspecific as to the modalities and timing of sale or distribution of land. Much appears to be left to individual republics' initiative. Thus, it is difficult to assess at the present time to what extent or how soon private ownership will in fact replace inefficient state and collective farms.

The program emphasizes the need for interrepublican agreements to secure the free flow of agricultural commodities among republics, and calls for the establishment of an all-union fund, with preestablished contributions of each republic, to ensure the supply of food for the army and for agricultural exports to be carried out under state agreements with foreign governments.

c. Price reform

In the price policy area, the presidential program appears to follow more closely the approach envisaged in the Government program than in the Shatalin plan. Liberalization is to proceed rather cautiously at both the wholesale and the retail levels, while an attempt is to be made to correct administratively the largest distortions in relative prices. Specifically as regards wholesale prices, the Soviet authorities envisage two major

- 5 -

categories. One group (consisting of energy products, raw materials and strategic intermediate goods) is to remain controlled, with prices set at uniform nationwide levels on the basis of interrepublican agreements. 1/ For other products, prices are to be set contractually between enterprises and governmental agencies, or among the enterprises themselves. However, it is also expected that these prices would be set either following the guidelines of a list prepared by the State Price Committee or on the basis of cost developments plus a standardized markup. Thus, enterprises' freedom to determine prices, at least for next year, remains closely circumscribed. The planned price increases are reportedly large, ranging from 20-30 percent for machine building products up to 150 percent for certain energy products and raw materials. The average increase of wholesale prices for 1991 is estimated by Gosplan to be of the order of 60 percent. Agricultural procurement prices, which are also to be set on the basis of interrepublican agreements, are expected to rise on average by about 30 percent.

The picture is less clear for retail prices: 5-15 percent of these prices (mainly for "luxury goods") are to be liberalized before the end of the year. The pace of further liberalization in 1991 is to be determined--mainly at the republican level--in the light of progress in stabilizing financial conditions in the economy and supply conditions in the market. Some of the Soviets met by the mission spoke of some 70-80 percent of retail prices being liberalized by end-1991--along the lines of the Shatalin plan--but no such commitment appears in the published guidelines. A substantial proportion of these prices--notably those of essential foodstuffs which are highly subsidized--will probably continue to be set administratively. Large (in some instances many fold) increases in some of these prices are essential if consumer subsidies--which currently account for about 10 percent of GDP--are to be prevented from rising sharply and indeed if, as should be the case, they are to be reduced. 2/ The Soviet authorities have not decided yet the policy course in this respect, and were therefore reluctant to venture any estimate of inflation in retail prices for next year. It appears that they would prefer to shift the burden of these very unpopular decisions to republican governments by transferring responsibility for provision of consumer subsidies to the republican budgets. This could prove to be (intentionally or not) a recipe for procrastination.

d. Labor market, wages and social policies

The program recognizes that the restructuring of industry will inevitably entail significant losses of jobs in the affected enterprises. It calls for steps (such as the creation of a state employment service) to facilitate retraining and exchange of information on available vacancies,

1/ For 1991 many of these prices will in fact be set by Presidential decree, under the emergency powers recently granted to Mr. Gorbachev by the Supreme Soviet.

2/ The Ministry of Finance estimates that if the prices of major subsidized commodities (milk, bread and meat) were to remain unchanged, consumer subsidies would rise in the 1991 budget to the equivalent of 16-18 percent of 1990 GDP.

- 6 -

for the provision at the local level of public work opportunities for laid off workers, and for the early introduction of an unemployment compensation scheme. No details are, however, provided on the costs and sources of the financing of the scheme. Gosplan officials estimate that unemployment might rise from the current level of around 2 million (1.2 percent of the labor force) to 6-8 million in 1991, and that about half of unemployed workers would be eligible for unemployment compensation.

As regards wage policy, the presidential program appears to mark a cautious move towards allowing some widening of wage differentials, to reflect productivity. Specifically, it states that enterprises will be free to determine the form and level of their workers' compensation, subject to the setting of nationwide but industry specific minimum wages. It is unclear whether the recently introduced steep tax on enterprises granting wage increases in excess of governmental guidelines will be maintained and, if so, how effective it may be in containing wage pressure. The program calls for an up to 70 percent indexation of wages to the prices of a minimum consumer basket, with the degree of indexation declining with income levels. This, however, may tend to compress wage differentials. Pensions and family allowances are to be 100 percent indexed. It is envisaged that the minimum consumer basket would be calculated at the republics' level, to allow for regional differences in living standards, which are quite marked in the USSR.

e. Budgetary policies

The most specific quantitative objective in the presidential program involves the deficit of the state budget (consolidated union and republics' budgets), targeted to be reduced from an estimated rub 60-65 billion (6-6 1/2 percent of GDP) in 1990 to around rub 25-30 billion in 1991. 1/ Little information is provided, however, in the document on the measures needed to achieve this target. The mission's analysis, based on extensive discussions with officials in the Ministry of Finance and Gosplan, suggests the underlying budget picture for 1991 (in the absence of corrective measures) is for a sharp deterioration, with the deficit of the state budget likely to at least triple in nominal terms. The main factors accounting for this deterioration can be summarized as follows: (a) a near doubling of outlays on consumer subsidies and a loss of about rub 40 billion in revenue from the turnover tax, 2/ if retail prices are not raised to reflect the planned and already implemented increases in wholesale and agricultural procurement prices; (b) a loss of revenue from the company income tax, following a substantial reduction in its effective rate; (c) a likely loss of revenue from taxes on foreign trade, stemming from the planned reform of

1/ The mission was told, however, by Ministry of Finance officials that the target was likely to be raised to rub 40 billion in the revised version of the program, which is to be published following its detailed debate in the Supreme Soviet.

2/ The present turnover tax is just a (variable) wedge between retail and wholesale prices. Therefore an increase in the latter not reflected in the former leads to a corresponding loss of revenue to the budget.

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the exchange rate system (see further below); (d) a recently approved pension law, which involves on average a 50 percent increase in benefits, and envisages a 100 percent indexation of pensions to future price increases; (e) the planned increase in interest rates on savings deposits (see below), which will need to be at least in part reflected in an increase in interest rates on the government debt; and (f) the likely cost to the budget of various tax preferences, subsidized credit schemes for enterprises, support to loss-making firms during restructuring, and the financing of a number of new funds (some of which have been mentioned above) called for in the presidential program.

To counter this threatened deterioration, the authorities have identified a number of corrective measures, involving: (a) substantial cutbacks in budgetary expenditures on investment, on military procurement, on administration at the union level, on subsidies to loss-making enterprises, and on foreign aid; (b) a confiscatory taxation of "excess" profits of enterprises (which is also seen as an anti-monopoly device) and a 20 percent levy on depreciation funds of firms; and (c) sales of government property. However, net savings from the planned expenditure cuts may amount at most to about rub 30 billion. The proceeds from sales of government property (which, given their once-over nature, should not be counted as equivalent to other revenues) are unlikely to be large in the near term. The excess profits tax and depreciation levy appear to be retrograde steps, running counter to the objectives of promoting enterprise autonomy and responsibility, and would probably be best replaced with a mandatory dividend pay-out ratio.

Thus, it seems clear that, in order to effectively contain the state budget deficit in 1991 to a level close to the target, it will be necessary to enact quickly a reform of the turnover tax (shifting it to an ad-valorem fixed rate basis) and to pass through increases in wholesale, procurement and import prices to the retail level. The attendant savings in outlays on consumer subsidies and the higher tax revenues will, however, be partly offset by increased spending on pensions and social allowances, given their indexation to price movements. In this respect, a more effective targeting of social assistance through, e.g., the provision of means-tested income support mechanisms in cash or in kind, such as food stamps, would appear desirable.

The budgetary prospects for next year are further complicated by the persisting lack of political consensus on the apportionment of revenues and spending responsibilities between the Union and the republics. There is a real risk that, as expenditure responsibilities are shifted to republics with varying degree of taxing capacity, and in the absence of adequate redistributive mechanisms, pressures will mount to resort to borrowing from the banking system or, for those republics (and other local governments) which have foreign exchange earning sources, to foreign credit, leading to a further loss of budgetary discipline. The mission stressed these dangers and advocated a ban (or at least very strict limits) on these forms of financing, preferably to be included in the Union Treaty--which is currently under negotiation but unlikely to be agreed by the target date of end 1990.

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f. Monetary and financial policies

The President's program envisages measures to deal with both the "stock problem" of excess liquidity (the monetary overhang) of households and firms and with the "flow problem" of effectively moderating future growth of the monetary and credit aggregates. In the first respect, emphasis is laid on measures to tie up liquidity (sales of dwellings and land plots, military property with civilian uses, small businesses in the retail and service sectors, and financial assets such as the so-called commodity bonds) 1/ and to increase the attractiveness of holding deposits through an increase in interest rates. 2/ While these proposed steps go in the right direction, clearly there remain questions as to whether they can be realistically of a magnitude and timing adequate to the task at hand. From the discussions during the mission, it became apparent that the authorities are keen to limit the inflation tax on households to their cash holdings. Gosbank advocated a (budget financed) revaluation of deposits, to compensate their holders for any substantial adjustments in retail prices. This view does not appear to be shared by the Ministry of Finance, which is concerned with the potentially large budgetary cost of such a step (households' deposits amount to the equivalent of about 35 percent of GDP). The mission shares these concerns.

As regards the excess liquidity of enterprises, the mission heard suggestions that their deposits may be at least partly frozen in the early phases of the program, a move which, in combination with proposed increases in loan rates and in the prices of most production inputs and with planned cutbacks in budgetary subsidies and bank credit growth, would probably result in a significant liquidity crunch on the enterprise sector. To what extent such a crunch would be reflected in a liquidation of excessive inventories, wage moderation and cutbacks in the labor force, and/or in a sharp fall of output and investment is difficult to predict ex ante. It may be safe to expect that it will lead to sharply increased pressures for selective budgetary support and for preferential breaks in taxes and interest rates, as well as in increased resort to inter-enterprise credits, which reportedly are already rising.

The presidential program also refers to a number of measures to contain monetary growth in 1991 and beyond 3/ (although no quantitative target is specified, and Gosbank authorities were not prepared to be more specific in this respect either). These measures include the planned elimination (except for short periods in exceptional circumstances) of financing of

1/ These are non-interest bearing bonds providing the right to receive, within a prespecified period of time and at a state-guaranteed price, consumer durables. Their prospective cost to the budget could turn out quite high if prices rise substantially in the next few years.

2/ A first increase in these rates (up to 9. percent) has just been announced by Gosbank.

3/ The rates of growth of total bank credit and broad money are projected at 10.5 and 15.3 percent, respectively, compared with an estimated 3-4 percent growth of nominal GDP.

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budget deficits by Gosbank, ^{1/} and a more active use of indirect means of monetary control, including reserve requirements, refinancing policies and the establishment of at least non-negative levels of real interest rates.

In the mission's view, given the still underdeveloped state of the capital market, the likelihood of effectively containing to near zero the monetary financing of the budget deficit in 1991 depends crucially on the authorities' ability to cut sharply the deficit. Also, given the foreseeable difficulty of gauging inflationary expectations and thus of establishing administratively an appropriate level of interest rates, it appears unlikely that adequate credit restraint can be achieved next year without continued resort to quantitative controls over bank credit.

Significant progress has been made in recent weeks towards the approval of legislation to reform the banking system. The picture emerging from this process is one of an autonomous Union Reserve System, consisting of the Gosbank and republican central banks. The system would be based on a single currency. A Board of Governors would manage a centralized monetary and credit policy and issue uniform prudential rules and regulations for the entire system. The republics would adopt their own banking legislation in accordance with the laws of the Union Reserve System. However, important policy, operational and organizational issues remain quite open at this time. These principally include the respective roles of the union and republican central banks and the composition of the Board of Governors of the Union Reserve System, in particular the weight of the Russian Republic in it. It is also unclear to what extent the proposed responsibility of the republican central banks to their respective Supreme Soviets will constrain and hamper financial and monetary discipline.

Increased competition within the banking system is to be achieved through the breaking up of the five large state-owned specialized banks into independent stock companies, and through continued growth of new and existing commercial banks. The draft central bank law envisages that the registration and supervision of such banks would be the responsibility of the republican central banks. For this process to work in a smooth and well-coordinated manner, reasonably uniform rules and regulations for prudential control and common accounting criteria would seem essential.

g. External policies

(1) Exchange rate system. While the presidential program is nearly silent on the matter, discussions with Gosbank officials provided the mission an overview of reforms planned in the exchange rate system. These reforms have begun to be implemented with a presidential decree of October 26, 1990, which introduced a new commercial exchange rate effective

^{1/} It is, however, envisaged that the budget could be financed through recourse to the Savings Bank, which is to remain under state control.

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November 1, initially set at \$1 = rub 1.8, 1/ compared with the current level of the official rate of \$1 = rub 0.58. This level of the rate was chosen to ensure that, for 90 percent of exports, their prices converted in domestic currency would at least equal their present domestic wholesale prices (after the planned elimination of the differentiated exchange rate coefficients-DVKs). 2/

The commercial rate will be applied to the bulk of current account transactions, in particular export proceeds subject to surrender, imports covered by the foreign exchange allocation plan and service of the foreign debt, and to inflows of financial loans. A special rate (equivalent to ten times the official rate) will remain in effect for tourist transactions.

The authorities also intend to create at the beginning of 1991 a free auction market to which access will be allowed for exporters with surplus retained foreign exchange 3/ and importers holding valid licenses but without adequate foreign exchange allocations. It is envisaged that the Gosbank will intervene in this market. The mission was also told that the some republics (notably the Russian Federation) intend to create their own foreign exchange markets and to intervene in it, using their shares of surrendered foreign exchange. Presumably the various markets will be linked by arbitrage.

It is difficult to assess the prospective impact of the introduction of the new commercial rate, since it remains unclear to what extent the implied devaluation will be allowed to be reflected in domestic wholesale and retail prices of imported goods. It is equally difficult to predict (and the authorities were not forthcoming in this respect) the future conduct of exchange rate policy and, in particular, the time horizon for, and path towards, an eventual unification of the commercial and free market rates. Given, however, the likely persistence of significant excess liquidity and (open or repressed) inflationary pressures in the economy in the foreseeable future, it would seem very likely that the gap between the commercial and the free market rates will remain wide, thus providing incentives to illegal channeling of transactions through the free market and distorting resource allocation towards those goods for which a higher retention of export proceeds is envisaged.

1/ The rate will be pegged to the same basket of six currencies as the official rate (which remains in effect for ruble-denominated claims of the USSR on LDCs). Thus, the commercial rate will fluctuate weekly vis-a-vis the U.S. dollar, reflecting changes in the rates of the latter vis-a-vis the other currencies in the basket.

2/ These are multiplicative coefficients (greater or less than 1) heretofore applied to the official exchange rate, differentiated by category of goods and direction of export or import.

3/ It is envisaged that exporters will continue to be allowed to retain a share (varying by type of export) of their foreign exchange earnings. Surrendered proceeds will be shared between the Union and the republic from which the export originates, in as yet undetermined proportions.

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(2) Liberalization of foreign trade and investment. The presidential program envisages further progress in eliminating the state monopoly on foreign trade, except for energy products, gold, diamonds and a few high technology goods. This would also make less predictable in the near term the development of exports heretofore dominated by state trade, e.g., to the CMEA countries.

The mission did not discuss in detail the authorities' intentions in the trade policy area, a topic which is to be covered by the OECD. The general impression is that progress in trade liberalization is likely to be slow, given in particular the balance of payments prospects. Foreign exchange allocation and import and export licensing mechanisms and export quotas are likely to be maintained for some time. A new tariff, in line with the harmonized system, has been prepared, and will continue to be supplemented by selective import and export taxes, in some instances with quite high rates.

Liberalization is likely to proceed much faster with respect to foreign investment. A recent presidential decree allows for the first time full foreign ownership. The mission also discussed a draft foreign investment law which, inter alia, protects foreign investors against future adverse changes in Soviet legislation, and liberalizes rules for the transfer abroad of profit and capital.

(3) External debt. The presidential program calls for the creation of an all-Union currency fund to service the external debt outstanding of the Union. This fund is to be fed with--as yet undetermined--shares of foreign exchange surrendered by exporters to the republics. The fund would also service debt incurred in the future for all-Union projects and other activities, as determined by the new Union treaty. Foreign debt incurred by individual republics (possibly against collateral of their foreign exchange earning assets) will be serviced by them. While probably inevitable in the current political setting, the foreseeable loss of central control over external indebtedness gives cause for concern. It would also seem important that, with the further decentralization of foreign trade activities, an effective mechanism to monitor and control external financing obtained by enterprises engaged in foreign trade be put in place as soon as possible.

3. Recent economic developments and short-term macroeconomic prospects

Economic indicators, which have become available since the previous mission, confirm the trends in evidence throughout this year, namely declining output, accelerating inflation and worsening foreign trade performance. Reports of unfulfilled contractual agreements and of disruptions in production and interrepublican trade are continuing, and indeed worsening. For 1990 as a whole, the authorities project declines in industrial output (-1.5 percent), construction (-3.0 percent) and transportation (-1.3 percent). GDP is expected to fall by 2 percent and employment by nearly 1 percent (for the first time in recent history). The recorded rate of inflation of retail prices was nearly 4 percent in the

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first nine months of 1990 and is projected at almost 5 percent for the whole year. Goskomstat estimates the underlying rate of inflation to have accelerated to around 12 percent.

The outlook for the balance of payments appears to have worsened, despite the increase in oil prices. The authorities now project a sharper decline in oil export volume (-15 percent), reflecting a 6 percent fall in production; the decline will be concentrated in exports to CMEA countries. For the year as a whole, the trade deficit is expected to reach the equivalent of US\$17 billion. Partial indications obtained by the mission suggest that the rundown of short-term credits and of foreign exchange reserves is continuing, and trade payments arrears have increased further (to about US\$5.5 billion by end September).

Given the continuing uncertainties regarding crucial aspects of, in particular, price, budgetary, and other financial policies, it is impossible to forecast with confidence macroeconomic developments for 1991. Perhaps a central--most likely--scenario can be thought to involve a nearly full pass through of the planned increases in producer prices to the retail level, so as to at least stabilize the level of consumer subsidies and prevent a loss of turnover tax revenue. The attendant boost to consumer prices (probably well over 30 percent) is likely to be partly compensated by differentiated indexation mechanisms for various income groups. A probably less than full compensation is also likely for households' deposits. In these circumstances, the price boost would only partly eliminate the existing monetary overhang. The budget deficit could probably at best be stabilized in relation to GDP, thus requiring additional bank financing. A significant tightening of liquidity and an increase in the cost of credit are likely to occur in the enterprise sector, forcing some release of accumulated inventories and a continued fall of investment. Tighter liquidity conditions would help moderate wage increases over and above mandatory indexation.

The impact of the likely fall of real household income on consumption is likely to depend crucially on the availability of consumer goods (in particular foodstuffs). If disruptions of output and interrepublican trade do not proliferate, and financing is available to step up imports of consumer goods, private consumption is likely to be sustained by a rundown of accumulated financial assets. In this event, the decline in GDP, albeit sharper than the 2 percent currently estimated for this year, may remain moderate. By the same token, it is unlikely that, under this scenario, a substantial restructuring of industry and increase in unemployment would occur.

The outlook for the balance of payments is clouded by substantial uncertainties regarding, in particular, developments in trade with the CMEA and the availability of financing. Prospects for energy exports remain bleak, as oil production is expected to decline by a further 5 percent. Although domestic consumption is also likely to decline slightly, in reflection of the fall in GDP and the planned sharp increase in domestic energy prices, a further decline in volume of oil exports on the order of 15

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percent may not be ruled out. The distribution of this fall as between industrial and other countries (including CMEA) will depend, *inter alia*, on arrangements currently being negotiated on a bilateral basis with various trading partners. The outlook for non-energy trade, and its distribution between industrial and other countries, is more difficult to predict in view of the growing weight of non state trade. The preliminary staff projections assume broadly unchanged non-energy terms of trade and export volumes vis-a-vis the industrial countries, and a significant gain in the non-energy terms of trade vis-a-vis the CMEA area. 1/ These projections (which are predicated on an average price of oil of US\$30 per barrel in 1991) suggest that, given the scheduled debt service 2/ and already secured financing (including about US\$2 1/2 billion newly announced credits from France and Spain), about US\$8 billion in convertible currencies would be required to maintain imports at their 1990 level and to clear up arrears, assuming no further reduction in short-term debt and in foreign exchange reserves. A portion of these financing requirements could be filled by the prospective substantial surplus vis-a-vis CMEA countries 3/--which, however, is likely to be at least partly reflected in a rundown of accumulated debt-of the USSR vis-a-vis some of these countries.

3. Some concluding observations

From the above overview, it seems clear that 1991 is unlikely to witness major liberalization in any area of the economy. It is interesting that the mission's arguments in favor of a faster pace of liberalization--accompanied by a firm stance of financial policies--met with generalized skepticism among the Soviet officials and, in particular, with statements to the effect that "the Polish model of adjustment would not be appropriate in the present economic and political circumstances of the USSR." Thus, it is probable that we shall see a continued effort--in particular through presidential decrees--to maintain in place, or revive, the main administrative control mechanisms and to preserve the bulk of the existing productive structure, albeit with attempts at beginning to correct some of the major disequilibria and relative price distortions. The macroeconomic implications of these policies would probably be a continued slide of output, a marked pickup in the rate of recorded inflation and of inflationary expectations, and some erosion of real incomes and real financial wealth of the population. The balance of payments will show a substantial improvement in the current account--assuming continued strength of oil prices--but imports will be constrained by the heavy burden of

1/ Specifically, it is assumed that prices of Soviet exports of raw materials to CMEA will move in line with world market prices, while prices of other exports and of imports will both fall by 40 percent.

2/ The debt service (interest plus amortization of medium and long-term debt) is projected to exceed US\$13 billion (about 25 percent of projected exports to the convertible currency area) in 1991.

3/ The mission's preliminary projections put this surplus at around the equivalent of US\$7 1/2 billion in 1991. They need, however, to be checked against updated projections by the desk economists of Eastern European countries.

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servicing the external debt in 1991, unless substantial additional financing (directly or possibly indirectly through stepped up assistance to the CMEA partners) can be secured.

In these circumstances, the already dwindling political capital of President Gorbachev may well be exhausted sooner rather than later. Whether this would lead to an acceleration of centrifugal forces and a breakdown of the Union, or possibly to a conservative backlash, or, more optimistically, to the realization of the need for a much more rapid shift to a market economy, is of course, anybody's guess at the present time.

cc: Mr. Whittome
Mr. Beza
Mr. Frenkel
Mr. Toure
Mr. Van Houtven
Mr. Boorman
Mr. Gianviti
Mr. Laske
Mr. McLenaghan
Mr. Mohammed
Mr. Narvekar
Mr. Russo
Mr. Shaalan
Mr. Tanzi
Mr. Wright
Mr. Zulu
Paris Office
Geneva Office
Mr. P. Andrews

Bansy File?
yes

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: 10-Nov-1990 01:29pm EST

TO: Robert Picciotto (ROBERT PICCIOTTO)

FROM: Stanley Fischer, DECVP (STANLEY FISCHER)

EXT.: 33774

SUBJECT: Comments on the Draft Soviet Study

Greetings:

Life has been tolerable but dull without seeing you.

Paul Isenman passed on your comments on the PC draft of the JSSE study. I assume you understand that this is just the draft that will be submitted to the drafting session for the final report, which is scheduled to meet November 19-21. This is not the time to do a major edit of Economist level. The integrated final draft of the main report will no doubt be very carefully edited, and will come out much smoother than this.

Second, the question of how to handle decentralization /the potential breakup of the USSR, and the advice we give, is being discussed now. One likely strategy is to premise the report on the existence of a national market, single currency, no internal tariffs, etc. and then in each section to spend a few paragraphs explaining how the system would work (and not work) if it were more decentralized. More fundamentally, there are deep political questions about the conditions under which foreign aid should be given and can be used effectively.

This leads into the next issue: there is a separate section of the final report which will draw together the set of conditions under which we believe aid can be effective. That is being drafted by the EBRD, but will obviously be the subject of intense scrutiny and discussion by all the agencies.

Best

Stan

CC: Paul Isenman

(PAUL ISENMAN)

CC: John A. Holsen

(JOHN A. HOLSEN)

CC: Kate Oram

(KATE ORAM)

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: 10-Nov-1990 11:11am

TO: Sven Sandstrom
TO: Anupam Khanna

(SVEN SANDSTROM)
(ANUPAM KHANNA)

FROM: Robert Picciotto, CPBVP

(ROBERT PICCIOTTO)

EXT.: 30202

SUBJECT: USSR

Sven:

John Holsen tells me that some effort is going into revising the report to make it responsive to the attached comment. I hope you will take a close look at the final draft to ensure it is less academic and more attuned to the realities and dilemmas of a disintegrating political order.

For the Bank to be less plain speaking and concrete than the Soviets themselves will make us lose credibility with those who commissioned the study ! The tone of the current draft reminds me of the tone we affected when we wrote about Rumania and Yugoslavia at the heyday of our lending to those countries. The reality there and then -- as now in the USSR -- is that government to government lending will not be productively used.

This is what the study should say as plainly as possible. And this is what Mr Conable should tell Mr Gorbachev -- along with the offer to provide policy reform advice to build the road to facilitate the integration of the USSR in the global economy.

The elements of reform listed in the study should be toughened as thresholds to the new European economic order -- as prerequisites and conditions rather than as polite advice. And the message should be addressed to the Republics as well as to the Center.

I would be curious to see the talking points being prepared for the President.

Bob

The World Bank/IFC/MIGA
O F F I C E M E M O R A N D U M

DATE: 08-Nov-1990 10:53pm EST

TO: John A. Holsen (JOHN A. HOLSEN)

FROM: Robert Picciotto, CPBVP (ROBERT PICCIOTTO)

EXT.: 30202

SUBJECT: RE: Fragmentation of the USSR

John:

Thank you for taking the trouble to respond to my rambling comments at the PC. Having witnessed the pernicious impact of food zones on the agricultural economy of India, I have no difficulty whatsoever with your hypothesis.

However, the main point I tried to make was different : any report on systemic reform in the USSR which does not explicitly recognize the centrifugal forces unleashed by Gorbachev's political reforms could be perceived as irrelevant by the very readers it is intended to reach -- including those who are trying to keep the Union together.

It is, of course, not possible to project what kind of political equilibrium will emerge. But the very complexity and social risk embedded in the reform strategy you are advocating militates for arrangements in which elected leaders in the republics (rather than the discredited central leadership) will eventually have to take charge of the adjustment effort. This will precisely have to happen in order to arrest the balkanization and fragmentation within the republics which, you appropriately note, is currently spreading.

Thus, the defensible borders of a stable Union moving towards a market based economic system may not coincide with current political boundaries. For example, an economically and politically viable core built around Russia and the Ukraine might be viable. Such a core might transact suitable economic arrangements with the periphery. In other words, it is as much up to local leaders to negotiate an appropriate role for the center as it is for the center to decide on an appropriate devolution of power to the republics.

This kind of perspective may be shared by G7 officials, many of whom would not be adverse (for geopolitical reasons) to encourage a peaceful transfer of power to the republics -- even at some cost to economic efficiency in the short run -- since the alternative could be socially disruptive and politically regressive.

Thus, I would have thought that the study would be enhanced by an explicit recognition (even if brief and sensitively phrased) of federalist options -- combined with a call for inventive political solutions capable of generating stable social arrangements and effective economic leadership for the difficult transition period which lies ahead.

Equally, the relevance of your prescriptions would be clearer if you indicated that the policy package you are recommending does not preclude a wide range of alternative political options in center-republic power sharing -- provided appropriate decoupling between the political and the economic realm is preserved.

It is precisely this willful decoupling which should be at the center of the reform. Indeed, the study should make clear that without such decoupling, i.e. power sharing arrangements which preserve the elements of viable markets, it would not be realistic to expect the West to provide the capital and the technology needed to modernize the Soviet economy.

You might also wish to make the report less conceptual and abstract by contrasting the poor performance of the economy with its vast potential. Trends, anecdotes and examples of economic distortions and their costs are needed to bring the report to life. In other words, you should link your arid prescriptions with a vision of the outcomes that could result in a relatively short time. And the grim alternatives.

In the same vein, you might indicate the extent to which your recommendations apply to the various parts of this extraordinarily diverse and complex country. Finally, a demonstration of the consistency of your recommendations with the findings of the sectoral teams would help validate a report which is fundamentally sound but suffers from an excessively dogmatic tonality. Why not bring in an editor from the Economist ?

Bob

THE WORLD BANK

ROUTING SLIP

Date

Nov. 15, 1990

OFFICE OF THE PRESIDENT

Name

Room No.

Members, President's Council

To Handle

Note and File

Appropriate Disposition

Prepare Reply

Approval

Per Our Conversation

Information

Recommendation

Remarks

Re: Soviet Study

The attached is distributed for your information.

Anupam Khanna

From

REFORM OF ECONOMIC ORGANIZATION

Introduction

1. The Soviet Union has undertaken a major transformation of its economy. In the past the Soviet economy has been comparatively autarkic as well as centrally planned and administered; the announced objective is to transform it into a more open and market oriented economy. The results of the partial reforms of the last several years have been disappointing. While the old system has, in many respects, ceased to function, the new one is not yet in place. There is a widespread recognition of the need to accelerate the reform process. Although there remain many differences about how the transition should be managed, there is a broad agreement on the objective of a more decentralized and market oriented economy. This section of the report discusses a number of aspects of this systemic transformation -- including the reform of pricing policies, privatization and enterprise reform, financial sector reform, the social safety net and labor policies, trade and other aspects of external economic policy, and the legal framework for a market economy. As well as discussing the general issues involved, this report provides a commentary on the program for systemic reform that were outlined in the Basic Economic Guidelines which were approved by the Supreme Soviet of the USSR on October 19, 1990.

2. The decentralization of the economy is being undertaken simultaneously with a major decentralization of political authority and responsibility. In other parts of the world, continuing political independence is being accompanied by increasing economic integration. This reflects recognition that the benefits of a market economy grow with the size of the market involved. The republics of the Soviet Union have recognized the desirability of greater openness with respect to the world economy. Given the many ways in which these republics are economically interdependent, any significant decrease in openness with respect to each other would be very costly in terms of economic welfare. Consequently, and despite occasional recent moves in the opposite direction, this report assumes that the republics of the Soviet Union will wish to maintain the All-Union market at the same time as there is greater integration with the broader world market. Maintaining the All-Union market implies a common currency, the absence of trade barriers between republics, and a common external tariff and exchange rate.

3. The timing and sequencing of economic reform measures has been a subject of much debate. Because reforms in one area often complement those in another, to a considerable extent it is desirable, and perhaps necessary, to make progress on many fronts simultaneously. However, satisfactory macroeconomic management -- particularly, bringing the budget deficit under control -- is prerequisite to successful implementation of almost any kind of systemic reform. This is especially important in the Soviet Union, where the monetary situation could become very serious problem if there was a "flight from money." In the area of systemic reform, first attention should go to those measures that will complement macroeconomic management. Such measures include reduction in consumer subsidies as part of price reforms, the "hard budget constraint" as part of reform of state enterprises, and privatization measures that will help reduce the monetary overhang.

Price Reform¹

Background

4. In the transition to a market economy, nothing will be more important than changing the way prices are determined so they can serve as signals to guide the allocation of resources. In a system of central allocation, such as existed until recently in the Soviet Union, prices were regarded as playing essentially an accounting role with little influence on consumption, investment, or production decisions. The efficiency of resource allocation depended instead on price-insensitive administrative decisions. Even with the focus on physical balances, however, it is likely that the low prices maintained, for example, on industrial raw materials, both reflected and helped to perpetuate the low priority given by planners to economizing those resources. Inadequate investment in housing and poor maintenance may also be attributable, in part, to the low financial flows to the responsible government agencies that has resulted from low rents. Household consumption patterns have been influenced by the heavy subsidization of particular foodstuffs.

5. The signals provided by market prices become crucial as allocation decisions are decentralized to enterprises, and those enterprises are placed increasingly on a self-financing basis.² As noted in the Basic Economic Guidelines, "Market mechanisms can function efficiently only if most prices are freely established in the market, by balancing supply and demand. State price controls are permissible only in a limited sphere." In our view, early and rapid price reform is crucial to the essential restructuring of the Soviet economy and to resolving the severe resource diversions, supply shortages, and macroeconomic imbalances that now characterize the system. For this reason, we strongly recommend substantial correction of existing price distortions, including increasing the prices of basic consumer goods, as part of the first phase of economic reform.

6. The economic reform proposals recently under consideration in the Soviet Union, while recognizing the central role of price reform in the transformation of the economy, have all tended to take a cautious approach in this regard, and this caution is also reflected in the Basic Economic Guidelines. Emphasis is given to the need to stabilize aggregate demand in the economy, to remove monopolistic elements, and to stabilize the supplies of basic commodities prior to the liberalization of prices. The underlying concerns that freeing prices in the face of macroeconomic imbalance, extreme concentrations of market power, supply shortages and inelasticities, and the absence of an effective mechanism to protect the real incomes of pensioners and other fixed and low income people could lead to a serious wage-price spiral, large monopoly profits, major disruptions of production, and heavy social costs are all understandable and justified. What is involved, however, is a set of "vicious circles", in which the price distortions themselves lie at the heart of the very problems that, in turn, inhibit price reform.

7. It must be acknowledged at the outset that economic reforms will involve inevitably a substantial increase in the average level of prices and money wages in the Soviet Union. Many prices would have to be raised several-fold to approach international price levels. Given the "stickiness" of prices in the downward direction, the upward adjustments are unlikely to be offset by price declines in those goods currently overpriced in relative terms. The needed price increases will, in turn, have a serious impact on the real incomes of Soviet families. The challenge facing the Soviet authorities is how to achieve the higher market-based price plateau and to cushion the impact on household incomes without

¹A more detailed discussion of the current price system in the Soviet Union and of our recommendations for reform may be found in Chapter -- of the Background Paper.

²The analysis of prices in the Soviet Union is complicated by the imposition of turnover taxes at widely different rates on different products (see Section --). As a consequence, a wedge of varying dimensions is placed between the prices charged to buyers and the price received by sellers. This problem is ignored in the discussion here, and the recommendations that follow necessarily assume that the distortions of the turnover tax are removed, preferably to be replaced by a value-added tax.

setting off an uncontrolled process of continuous inflation.

The Pros and Cons of Early and Rapid Price Decontrol

8. The Basic Economic Guidelines correctly put heavy emphasis on the need for a tightly restrictive fiscal and monetary policy to reduce the inflationary pressures that are already present in the Soviet economy and to control the additional pressures that will emerge during the reform process. The subsidies currently required to hold down prices, particularly of basic foods, comprise a major proportion of the deficit in the state budget. The need for adequate prices for producers is clearly recognized in the Guidelines. Without significant adjustments of prices to consumers as well, subsidies will grow rapidly in the coming year, making extremely difficult, if not impossible, the achievement of the stated fiscal targets and the control of inflation.³

9. As noted above, economic reform will result unavoidably in a significant increase of prices in the Soviet Union, even if monetary and fiscal discipline are maintained. The increase in the prices of basic consumption goods would, unless compensated, have a serious impact on the living standards of people on low and fixed incomes. For many Soviet citizens, the results could be devastating. Some way must be found, therefore, to provide at least partial amelioration of this impact. The Soviet authorities are also properly concerned about the possible disruption to the economy that the elimination of subsidies and, as part of the transition to a more open economy, the transition to world prices, could cause. The inefficient use of key inputs, particularly energy, that currently characterizes much of Soviet industry makes many enterprises' financial viability dependent on heavily subsidized prices of such inputs. A rapid increase in those prices could, therefore, jeopardize the solvency of enterprises unable to adjust their production processes and input mixes quickly to the changed terms, and unable to raise output prices accordingly in the face of domestic or external competition. There is also concern that uncertainty about the prices of basic industrial inputs would make it exceedingly difficult for enterprises to enter into contracts for future deliveries; the added risk is likely to add to prices and thus to inflation. Finally, the danger must be acknowledged that the initial large price adjustment and its attendant disruption of the real economy and of real incomes could awaken inflationary expectations and demands for budgetary and credit assistance that will be difficult for the authorities to resist, thus opening the possibility of accelerating price increases far beyond what is necessary to correct relative price distortions.

10. On the other hand, failure to allow full price correction early in the reform process implies that resources would continue to be used inefficiently throughout the system, as producers and consumers both responded to distorted signals. Energy would continue to be wasted, along with other underpriced inputs. The housing stock would continue to depreciate more rapidly than technically necessary or economically justified. The distorted profit patterns among industries would attract investment and credit to relatively low-priority uses, while higher-priority activities were unable to attract the resources they needed. Similarly, controlled prices are an underlying cause of the supply shortages and disruptions currently evident in the Soviet economy. The decentralization of decision-making that has already occurred as a result of the enterprise reforms that began in 1987, in the face of continuing price distortions, has resulted in significant breakdowns in the state supply system, as even deliveries subject to state orders are diverted to barter and "shadow" markets, where they capture significantly higher prices or price equivalents. Scarce inputs, under these circumstances, are increasingly rationed by personal connections and corruption, as well as by hidden inflation, while supply uncertainties and the logistical complexities of barter trade sharply raise the costs of production and the pressures for additional credit and budgetary support.

11. As regards the impact of price increases on consumers, governments around the world have instituted price controls with the intention of protecting the purchasing power of the poorest members

³Indeed, to the extent that price controls at the retail level stimulate additional demand for the product, freed prices at the wholesale level will rise more than they would were prices freed at both levels, increasing the gap that has to be filled by subsidies.

of the society. These efforts have been exceedingly costly, however, and have seldom succeeded. In addition to the costs to the economy of price distortion itself, price controls benefit all purchasers of the subsidized goods, whether or not they need such assistance. A targeted program providing supplementary income can meet the same social objective without imposing price distortions and placing a far smaller burden on the state budget. Moreover, price-controlled goods in short supply are commonly diverted to the black markets, where they are bought by those who can afford to pay the higher prices. The benefits of the subsidies thus accrue in large measure to the black marketeers and the corrupt officials who help them to acquire the scarce supplies of goods at the subsidized prices. It is clear that this is currently happening in the Soviet Union.⁴

12. Finally, price reform is prerequisite to efficiently carrying out other important reform measures. One of these is the hard budget constraint (see paras. __-__) needed both to strengthen macroeconomic management and to provide the financial autonomy required as part of enterprise reform. The market can also be a powerful tool for demonopolization (paras. 44-45), especially where regional monopolies are concerned, but the process will not work if price signals are not allowed to operate. The fixing of prices to reduce profits removes the very market forces that would attract new enterprises into a market to provide the desired competition. Moreover, with distorted prices, it is difficult to carry out the needed restructuring of enterprises, including the conversion of military enterprises to other lines of production, and, since value depends on profitability and prospects in the marketplace, to accurately value assets for the purposes of privatization.

13. In short, while there are risks involved in rapid price decontrol, a strategy to delay providing the price incentives necessary to spur the restructuring of the economy is also fraught with the danger of supply breakdowns and accelerating inflation. To the extent that delay succeeds in reducing the immediate pain of adjustment, this gain may come at the cost of facing a more painful adjustment in the future. Granted that changing relative prices will involve an increase in average prices, extending the process over a longer period seems more likely to generate destabilizing inflationary expectations than would a more rapid correction of relative prices followed by measures to hold average prices at the new plateau.

Recommendations

14. For the reasons given above, we believe that the desired transition to a market economy in the Soviet Union would be best served by an earlier, more rapid, and more comprehensive liberalization of prices than is currently being contemplated. We are persuaded to this view in part because of the degree to which the administered supply system has already broken down, resulting in shortages of both industrial inputs and consumer goods, hidden inflation, and an apparently massive shift to barter activity to keep production going. Despite Government's admonitions to enterprises to respect traditional supply relations and to honor state orders, it is doubtful whether the administered system can be put back together to function at anything near its previous effectiveness. In addition to encouraging greater efficiency, rapid price decontrol may now be the fastest, if not the only, road to reestablishing a stable flow of goods in the Soviet economy. At the same time, however, measures need to be taken to ameliorate the impact of price increases on household incomes.

15. We recommend, first of all, that the prices of most goods in the economy be freed from administrative controls. Exceptional treatment should be accorded to a limited number of key inputs—e.g., energy and certain basic metals. These should be inputs for which (i) the supply response to increased prices is likely to be slow; (ii) the potential disruption of industrial production is large unless a reasonable period for adjustment is allowed; and (iii) the products concerned are important inputs, for

⁴To that extent, the raising of official prices would simply recognize and validate the inflation and reduction in real incomes that has already occurred and would permit the direction of compensating income subsidies to the intended beneficiaries instead of to the pockets, as at present, of the rent-seekers.

which substantial price predictability is significant. In addition, in each case the state supply system should be capable of assuring reliable supplies at or near the present levels. For these key inputs, we recommend a time-bound, preannounced schedule of adjustment to world prices over, say 2-3 years. This would give the affected industries forewarning of the need to adjust their technologies, product and input mixes accordingly.⁵ The Guidelines now call for the prices of energy and other basic materials to be set by agreement among the republics. If this procedure is used, it should be agreed from the start that the purpose is to ease the transition to international prices within an established time frame. The adjustment of industry could also be eased somewhat by an initially high uniform external tariff (replacing the present myriad of quantitative restrictions), reduced over time in accordance with a preannounced schedule.

16. We further recommend that, through the first stage of reform, the government use imports to stabilize the retail prices of the most sensitive basic consumer goods--wheat, milk, butter, meat--at levels that fully cover freed producer prices and the costs of transportation and distribution. As the wholesale and retail marketing networks are privatized (paras. __ and __), government intervention through managed imports could be eliminated. The stabilization of inflationary expectations in the wake of this adjustment would depend heavily on the success of the monetary and fiscal program and on guaranteed supplies of imports of the indicated goods. It is recommended that bilateral assistance be provided during the first stage to assure import supplies. The composition, volume, and resale prices of specific commodity aid, however, would have to be carefully managed to avoid harming domestic producer incentives.

17. For workers, the removal of consumer goods subsidies (and increased rents) would represent a sharp reduction of what has, in effect, constituted wages in kind. It is appropriate for both economic and equity reasons that the reduced subsidies be at least partially compensated by an administered increase in money wages.⁶ This increased cost to the enterprises would be partially offset by the transfer of certain social expenditures from the enterprises to the government (see para. 5), and would constitute a first step toward the market-oriented reform of labor remuneration policies also alluded to in the Guidelines. Increased labor costs, along with other input costs and higher interest rates (paras. 73-76), would get reflected in the prices of goods in the market.

18. Pensions and other transfers to individuals not active in the labor force would have to be adjusted. One approach that has been used elsewhere is a flat per capita transfer for all individuals. Although administratively more difficult, a targeted approach, based on maintaining acceptable real minimum family income levels, should be able to accomplish the same social objectives at lower cost to the budget. Overall, the extent of compensation to consumers for the loss of subsidies would depend on their fiscal impact and on the requirements of macroeconomic stabilization. Short-term reductions in the real incomes of some members of the population are probably an unavoidable cost of the reforms. The challenge to the government is to assure, through the design of the reform program, that this short-term cost is (and is perceived to be) a sound investment in the future.

19. The above recommendation to allow the prices of consumer goods to rise to market levels is the preferred approach. However, it is a widely held view in the Soviet Union that prices of some essential consumer goods should continue to be subsidized. Although we believe that the social needs involved could be more effectively met by compensation arrangements, such as those described above,

⁵The move to market pricing for housing rents might also be phased over time (see Section --) because of the time required to develop the necessary institutional base (including programs for low-income families that might be needed to complement the private housing market). In cases of natural monopoly, prices would continue to be controlled but at levels that fully cover long-run marginal costs.

⁶In considering the appropriate magnitude of wage adjustment, it should be noted that substantial real wage increases in excess of productivity growth have occurred over the past few years (Section --), and that a comparison of new consumer prices with official prices will overstate the actual incremental impact on households (para. 14).

insistence on immediate price liberalization might jeopardize popular support for the broader economic reform program. Consequently, some continuation of retail price subsidies may be deemed unavoidable for a small number of essential consumer goods.⁷ Since the level of the subsidy will be limited in the light of the budgetary situation, the retail price subsidy should be provided in a manner which would limit the cost to the budget through the diversion of subsidized goods to unintended uses and beneficiaries. This could be done by allowing prices to rise to their market levels, but providing individuals with coupons which gave each person the right to purchase a fixed quantity of the basic foods at an administratively fixed price. Those wanting more of an eligible good would be able to purchase it, but only at the unsubsidized market price. A variant of this would be to provide each person with a given amount of food stamps which could be used as money in buying eligible foods at their regular market prices; since the stamps would have a fixed monetary value, an individual's cash payments would vary with the market prices of the goods concerned, but the budgetary cost of the subsidy would be precisely known.

⁷It is assumed, as indicated in the Guidelines, that producers would receive a market price for their output, so that shortages and their attendant problems are avoided. Subsidies would have to be financed, therefore, from the fiscal budgets of the Union, Republican, or local governments. A high degree of decentralization of authority over consumer prices already exists in the Soviet Union and would be continued under the Guidelines. If price differentials between localities exceed the costs of transportation, goods would, of course, tend to be diverted toward the higher price market. Administrative controls imposed to prevent the diversion, already evident in many parts of the USSR, threaten the desired promotion of the national market.

Enterprise Reform

20. As noted above, the Basic Economic Guidelines clearly affirm the Government's intention to devolve microeconomic decision-making to individual enterprises, operating under different forms of ownership, including private ownership, in an environment of market-determined prices, competition, and equal status under the laws. Today, however, the vast industrial sector of the Soviet Union is characterized by huge, monopolistic state enterprises; which still receive a large proportion of their production orders and inputs from the state, face administered prices, have little control over company finances, and are run at the plant level by people who are production engineers rather than enterprise managers in the Western sense. Along side these giant enterprises is a rapidly growing number of much smaller firms, operating largely outside the state planning system, under various forms of organization whose legal status and ownership rights remain unclear. The increasing decision-making responsibility accorded to the managers of state enterprises over the past three years, and the rapid proliferation of these new enterprise forms, taking place in a context of rigid state prices and unclear ownership, is resulting in enterprise decapitalization and a progressive breakdown of the state supply system. The latter adds to the urgency of a rapid transition to market-determined resource allocation. This section examines several interrelated aspects of the enterprise reforms that must form part of this transition: the denationalization of ownership, enforcement of a hard budget constraint on enterprises, the demonopolization of industry, organizational and managerial changes in those enterprises destined to remain, at least for the foreseeable future, under state ownership, and the training of enterprise managers.⁸

Denationalization of Ownership

Background

21. Ownership of the means of production in the Soviet Union is formally vested in the people as a whole. Production and pricing decisions were, for many years, made by central planners rather than by enterprise managers guided by market signals. Managerial performance was judged primarily by whether or not physical output targets were fulfilled. Capital tended to be inefficiently used and poorly maintained, partly because neither managers nor the state officials to whom they reported had either a direct stake in the enterprise's efficiency or in protecting the value of the capital stock.

22. Interrelated problems of ownership, management, and incentives lie at the heart of the unsatisfactory performance of Soviet enterprises, in respect to productive efficiency, product quality, and technological backwardness. To achieve a fundamental change in this situation, the Basic Economic Guidelines call for the "denationalization and demonopolization of the economy and the development of enterprise and competition". "Denationalization," which is also sometimes characterized as "destatization" or "commercialization," means establishing an enterprise as a financially and managerially autonomous entity. As stated in the Guidelines, "Not only are they autonomous in their activity, but they are also economically responsible for the results of this activity--in terms of both current income and their own property."

23. For large enterprises, denationalization would typically be carried out by converting the enterprises to joint stock companies while still under public ownership. The locus of ownership, however, would be clearly identified; ownership would initially pass to State Property Funds, which would act as holding companies. Privatization through the sale of shares is seen as a subsequent step for most medium and large denationalized enterprises. However, the need for denationalization and commercialization applies equally to those enterprises that would be expected to remain in the public sector. Smaller enterprises, on the other hand, could be quickly privatized without going through the intermediate stage

⁸Greater detail and description are found in Chapter -- of the Background Paper.

of being reorganized as joint stock companies.

24. While details of denationalization programs are to be worked out by the Union and Republic governments in their respective areas of ownership--a discussion complicated by intergovernmental disputes over enterprise ownership--the Guidelines propose that outright privatization begin immediately in such activities as trade, restaurants, consumer services, repair shops, construction, and small enterprises generally. The denationalization or commercialization of large and medium-sized enterprises is also to begin right away. Eventually, it is expected that most of the production and service sectors of the economy will have been transferred to private ownership.

The Pros and Cons of Rapid Privatization

25. The decentralization and clear definition of ownership rights and responsibilities is, along with price reform, the most urgent step in the transition to a market system in the Soviet Union. Beyond the general principles outlined above, however, the Guidelines do not set out a clear program or time frame for transforming enterprise ownership, and questions of speed and sequencing continue to be a matter of debate.

26. Early privatization, in particular, raises several problems. It may be difficult to estimate the value of enterprises when relative prices are still unsettled, and their future prospects are unclear. Moreover, as the Guidelines point out, the value of the state's productive assets far exceeds the savings available in the private sector to pay for them. Even in the case of small enterprises, provision will be needed for buyers to pay in installments. Denationalization and privatization in the industrial sector⁹ is complicated by the large and frequently indivisible nature of the assets involved, the high degrees of market concentration, oversizing of plants, and uneconomic vertical integration of production. Two possible consequences of rapid privatization, therefore, are that the assets might be acquired at far below their actual values, providing a windfall to the buyers, and/or that asset ownership might become concentrated in the hands of a few individuals who have the money or political connections to acquire it. Another issue is whether existing monopolies (other than the limited number of natural monopolies) should be broken up, and enterprises restructured, prior to privatization.

27. Receipts from the sale of state assets could help to reduce the monetary overhang and provide important revenues to the government during a period when fiscal management is crucial to the success of the economic reform generally, but rapid privatization of larger enterprises would probably require some giveaway of the assets concerned, perhaps through a voucher scheme that ensures an equitable distribution of shares. Besides the failure to generate needed government revenues, such giveaways have a number of disadvantages. The resulting sudden addition to household assets would probably result in an increase in consumption (while sales on favorable terms over time would probably increase household saving). A voucher system could result in widely scattered ownership of individual enterprises; this would be unlikely to result in effective monitoring and control of enterprise managers. It is further argued that persons or entities receiving ownership rights over productive assets at low cost to themselves might feel less a stake in assuring the efficient use of those assets.

28. On the other hand, while rapid privatization of shares in the larger enterprises would reduce the cash proceeds to the state, it would also permit a wider distribution of assets now seen as belonging to all the people. The problem of enterprise control could be overcome by transferring the ownership of enterprises to holding companies, whose shares could then be distributed to the public. This is not very different from what is suggested for non-privatized enterprises, except that the holding companies would pay dividends to private shareholders rather than to the state. In either case, with large enterprises there are problems of establishing managerial incentives at both the individual enterprise and holding company levels. Until and unless interest in the efficient use and value of capital becomes imbedded in enterprise

⁹Questions related to the privatization of housing and of agricultural land are discussed in Chapters - and --, respectively.

decision-making, the nation's capital stock will continue to be wasted and dissipated.

29. By the same token, clear ownership and property rights must accompany rational prices to achieve the desired demonopolization and efficient restructuring of industry. As elaborated below (paras. ___ - ___), we believe that enterprise managers, acting in response to market signals, can do a major part of the job of demonopolization more efficiently than would be done by officials in ministries. However, enterprise ownership must already have passed to persons or organizations that have a stake in the efficient use of its assets. The rapid "spontaneous privatization" process that is already under way also points up the need for a quick regularization and completion of ownership reform.

30. The proposed middle stage of commercialization of state enterprises under the aegis of state holding companies offers a distinct improvement over the present ministerial control of enterprises. Efforts in other countries to place state enterprises under a hard budget constraint and to subject them to market discipline have not always worked out well in practice, however. It has been found very difficult to insulate state enterprise management from political pressures and the noneconomic objectives of governments. For the above reasons, we would urge the authorities to consider an even more rapid privatization process than is proposed in the Guidelines.

Recommendations

31. We recommend that denationalization and privatization be accelerated by taking a mixed approach that will vary by type of activity and size of enterprise, as well as according to the preferences of the different Republics. Specifically, we recommend the rapid privatization of small enterprises through outright sale to individuals, cooperatives, etc., willing and able to acquire them and to accept the risks of entrepreneurial activity. The privatization of larger enterprises will necessarily take longer and could proceed along essentially two paths: (i) the direct sale or leasing of divisible products lines, stages of production, or service activities to individuals, cooperatives, etc.; and (ii) conversion into joint stock companies under the initial ownership of state holding companies created for the purpose, with privatization proceeding through the market sale of shares to individuals, financial institutions, and other enterprises and organizations, either directly or through mutual funds.

32. In the service sectors, the Government's proposal to sell the assets through open and well publicized auctions is an excellent one and should proceed as quickly as possible. We agree also that buyers should be allowed to make payment in installments to permit both rapid sale and a wide and equitable distribution of the assets. Particularly important is the denationalization of transport, storage, and distribution services, where assets--e.g., trucks, warehouses, retail shops--are easily sold off one by one, and where the existing commercial monopolies can therefore be rapidly broken up.

33. With respect to larger enterprises with multiple product lines, or whose production processes are divisible, we would encourage the process of sale or leasing of discrete parts of enterprises that is already taking place. The sellers or lessors could be either the newly formed joint stock companies or, in advance of the completion of conversion, existing state enterprises. Sale would be by open and well publicized auction and would require a significant equity downpayment by the new owners, equivalent, say to 15% or more of the purchase price, allowing them to finance the remainder with interest at normal terms.

34. Leasing arrangements could be used to privatize enterprises of all sizes. Monthly lease payments could be established by auction or, alternatively, made equal to an estimated straight-line depreciation of the assets, plus a negotiated return to the lessor; the life of a lease would be based on the expected life of the covered assets. While leases were in effect, the original assets would be held as collateral by the lessor. No new state or lessor investment would be made in the leased enterprise; any replacement or new investment would be the responsibility of, and would be owned by, the lessees, who would also be responsible for arranging its financing without state subsidy or guarantee.

35. Lessees would be free to organize their enterprise as they see fit--joint stock company,

cooperative, individual proprietorship, etc.--and to alter their product lines and methods of production. It should also be possible for lease contracts to be sold to other individuals or organizations, subject to antimonopoly laws and regulations. Otherwise, lease holders would lose their interest in protecting the value of the leased assets. At the end of a lease contract, the value of the original assets would have been entirely depreciated, and any new assets would be fully owned by the lessee. Enterprises that become unprofitable during the life of the lease, whether because of mismanagement or changing market conditions, would be allowed to fail.

36. To ensure against arbitrary and opportunistic behavior in the valuation of assets, it might be desirable to establish a review procedure for sales and leasing contracts, vested in independent government agencies answerable to the Union and Republican Parliaments. To avoid undue delays in the privatization process, as has occurred in other countries undergoing similar reforms, the review should be limited to questionable cases. These could be brought to light by a requirement that all such arrangements be publicized in the newspapers, identifying the sellers and buyers, or lessors and lessees, the assets covered by the contracts, and the terms of the sale or lease.

37. As long as they continued under public sector ownership, large enterprises should operate as joint stock companies. Shares would be owned initially by state holding companies, independent of the line ministries, and charged with operating the entities under their responsibilities as commercial, market-oriented enterprises and with husbanding the long-term value of their assets. Such enterprises should be accorded no preferential treatment from the state, however, by virtue of their public ownership. Moreover, to encourage competition, ownership of enterprises producing the same goods or close substitutes should not be concentrated in the same holding company.

38. Over time, as financial savings and markets grew, it is expected that the state holding companies would sell their shares to individual and institutional investors, including mutual funds, pension funds and insurance companies. Alternatively, or in addition to selling off their holdings enterprise by enterprise, holding companies could, in effect, convert themselves into mutual funds, selling shares in their total respective portfolios. In appropriate cases such intention could be written into their charters, including a statement of intentions regarding the period over which the assets would be sold or the holding company itself would be privatized.

39. The Guidelines propose that priority in the buying of property and shares be given to labor collectives, and that their members be accorded various forms of financial assistance to help them to become owners. We would note in this regard that the experience of labor-managed enterprises in other countries has been disappointing. Workers in control of their own enterprises have tended to concentrate on the maximization of their own incomes with a relatively short-term time horizon, with the result of limiting the employment of new workers and decapitalizing the assets of the enterprise over time. We recommend, therefore, that substantially less than a controlling ownership be made available on a preferential basis to an enterprise's own workers, and that these shares be distributed to workers on an individual, rather than collective, basis. Workers would thus enjoy the same ownership rights of other shareholders, including the right to sell their shares (as well as to acquire new shares) in the market.

40. Another issue concerns the treatment of the debts of existing enterprises. Should these be assumed by the new owners? As a general principle, debts not attributable to existing assets--i.e., the monies have been expended on consumption or wasted on investments of little or no value--should be written down and not passed on as a burden to the new owners.¹⁰ Insofar as the debts correspond to valuable assets, however, these should be assumed by the new owners of those assets, as if they had borrowed the funds themselves. In the case of valuable leased assets, the debt liability would remain (along with asset ownership) with the lessor, but the related debt service would be included in the lease payment.

¹⁰Implications of this debt write down for the financial sector is discussed in Section --.

Imposing a Hard Budget Constraint

41. Enterprises, whatever their ownership, will only respond to market signals and to the pressures of competition if the owners and managers are truly held responsible for the financial results of their decisions. Market discipline is obviously undercut when there is a "soft budget constraint"; i.e., when losses are covered by transfers from other enterprises, the state budget, or soft loans from the financial system. The imposition of a "hard budget constraint" means making enterprises financially independent of these sources, including stopping loans from the financial system on anything other than normal commercial terms. This financial autonomy needs, of course, to be accompanied by a managerial autonomy which permits enterprises to adjust to changing constraints and opportunities; i.e., to adjust prices, outputs, employment and other inputs in response to the signals given by the market. We strongly support the Government's intention, as outlined in the Basic Economic Guidelines and agreed in all the major reform proposals, to put a halt to budget subsidies to enterprises, to force the restructuring of enterprises that can, by that process be made financially viable, and to liquidate chronic loss-makers. Also consistent with this objective and worthy of support is the intended reform of the financial system, which is also to be put on a self-sustaining, commercial basis (see Section --).¹¹

42. The Guidelines correctly state, however, that time will be required by many enterprises to adjust to the new economic conditions, and it is proposed to create Union and Republican stabilization funds, with independent administrations, to provide financial support of different kinds to properly evaluated and justified restructuring efforts. This should help avoid unnecessary declines in employment and output, but there is also a risk that such special financing arrangements could become a substitute for, rather than a complement to, the needed restructuring. Consequently, the funds that are provided will have to be allocated under rigorous criteria. As the stabilization funds are to be financed from budgetary resources, macroeconomic stabilization objectives will limit the resources available for restructuring programs.

43. Finally, it is important that the imposition of hard budget constraints on enterprises be accompanied by the elimination of existing differentials in the tax treatment of enterprises in accordance with their size, branch, mode of organization, or other factors. Competition in a market system should take place on as level a "playing field" as possible.

Demonopolization

44. Production in most branches of Soviet industry is highly concentrated, with a large number of important products being produced at a single factory. Even where there is more than one enterprise, moreover, the industrial branch ministries tend to view the enterprises under their control as cogs of the same wheel, assuring that their activities are coordinated, rather than competitive, and transferring resources among them in complex processes of cross subsidization. This tendency to huge scale and extreme concentration reflects, in large part, the preferences of central planners, whose abilities to process information and enforce directives depends on keeping the number of entities they deal with as few as possible. Such monopoly power, however, cannot be tolerated in a market economy.

45. Thus, the emphasis given by the Guidelines and other reform plans to the demonopolization of Soviet industry, as a prerequisite to efficient market operations, is fully warranted. We would see demonopolization occurring as an outcome of the market process itself as well as being the result of administrative actions taken prior to privatization. For tradeable goods, as long as quantitative restrictions are removed, imports could effectively set and enforce ceiling prices on similar products that are produced domestically. The cost of foreign exchange on the auction market plus likely tariff

¹¹The importance of this reform further highlights the urgency of rapidly eliminating existing price distortions. Otherwise, the needed imposition of a hard budget constraint would have the undesirable result of making many relatively efficient enterprises financially inviable, while encouraging the expansion of enterprises made profitably only by virtue of the distorted prices.

protection would initially make competitive imports relatively expensive, but prices tariff protection should decline over time. (See paragraphs __ for a discussion of trade and exchange rate policy as a source of competition.) Insofar as domestic monopoly powers were not limited by import competition, enterprises enjoying monopoly power could be expected to exploit that power by raising their prices further, and there would be a period in which they succeeded in garnering abnormally high profits. However, in a market economy, these high profits could attract new entrants who would provide the needed competition. Thus, at least in those activities where new entry was relatively easy, demonopolization could be expected to take place over time as a result of market forces. However, price controls and "excess profits" taxation would discourage market entry. Consequently, by seeking to limit the benefits to the monopolist, such an approach might serve to perpetuate the monopoly.¹²

46. On the other hand, it must be acknowledged that, with the predominance of monopoly or oligopoly on both sides of most Soviet markets, and the absence of a commercial tradition, the lag in market response to opening opportunities might be considerably slower than in established market economies. Foreign investment can help. In addition, governments in market economies have a major responsibility for promoting and protecting competitive market conditions, and the Soviet Government should act quickly to introduce an effective framework of antimonopoly laws and regulations along with the institutions to enforce them. This should ensure the freedom of new enterprises to enter an industry, help prevent collusion among enterprises, and discourage predatory behaviors that would lead to the monopolization of an industry (see Section --). This is an area where the experiences of Western countries can be an valuable resource to draw upon through bilateral or multilateral technical assistance.

The Management of State-Owned Enterprises

47. Establishing financial discipline by imposing a hard budget constraint is an essential first step to strengthen the management of state enterprises (see paras. __ - __). In addition, a central factor in the poor performance of Soviet state enterprises has been the absence of any stake, on the part of those making the fundamental decisions regarding the enterprises' activities and policies, in the efficient use and future value of its capital assets. Once enterprises are converted into joint stock companies (paras. __ and __), the authorities will still need to face the question of how this need to represent the interests of owners in the assets of the enterprise is to be instilled into both the public holders of enterprise shares and the enterprise managers that they employ.

48. The commissions or State Property Funds set up to hold and manage state shares in the enterprises not yet fully privatized must be charged with representing owner interests. They would, in effect, be holding companies. They should not be able to cross-subsidize some enterprises with the profits of others or otherwise relax the hard budget constraints on any enterprises. Nor should they have the ability to tilt public policies and the enforcement of regulations to give their enterprises a competitive advantage over others.¹³ These holding companies should make clear that the primary objectives of their enterprises were to maximize productive efficiency and profitability, consistent with protecting the value of enterprise assets, and they should monitor and assess enterprises' performance in this regard. But they

¹²High profitability may also be the initial result and reward for introducing a new product or method of production. The proposed tax on monopoly profits, if it wrongly identifies the sources of unusual profits, could thus weaken the incentive for innovation.

¹³This change in the manner and mechanism by which government relates to the enterprises under its ownership would replace the present control exercised through the branch ministries and various functional agencies. These would either be eliminated (their numbers have already been greatly reduced, and others are slated for elimination), or their responsibilities changed to broad sectoral planning and policy analysis.

should not interfere in the daily management of the enterprises.¹⁴ In the interest of limiting owner losses, the holding company would also see to the restructuring of enterprises, where this was desirable, and to the liquidation of chronic loss-makers in its portfolio and to the auctioning of remaining assets.

49. Given the complexity of supervising the activities of large numbers of enterprises in different sectors, we would expect that the holding companies would exert their ownership rights through boards of directors. Board members would be appointed and held responsible for their performance by the holding companies. The boards would be directly responsible for setting enterprise policies monitoring performance, and hiring, evaluating, rewarding, and, as necessary, dismissing enterprise managers. Enterprise managers would have full responsibility for the management of the enterprise, including the power to determine the organization of production; to set the offer price, quantity, and composition of output; to hire, reward, and dismiss workers; and to manage the enterprise's finances.

The Training of Enterprise Managers

50. The shortage of trained and experienced managers is likely to be the most serious bottleneck to rapid improvement in enterprise performance in the Soviet Union. A large number of training programs of varying quality have sprung up in recent years in the Soviet Union, ranging from short courses in how to attract joint venture partners to full management curricula. Some of these programs are being carried out in collaboration with foreign educational institutions. Such contacts should be encouraged and expanded. Given the enormous needs of the USSR's rapidly reforming economy, this is an area of high priority and could be a useful focus of external assistance.

¹⁴As indicated in the Guidelines, the social responsibilities of enterprises would be progressively shifted to government at its various levels. To the extent that state enterprises continue to be charged with the execution of social programs, these should be paid for from the government budget rather than the after-tax profits of the enterprises.

Financial Sector Reform

The Banking System

51. The Soviet banking system under central planning was viewed as an integral part of the central allocation system. The primary function of the State Bank was to hold enterprise deposits and to allocate credit to enterprises in accordance with the requirements defined by plan production targets, and to monitor subsequent resource use by the enterprises to make sure it corresponded with central directives. Meanwhile, the State Savings Bank (SSB) monopolized the collection of household savings, which it redeposited in the State Bank for relending to the government and to the enterprises. All foreign exchange operations were conducted on behalf of the state by the Bank for Foreign Trade (later the Bank for Foreign Economic Affairs--BFEA). Reforms introduced in 1987 added three specialized state-owned banks to the system--the Industry and Construction Bank (ICB), the Agriculture Bank, and the Social Investment Bank (SIB)--to channel credit to enterprises in their assigned sectors. Although these banks also hold deposits from the enterprises in their sectors, the bulk of their loanable funds is still supplied by the State Bank.

52. The Soviet banking system is currently evolving on two tracks: the division and commercialization of the state specialized banks and the rapid proliferation of new, small commercial and cooperative banks. Both tendencies, which could eventually merge into one unsegmented banking system, are consistent with the development of an efficient, competitive financial sector and are supported by the Basic Economic Guidelines. As in the enterprise sector, however, both suffer from gaps in the legal and regulatory framework and from uncertainties about their ownership and ownership rights.¹⁵

The Specialized Banks

53. The specialized state banks currently account for some 95% of total credit in the Soviet Union. Their evolution and financial soundness are, consequently, fundamental to the efficiency of the financial sector and to the stability of the monetary system. The Government has announced its intention to transform these institutions into independent joint stock, commercial, universal banking institutions, operating strictly within the limits of their own resources and the funds they succeed in mobilizing, and completely responsible for their own profits and losses. The Guidelines enter caveats, however, that it might be necessary to retain one state bank with budgetary support to channel concessional resources to activities "in the state interest", and that the Savings Bank would remain a state bank.

54. As a step toward their commercialization, the process of transforming the specialized banks into joint stock companies has already begun. Shareholders are initially expected to consist largely of state organizations, including the Finance Ministry, other ministries at both the Union and Republican levels, Republic and municipal governments, and state enterprises. The situation of the banks is complicated by conflicting ownership claims by Union, Republican, and, in some cases, municipal governments. It now appears that the specialized banks are likely to be broken up along geographical lines. The Russian Republic has declared its intention to liquidate the branches in its territory of the SIB and to pass the premises and equipment therein to a new commercial bank, whose owners will include the Moscow City Council.

55. A major concern with regard to the commercialization of the specialized banks is the unknown quality of their loan portfolios. While the banks now have greater freedom to allocate credit than when they were under the strict control of the credit plan, their loans have, by and large, continued

¹⁵This Section focuses only on the resource mobilization and allocation functions of the banking system. The control of the aggregate volume of money and credit is treated in Section --.

to go to traditional borrowers, responding both to personal relationships and to the still important role of state orders in the resource allocation system. Supervision by the State Bank, once intensive in ensuring adherence to the credit plan, is now largely limited to the quarterly receipt of balance sheet information and annual reports. Any portfolio problems that may exist are hidden by the virtually automatic rollover of credits practiced by the banks and the accrual of interest, so long as principal payments remain, in this way, up to date. That problems exist is evidenced by the recent writeoff of R 70 billion of Agriculture Bank assets and reports that further writeoffs are forthcoming. The quality of bank assets will also inevitably be affected by economic reforms in the real sectors and the significant impact they are likely to have on the relative profitabilities of different enterprises.

56. The uncertainties of the present situation make it a particularly difficult time to launch into commercial banking. This difficulty is magnified by the almost total lack of experience in the specialized banks in the types of decisions faced by commercial bankers in managing the multiple risks involved in financial intermediation. With the exception of the SSB, the specialized banks have substantial familiarity with their sectors and their borrowers. Soft budget constraints have reduced the importance of analysis of credit risk, however, while interest rate risk has simply not existed (see Section --), and foreign currency risk has been of concern only to the BFEA. With the bulk of funds coming to them from the State Bank and from mandatory enterprise deposits, the banks have also not had to concern themselves with deposit mobilization and liability management. SSB, on the other hand, has operated as a pure deposit bank, offering savings accounts to households having few alternatives for safeguarding and earning interest on their savings. Although it has recently begun to do a small amount of consumer lending, SSB passes virtually all of its deposits to the State Bank. In this way, household savings have been the major source of financing for the budgetary deficit and for the credit lines of the State Bank to the other specialized banks. SSB's commercialization is thus inhibited by the current lack of alternative noninflationary mechanisms for financing of the fiscal deficit.

The Commercial and Cooperative Banks

57. The formation of new commercial banks under cooperative and joint stock forms of ownership began with promulgation of the Law of Cooperatives in 1988. By September 1990, these institutions numbered more than 400 and accounted for about 5% of total bank credit. These banks enjoy considerably greater freedom than do the specialized state banks in their lending decisions, the interest rates they are allowed to pay for enterprise deposits and to charge on loans, the salaries they can pay to employees, etc. On the other hand, unlike the SSB, their deposits are not insured, acceptance of household deposits cannot exceed their capital, interest rates on such deposits cannot exceed those offered by the SSB,¹⁶ and the lack of a real estate market has made it difficult for most of them to acquire well located premises of adequate size and expansion potential.

58. The CCBs report themselves to be conservatively managed, well staffed with personnel bid away from the specialized banks, and highly profitable. Although still very small in comparison to the specialized banks, their appearance constitutes a welcome source of competition in the system. Nevertheless, some aspects of their development could create problem for the future soundness of the financial system.

59. A large proportion of the CCBs have been established by a particular industry or group of enterprises with the explicit purpose, set down in their charters and by-laws, of serving the credit needs of those enterprises. As a result, loan portfolios tend to be highly concentrated. Shareholders also commonly include the specialized banks, other cooperative banks, branch ministries and other agencies of the Union, Republic, and local municipal governments. There is some concern that the newly organized commercial banks could, if they provided loans to their owners on anything other than regular commercial conditions, prove to be ways for enterprises to get around the "hard budget constraint". The

¹⁶Until --, the CCB's were free to negotiate interest rates on household deposits. The above limits were evidently imposed to protect the deposits of the SSB.

concept of conflict of interest does not appear to be well developed in the Soviet Union, and there are no regulations to avoid it.

60. Auditing, prudential regulation and supervision of the CCBs is the responsibility of the State Bank, and a special department of the Bank was established two years ago for that purpose. Detailed prudential standards have since been issued by the State Bank, which has also assumed the authority to seek corrective measures in cases of noncompliance.¹⁷ This authority is now being challenged by Republican authorities, however. Dispute over this and other issues has held up passage of new banking and central banking laws for two years. The quality of supervision is, in any event, suspect, given important shortcomings in current accounting standards (for both supervisory and internal bank management purposes), the shortage of qualified examiners and other staff, particularly at the Republican and regional branches of the State Bank. There is also evidence to suggest that exceptions to the prudential regulations have been granted by the local branches.

Recommendations

61. Macroeconomic stability, especially in a market economy, is highly vulnerable to public loss of confidence in domestic monetary assets and in the banking system. For this reason, bank failures are potentially far more disruptive and are treated more seriously by governments than the failure of a real sector enterprise. For this reason also, the Soviet Government should proceed as a matter of urgent priority to clarify and strengthen the legal and regulatory framework for the banking system. Particular attention is needed to strengthening and enforcing (i) capital adequacy standards for the formation of new banks and for permitting existing banks to continue at their present levels of activity; (ii) limits on asset concentration in loans to single or related individuals, enterprises, and industries; and (iii) rules regarding loans to the banks own officers and employees. This reinforcement of licensing and regulatory standards might result in a slowing of new bank formation and in the merger or disappearance of some existing CCBs, but the result should be the emergence of a stronger and more stable banking sector. In the meantime, ownership rights and the legal status of different forms of organization would also have been clarified, for banks as well as other enterprises, putting the CCBs on a level competitive playing field with the specialized banks.

62. Bank supervision, including on-site inspection, also needs to be intensified. Before this can be done, however, accounting standards have to be upgraded, with particular regard to the treatment of late and doubtful loans and requirements for loan provisioning; and an intensive training program needs to be mounted for accountants and supervisory personnel, including auditors and examiners. A nucleus of people with the essential basic skills already exists in the State Bank and its various branches, but their analysis needs to be refocused.

63. Likely reclassification of the assets of the specialized state banks could force a reassessment of their overall financial solvency, or that of many of their branches, and cause a slowing of the process of denationalization. Instead of being passed on to new owners (whether state, private, or mixed), bad and doubtful assets should be written down and/or shifted to a special state agency for their subsequent collection or liquidation. The government should, in effect, take responsibility for the inherited bad debts, and the new owners should be responsible for subsequent operations. The magnitude of this problem cannot be known until these banks have been subjected to comprehensive portfolio audits, and the dust has settled on the real sector reforms.

64. In the meantime, the credit needs of the economy would still have to be met, including credit for newly emerging enterprises. We recommend that, during this period of clarifying and rectifying the financial status of the banks, the government proceed with the transformation of the ICB, SIB, and Agriculture Bank into joint stock companies, and that share ownership be vested in special state holding

¹⁷Thus far, three CCBs have been forced to restructure or to close. These have resulted from currency and other violations, however, rather than failure to comply with prudential standards.

companies established for the purpose. Those companies, as in the case of industrial enterprises, would exercise the state's ownership rights, ensuring that managers are held to the new performance criteria of commercial lending and that the requisite training is being provided to bank managers and staff. Only as the banks are placed on a sound financial footing, in conformity with the same regulatory standards applied to commercial and cooperative banks, and adequately staffed for their new functions, should ownership be fully denationalized. In a number of cases, it might be decided to liquidate particular bank branches where the market were deemed adequately served by other institutions, and viable restructuring appeared doubtful or excessively costly.

65. During this transition period, the SSB could, as suggested by the Guidelines, remain under state control as the principal mobilizer of household savings to the other banks and to the government. As the government's financing needs were both reduced and increasingly satisfied through a growing securities market, and as the specialized banks were progressively commercialized, the SSB could expand its own lending activities through the interbank market and increasingly directly to private sector customers. It, too, would be put on a commercial, self-sustaining basis, the foundation of managerial and staff skills having been laid during the transition period. A corollary of this evolution would be the withdrawal of the State Bank from its credit intermediation role; in the meantime, it will have developed its indirect tools of monetary control.

66. Finally, we would urge the Government to reconsider its plans to retain one of the specialized banks under state ownership as a vehicle for channeling preferential credit to state-designated activities. Although such institutions are commonly found in other countries, the experience with them has not been good. While originally conceived as development-promoting institutions, their ability to dispense credit on subsidized terms has frequently turned them into vehicles for political favoritism and bad loans. Instead of mobilizing additional resources for development, their lending practices have resulted in a heavy drain on state resources.

67. As a general principle, we recommend that a clear distinction be maintained between activities to be determined by the state, and financed through the budget, and activities best left to market determination and to the financial system. Overlapping the two tends to undercut both decision-making processes. This suggests that, where there is a public interest in promoting activities that are unable to service credit on full market terms, any subsidies be provided from the state budget, where they can be reviewed in the normal budgetary process, rather than financed from the earnings of banks.

The Development of Securities Markets and Contractual Savings Institutions

68. The Guidelines indicate the Government's intention in the near future to support the creation of stock and commodities markets and related brokerage companies, as well as insurance companies and other institutions characteristic of developed financial systems. Although of lesser urgency than the strengthening of the banking system, the healthy establishment of such institutions is important, among other things, for the development of long-term instruments of investment finance, risk-sharing and the transfer of ownership rights, and improving the tools of monetary policy. The development of secondary securities markets greatly contributes to the mobilization of resources for investment by providing the long-term instruments required by investors while helping to meet the liquidity needs of savers.

69. Plans are already in preparation for the establishment of securities exchanges in Moscow and Leningrad.¹⁸ The only securitized claims in the system are a relatively small volume of government debt instruments, some bank certificates of deposit, and a limited number of shares issued by joint stock companies. The nature of ownership rights conferred by the latter and the negotiability of shares remain unclear. Insurance in the USSR is currently dominated by the State Insurance Company. Since 1988,

¹⁸A commodities exchange of sorts is already functioning in Moscow. At present, it is essentially a trading room where participants can meet to make barter deals.

however, a number of new companies have been organized as cooperatives or other forms. Pensions, meanwhile, continue to be funded from the state budget; a payroll tax on enterprises has generally been insufficient to cover payouts to retirees. As of January 1, 1991, a new pension system is to come into effect, administered by an independent institution and financed by a substantially increased payroll tax. Surpluses, if any, are to be managed at the level of Republican branches.

70. Important gaps in the legal and regulatory framework affecting securities markets need to be filled before substantial and stable development of these markets is possible. First and foremost, legislation is required to establish the legitimacy of financial claims and the rules and mechanisms of their enforcement. The salability of financial claims must also be clearly established, if secondary markets are to play their role in assuring the liquidity demanded by most potential buyers of long-term debt or equities. Laws, regulations, and enforcement mechanisms are also needed to protect savers and investors against the potential monopolistic, collusive, or manipulative behaviors of brokers and large market players and to assure that issuers of securities provide full and accurate information, upon which prospective buyers can make intelligent judgments regarding the likely returns and risks involved.¹⁹ Market intermediaries should also be required to disclose any financial interest they may have in the securities they are intermediating. It is important that the regulatory authority have the power to impose sanctions and that it be an independent agency, insulated from political pressures in its activities. This is particularly important in the Soviet Union, where the owners of many securities issuers may continue to include government agencies.

71. It will probably take two years or more before formal, well regulated securities markets for the trading of enterprise debt and shares are in place in the USSR. The issuance and trading of government debt instruments could begin much earlier, however, given the relatively low risk to buyers.²⁰ We would recommend in this regard that the government shift its focus from the long-term end of the market and work to develop the market for medium-term instruments. These will be of greater immediate appeal to savers, given past experience with government bonds and the inevitable uncertainties of the Soviet economy in the next few years.

72. In the meantime, the informal issuance and trading of securities is likely to grow. We do not recommend that government try to stifle this activity, which can play a valuable role in mobilizing risk capital and giving liquidity to the ownership claims arising from enterprise denationalization. Without a satisfactory regulatory framework in place, however, government should not officially endorse or sponsor this activity, and should clearly publicize the risks involved to its participants.

Interest Rates

73. Just as price flexibility is a crucial element of competition in the real sectors in a market economy, interest rate flexibility is essential to competition in the financial sector. Financial institutions that are most successful in channeling resources to high-return investments will be able to mobilize the greatest volume of funds by offering the highest interest rates to savers. In their competition for deposits and borrowers, moreover, financial intermediaries are forced to keep their spreads and costs of

¹⁹Disclosure standards may initially fall short of those applied in more advanced Western financial systems, given the present state of development of accounting practices. The quality of both will need to be raised over time, however, to international levels, if Soviet financial markets are to be made attractive to foreign savers.

²⁰Government debt in the Soviet Union has not, in fact, carried low risk historically. Payments have frequently been suspended, and interest rates lowered unilaterally. As a consequence, government debt issues are viewed with distrust, and the terms of a recent issue had to be substantially revised (halving the amortization period and doubling the interest rates) to attract even modest sales. It goes without saying that the government must establish itself as a dependable borrower if it is to attract voluntary financing in the financial markets.

intermediation as low as possible. The market determination of interest rates also permits the buyers and sellers of financial instruments to exercise their preferences among the various maturities, risks, and returns available to them according to the individual needs of their families and enterprises. On the other hand, the absence of interest rate flexibility in the face of changing economic conditions has led in many countries to flight from holdings of domestic financial assets, threats to the solvency of banks, and serious losses of international reserves.

74. The Basic Economic Guidelines point to the importance of interest rates in encouraging both household and enterprise savings, reducing the monetary overhang, controlling the demand for consumer goods and reducing wasteful investments. The Guidelines thus call for a sharp increase in administered interest rates on both deposits and loans. Deposit rates will be positively related to length of maturity, and the interest on loans for investment will be raised to 15%. The Guidelines suggest that the new administered rates would remain in effect for about six months, the time necessary to stabilize aggregate demand. After that, it is implied that interest rates would be freed to market determination, with the expectation that they are likely to fall somewhat from the administered levels, permitting a gradual recovery of investment spending.

75. We concur with the approach suggested by the Guidelines. Interest rates are currently well below market-clearing levels in the Soviet Union and contribute both to excess aggregate demand and to resource misallocation. Given the uncertainties attached to economic reform, the absence of effective banking supervision and regulation, and the high degree of market concentration in the financial sector, the simple freeing of interest rates could lead to substantial overshooting of equilibrium levels, contributing to uncertainties and to the further disruption of enterprise and bank finances. We recommend an administered increase in interest rates to market-approximating levels, controls later being relaxed once expectations are stabilized.

76. We also agree that rates should be restructured to provide a positive yield curve to both savers and intermediaries. To achieve the stated objective of protecting the value of savings deposits, and thus motivating households and enterprises to hold them, interest rates on those accounts should, at minimum, equal the rate of inflation, and lending rates should compensate the banks for their intermediation costs, including a reasonable profit on the capital employed.²¹ At the present time, this may require a nominal lending interest rate higher than the 15% proposed in the Guidelines. The indexing of term deposits and loans would provide an alternative mechanism for assuring the maintenance of their real values.

²¹For reasons described elsewhere (para. 14), official inflation indices in the Soviet Union significantly understate actual inflation. If savers' deposits are to be protected, it will be necessary to take account of not only the price increases based on fictitious producer claims of improved quality but also the increased proportion of consumer goods now being bought in the free markets and cooperative stores at substantially higher than official prices.

Legal Reform

77. In general terms, the effective functioning of a market-based system depends on the existence of clearly defined property rights, the freedom of market participants to exchange property rights through a system of legally enforceable agreements, and the existence of a system that provides reliable and predictable enforcement of such agreements. A large number of laws intended to set the foundation for a market economy in the Soviet Union have been passed in recent years, establishing, for example, new principles of enterprise ownership and organization, taxation, the financing of pensions, etc. How many of the established principles are to be interpreted remains to be clarified, however, in the elaboration of subordinate laws and regulations. Moreover, inadequate attention has so far been given to such crucial areas as property law, contract law, and the system for civil dispute resolution.

78. Consequently, the legal basis for the proposed reforms remains confused and leaves economic actors uncertain about the meanings of the laws passed, the resolution of apparent conflicts among different laws and regulations, the applicability of particular laws to their own circumstances, and the consistency of what appears legal under the new economic laws with what is considered illegal under the criminal code. The most fundamental problem is the lack of a clear structure of legal authority--i.e., which levels or agencies of government have the authority to legislate or to issue binding orders, superseding the laws and orders of other levels and agencies, over which matters. Soviet legal theory has traditionally failed to delineate the respective authorities of state bodies. The issue is greatly complicated now by the ongoing effort to reach a new definition of relations between both the Union and the Republics and among the various regions and governmental units within the 15 Republics. The discussion that follows focuses on several crucial facets of the legal framework for market activity: property law, enterprise law, contract law, the resolution of commercial disputes, and the criminal code.²²

Property Rights

79. Until quite recently, ownership law in the USSR was strictly divided between socialist ownership and personal ownership, the latter largely limited to family belongings, including the tools needed to farm small private plots or to engage in permitted handicraft or other individual labor activities. Personal ownership was not to serve as the basis for illegal or "unearned" incomes.²³ Socialist property, ownership of which was vested in the State, could not, in general, be alienated to individuals and only rarely could be used as security. The penalties for stealing, converting, or negligently wasting state property were notably higher than those for similar crimes against private property.

80. Over the past couple of years, the Constitution has been amended, and several pieces of legislation have been passed (e.g., Law on Cooperatives, Fundamentals of Legislation on Leasing), which substantially alter property rights. Under a lease-purchase option, for example, enterprises and other economic organizations may now purchase and own productive assets that once belonged to the state. It is not clear, however, what rights the owners under these arrangements have to freely dispose of the acquired facilities. Similarly, land users can now be given a life tenure in land and can pass those use rights to their descendants; whether the rights can be bequeathed outside the family is unclear, however, and there is no provision for unrestricted purchase and sale of land or land-use rights. The use of liens on property is now generally authorized in principle, but no subordinate legislation has been passed which defines the conditions of an enforceable lien or pledge, the procedures for foreclosure, or registration

²²A fuller discussion of these issues and other relevant topics are discussed in the Chapter -- of the Background Paper.

²³The precise definition of "unearned" income has always been somewhat elusive. Illegal income for individuals has included entrepreneurial activities involving hired labor, sale or lease of property, sale of goods above permitted price levels, and any variety of middleman or trading activity.

requirements for encumbered property. Finally, the law states that all forms of property in the Soviet Union will be equally protected, but provides no discussion of the means of protection. Effective protection depends on a clear definition of the rights to be protected and on the provision of effective remedies in the event of infringement. Neither of these yet exist.

81. The Basic Economic Guidelines point out that "privatization" does not necessarily mean a switch to private (individual) ownership alone, but rather refers to a more general process of transferring ownership of state property to collectives, cooperatives, shareholders, foreign firms, and private individuals, all of which are to be autonomous and responsible for the results of their activities. These various modes of ownership and organization are to compete with each other on equal terms. While there appears to be wide support in the Soviet Union for the expansion of individual property rights, there is still considerable resistance to the concentration of large amounts of property in private hands. Effective market relations do not, of course, require that individual property rights be unlimited or unregulated. It does require that the desired rights and restrictions be set out clearly and in detail. Without such clear legal statements, potential market participants will be deterred by uncertainties about the legality of their actions and the enforcement of their rights.

Enterprise Law

82. A principal focus of legal reform in the past few years has been passage of laws defining new forms of business activity--cooperatives, leasing arrangements, joint stock companies, small businesses.²⁴ While this approach has permitted the rapid creation of new business opportunities, it has also created some inconsistencies, left some gaps and anomalies, and invited subsequent contradictory amendments which have contributed to confusion over the Government's intentions.

83. One example concerns the 1988 Law on Cooperatives, which permits a cooperative enterprise to be formed by groups of three or more persons. It may hire labor, lease or purchase business premises and equipment, and operate without limits on its scale of production. Cooperatives are allowed under the Law to charge freely negotiated prices on their output, except when producing under state contracts or using state-provided inputs. In these cases, prices are subject to centrally set prices and/or markups. In response to negative public reaction to the higher prices charged by cooperatives, and evidence of diversion of state supplies to sale by cooperatives at higher prices, the Law was amended in 1989 to permit Republics to impose price ceilings on basic goods regardless of their source and placing restrictions on imported goods sold by cooperatives. Local authorities also have often refused to register cooperatives and have attempted to close them or interfere in their activities. Cooperatives remain subject to a variety of restrictions on the range of activities they may engage in and the prices they may charge, restrictions not shared by other forms of organization.

84. The 1986 Law on Individual Labor Activity was intended to expand individual involvement in the production of handicrafts and consumer goods and services. It contains a list of activities which are specifically authorized or prohibited, alongside a general statement that whatever is not explicitly prohibited is to be considered legal. The scale of such activities was clearly meant to be limited, however, and could not involve the use of hired labor. The law also requires that such activities receive the permission of local authorities and gives the latter substantial leeway to set conditions and fees for licensing and registration. Restrictions also continued on individual property ownership and on access to credit facilities.

85. These restrictions on individual activity may have been made moot by the August 1990 Decree of the USSR Council of Ministers on Small Enterprises by "citizens, family members, and other

²⁴These laws have included the Law on Individual Labor Activity in 1986, the Decree on Joint Enterprises and the Law on the State Enterprise in 1987, the Law on Cooperation in 1988, and a new Law on Enterprises, a Decree on Joint Stock Companies and Companies with Limited Liability, and a Decree on Small Enterprises in 1990.

persons jointly engaged in labor activity". While the reference to joint activity leaves the question in doubt, other passages in the decree refer to "individual" small enterprises, to the "founder or founders" of small enterprises, and to "individual...and other types of small business". This decree is still too recent to have been clarified by subsequent regulations or events. Such clarification will plainly be required for individual entrepreneurs to begin playing an active role in the development of the economy.

Contract Law and Dispute Resolution

86. In contrast to a centrally planned economy, where the obligations and rewards of producers, their suppliers, workers, and financial institutions are defined and enforced by central directives and clear, vertical lines of authority, a market system depends on voluntary transactions and relationships, governed by contracts which clearly set out the rights and responsibilities of the contracting parties. The confidence that buyers and sellers, owners and workers, borrowers and lenders can have in such contracts depends on the existence of a supporting legal framework and system of contract enforcement that provides clear, predictable adjudication of disputes that may arise under the contracts, with penalties to those who breach their contract responsibilities and compensation from them to the injured parties.

87. The basic principles of contract law in the Soviet Union, as elaborated in the civil codes of the Republics, are essentially consistent with market activity. However, these principles are broadly expressed and have never been elaborated in a detailed commercial code to govern business and financial transactions. Nor have the principles been directly applied to the inter-enterprise relationships under the planning system, where standard, mandatory contracts were handed down from above. Consequently, Soviet managers, lawyers, jurists, etc. are generally inexperienced in contract formulation and litigation.

88. Since 1957, the responsibility for court organization in the Soviet Union has rested with the Republics, and all lower-level courts are Republican courts. At the same time, Soviet courts have traditionally been subordinate to the Supreme Soviet and the Council of Ministers, and have not had authority to review or reverse legislation or regulatory acts of government bodies. Court rulings, in turn, have been relatively weak and subject to reversal. Civil cases involving disputes between business enterprises or juridical persons have been under the compulsory jurisdiction of state arbitrazh rather than the courts.²⁵ Civil processes were thus not designed to meet the needs of commercial litigation, and there are no rules and procedures in place to address complex discovery questions, protection of commercial information, multiparty disputes, etc.

89. Recent laws have begun to strengthen the independence and power of the courts, and they are increasingly being used to appeal infringements of individual and enterprise rights by government officials. They are also being given increasing jurisdiction over civil disputes (e.g., disputes involving a joint venture). Few steps have yet been taken, however, to provide the courts with the clear and final authority they need to resolve serious cases or to prepare court personnel to deal knowledgeably and efficiently with the new types of cases they will be encountering in the market economy. Until the courts have that ability, parties at dispute will have to continue to rely on discretionary administrative resolution.

90. It is obviously of paramount importance that the overriding issues of Union, Republican and local authority be resolved to eliminate the current uncertainty over which law is to be applied to a given case, and which court has final jurisdiction. It is also important that the relationships among the various courts be defined in terms of rights of appeal, jurisdiction for multi-Republic issues, etc. Given that the resolution of these questions is likely to take some time, consideration might be given to an interim

²⁵The state "arbitrazh" is not a system of arbitration in the Western sense, but rather an instrument of the state administration to review and decide disputes between state enterprises and to ensure that their decisions and state regulations generally are enforced. The arbitrazh system is described in greater detail in the Background Paper (paras.).

accommodation regarding these jurisdictional and relational issues to permit the overall reforms to proceed in an environment in which economic agents can be confident that judgments made today will not all be reopened at some future date.

91. The recruitment and training of court personnel is also a matter of some urgency in anticipation of the greatly expanded case loads that will accompany the expansion of the market. Western technical assistance in this training, as well as in fundamental questions of court organization and funding, the protection of judicial independence, civil processes, and the organization of nonjudicial mechanisms for dispute resolution, could make an important contribution to the entire reform process.

92. Meanwhile, the state arbitrazh are the only bodies that have experience with large commercial disputes and knowledge about the conditions and the traditional contractual and economic relationships that have existed among Soviet enterprises. Although long applied in an intrusive and coercive manner, such experience is invaluable to practical resolution of the disputes that will arise. Ultimately, it would seem desirable that arbitrazh and the courts become integrated into a single system. Whether or not this eventually happens, the relationship between the courts and the arbitrazh needs quick definition. It is vital that economic actors know where to turn for contract enforcement and what the standards to be applied are.

Antimonopoly Law

93. As argued elsewhere in this report, the principal forces breaking down monopoly in the Soviet Union are likely to emanate from the denationalization and privatization of enterprises, the liberalization of prices, opening the economy to greater foreign trade, and the improvement of transportation and communications. The preparation of antimonopoly law is under way but is still at an early stage. Existing drafts draw many of their ideas from Western antimonopoly laws and contain appropriate provisions against cartel agreements, false or deceptive claims about one's own product and false statements about a competitor's product, mergers that threaten to lead to monopoly, and abuse of a dominant position in an industry (e.g., limiting production to create a shortage, refusing to deal with a prospective customer who has placed a proper order, imposing "tie-in" conditions on a sale).

94. The drafts also call for the creation of an Antimonopoly Commission to enforce the law. Some of the powers being proposed for the Commission--e.g., the imposition of price controls and excess profits taxes--would run contrary to the market discipline of market power, through the entry of new enterprises, and should be reconsidered (see paras. __-__). One area of considerable concern is the current tendency of many enterprises, engaged in the same or different activities, and financial institutions to join together in "associations", to promote mutual business interests and, frequently, interlocking ownership. While it is normal in all countries for various trade associations to form for discussion of topics of mutual interest (e.g., future market prospects, recent technological developments, government tax and foreign trade policies, etc.), they should not be allowed to become devices for limiting competition and controlling entry to the market. This is an area where antimonopoly laws and policies need to be clarified.

95. The antimonopoly law that eventually emerges will presumably be applied through the court and/or arbitrazh systems, which, at present, are unprepared to make the kinds of sophisticated economic analyses and legal judgments that will be required. It might be advisable to create a specialized tribunal for hearing antitrust cases. In any event, external assistance in drafting the final law, in organizing the enforcement authority, and in training the administrators and judges involved in this complex area would make a valuable contribution to the creation and maintenance of competitive markets.

The Criminal Code

96. The Soviet Union has traditionally sought to discourage undesirable economic behavior not only by directly controlling economic activities but also by criminal or administrative sanctions for prohibited behaviors. While the severity of these sanctions has diminished in recent years, there are still

a number of articles in the criminal and administrative codes that criminalize activities that are both necessary and desirable in a market environment. Other articles properly identify undesirable and criminal behavior, but the manner in which they are written leaves them open to excessively broad interpretation.

97. A new draft Fundamentals of Criminal Law was issued for public discussion in January 1989. The draft would eliminate the current differentiation between crimes against state property and those against other forms of property and would decriminalize a number of activities. No follow-up action has been taken since the appearance of the draft, however, and the objectionable sections of the Republican criminal codes continue to stand. In the RFSFR code, widely used as a model by the other Republics, it is criminal to produce or sell poor quality or otherwise substandard products, to feed bread or other grain products meant for human consumption to animals, to operate as a commercial middleman, or to engage in speculation, defined as the buying and reselling of goods for profit.²⁶

98. The problem with the first "crime" is that it leaves the definition of quality to the arbitrary judgment of a government administrator. In a market economy, however, the judgment would be made by the potential buyers of the product, who will "punish" its producer by buying from his competitors instead. The use of bread as feed for animals results from distorted administered pricing and would not occur in a free market. The activities of wholesalers and traders, who are essential to the efficient functioning of markets, are made criminal by the provisions against middlemen and speculators; these provisions of the Republican codes must clearly and quickly be removed if market activity is to flourish. This is explicitly recognized in the Basic Economic Guidelines, which calls for the immediate introduction of wholesale markets to replace central allocation, and for the decriminalization of such activity.

Recommendations

99. It is likely to take two years or more to put in place the full legal foundations for a market economy in the Soviet Union. Suggestions and recommendations toward that end are made throughout the report, inasmuch as virtually all the policy and institutional elements discussed here depend on a base of clear legal principles, established rules, and dependable enforcement. It would be utopian to expect that a full blueprint for legal reform could have been designed and installed in advance of launching the reform in other areas, and it would be both unrealistic and undesirable to try to delay the process now. Inevitably, much of the legal framework will be constructed through the passage of laws and legal interpretations in response to problems as they arise. However, certain elements of the framework are crucial for market activity and deserve the Government's urgent priority.

100. Simply stated, the conduct of market relations requires clearly defined property rights, including the ability to sell such rights. Development of the financial system further requires the ability to borrow against the security of property. As briefly described above, recently passed fundamental principles and the Basic Economic Guidelines support expanded property rights, but both these statements and recent legislative acts--e.g., the Fundamentals of Legislation on Leasing, and on Land, and the Draft Law on Pledge--do not appear fully consistent with one another, and they leave the scope of property rights and the salability of property and property rights ambiguous. The right to dispose of property and property rights needs to be clarified, if a substantial expansion of nonstate enterprise is to be supported. At the same time, the rights of individuals with respect to property use should be made equivalent to those of other entities. These principles could be achieved through appropriate modification of the Union-level fundamental principles legislation.

101. More complicated, however, is the necessary accompanying clarification of the means for protecting property and property rights vis a vis both other private parties and the state itself. The normal means for such clarification would be through the respective Republican civil codes, a process that will

²⁶Speculation is functionally the same as operating as a middleman but usually involves state-subsidized goods.

take considerable time. In the interim, it may be possible to improve the definition of key property rights and their protection through specific Union-level legislation. The draft Law on Pledge, for example, could be a vehicle for clarifying the registration and enforcement of liens and for resolving the inconsistencies between these provisions and those of the current land and resource legislation.

102. Soviet jurists recognize the need to elaborate a consistent body of contract law, and a committee has been established to draft new principles for adoption at the Union level. All-Union legislation on specific topics--e.g., an all-Union statute on fraud--would help to encourage uniformity and to guide civil code formulation at the Republic level. The necessary process at the Republican level, however, of amending civil codes and developing provisions appropriate for modern business practices will be a slow one. In the interim, it is advisable to develop and authorize specific types of contract through specific legislation--e.g., the Law on Pledge. Such laws could elaborate the standards, the requirements for written form or registration, and other matters necessary to allow business to be conducted under that contract.

103. The reliability of contract enforcement depends on a clear assignment of judicial responsibility and a supposition that the court's decisions are final and not subject to arbitrary reopening. The courts are now beginning to play a larger role in the economic affairs of the Soviet Union, and new legislation often provides a right to recourse to the courts to protest inappropriate actions by state officials. For the courts to function effectively, the relative jurisdictions of the court and arbitrazh systems must be defined. To the extent that the arbitrazh maintains some jurisdiction over economic disputes, its role in this regard must be clearly separated from its current law enforcement functions. In any event, the third-party reopening of judgments must be explicitly limited.

104. Whatever the precise outcome of the current negotiation of a new Union compact among the several Republics, a substantial shift of legal authority and regulatory power from Union and from Republican-level bodies to local bodies is contemplated in the Basic Economic Principles as well as in the other major economic reform proposals. Because of their limited responsibilities in the past, local bodies have not developed the institutions, skills, and experience necessary to many of these tasks. Systems for the registration of property and encumbrances thereon, for the registration of local businesses, etc. must be developed. Substantial programs of training and technical assistance are required.

105. Also needed is a major educational effort regarding the meaning, advantages, and requirements of market economy. Many local officials in the Soviet Union appear to conceive the move to market processes as meaning merely the decentralization of administrative controls in order to protect narrow local interests. The consequent segmentation of the national market could be as damaging to economic efficiency as central planning and ministerial administration.

ENHANCING THE SUPPLY RESPONSE OF SOVIET MANUFACTURING INDUSTRIES

I. The Current Situation

1. Soviet manufacturing industry now contributes about 36% of NMP, which is considerably higher than typical shares of manufacturing in output found in other countries (including those in Eastern Europe). There are some 46,000 enterprises including some 600 large firms with book value of capital over R 200 million each, 1,600 middle-sized firms with assets of R 50-200 million, 6,000 smaller firms with average assets of about R 25 million, and 38,000 firms with average assets of R 2-3 million. Total employment is 35 million or 32% of the labor force, almost half in machinebuilding, and almost 75% of employees are in firms with over 1000 employees. Most enterprises and "amalgamations" of firms are under Union or Republican ministries (there are some 15 civilian national ministries plus 9 defence industry ministries) although some smaller firms are under regional and city governments. The investment share of energy plus industry has remained fairly constant at about 35% of the total, but there has been a considerable shift towards energy and the share of manufacturing has declined, to 21% in 1986-90. Machine building is the most important subsector; this with metallurgy and chemicals constituted 55% of output in 1989. Trade in manufactured goods is a small part of output, and exports to non-socialist countries are less than 1%, which is extremely small even allowing for distorted prices.

In many respects, including labor and capital productivity, product quality, energy efficiency and environmental impact, Soviet industry is performing poorly. The capital output ratio (book value to output) rose from 2.0 in 1975 to 3.5 by 1987 reflecting (despite distorted prices and valuations) diminishing returns from large-scale investments. By most measurements, labor productivity is only 40% of US levels and overmanning is estimated at 100% in many enterprises. Shortages of industrial products, particularly consumer goods, are widespread (a recent survey found that 243 out of 276 basic goods are in short supply) but at the same time some goods produced are not in demand. In 1988 industry accounted for 40% of energy consumption; the corresponding figure for OECD countries is 23%. In recent years hundreds of polluting firms have been closed, sometimes abruptly, and sometimes with disruptive effects on the production chain.

2. A number of factors adversely affect the performance of industry:

- (a) Until 1987, pervasive central planning stifled competition through creation of monopolies and denied management incentives to control and improve operation. Despite recent reforms (para 3) and substantial erosion of the allocation system, especially for inputs, which has resulted in a rapidly-growing barter economy, the economy operates much as it did in the past. In 1987, the establishment of cooperatives was allowed to foster competition, but state trading monopolies continue to act as barriers to their acquiring material inputs, and the republics prevent them from entry into a wide range of businesses.
- (b) While an exceptionally high degree of autarky has insulated industries from international competition, the industry's excessive extent of vertical integration has inhibited competitive subcontracting, compromised the potential for scale economies, and reduced flexibility in manufacturing.
- (c) Lack of enterprise authority to procure inputs, distribute outputs, and set product prices has caused poor product quality and inefficient operations. In 1988, state orders accounted for about 89% of output and, although the intention was to bring this down to 35% in 1989, state orders in manufacturing ranged from 40% to 100% in 1990.

Allocated inputs often do not meet product specifications, contributing to low quality.

- (d) Prices do not reflect market signals. Relative prices are severely distorted, with prices of capital goods low relative to those of consumer products. The controlled distribution system has severed the essential trade relationship between the producer and consumer. Enterprise managers lack measures of efficiency and tools for improving it. Cost accounting is not employed to measure efficiency and profit centers are unknown.
- (e) Contributing technological factors include old machinery, inadequate quality control, incomplete technology transfer (high engineering content but deficient management and production techniques), and poor means and measures for environmental protection and labor safety.
- (f) In the command economy, manufacturing enterprises have no system of gathering and analyzing information regarding the needs of their clients, an essential system for successful performance of firms in market economies. There is also a dearth of general information about business development, financial markets, etc. When coupled with the inadequate communications network in the country, the Soviet manager has a serious disadvantage when it comes to reacting to changes in the business development and identifying new opportunities.
- (g) Physical infrastructure is rather poor, but even more important is the lack of a supporting service infrastructure. Among the most important lacks are financial and independent consulting services.

3. Under the reforms of 1987-1989, central plans became guidelines, and enterprise autonomy increased marginally (limited freedom in foreign trade, allowance to retain foreign exchange under a distorted system, authority to lease works and services, and the right to limit production). However, enterprises were not given sufficient autonomy - or placed under hard budget constraints - to enhance efficiency. Results of these part measures have been disappointing and in some respects the economic situation has deteriorated. Measures to convert military industry for civilian use have been initiated, but so far, neither a genuine transfer of technology nor widespread commercialization of military production has taken place. Recent (1990) reform measures, such as the Enterprise Law, the Small Business Law, and the Joint-Stock Company Decree attempt to address these problems, but a far more comprehensive approach will be needed.

II. Elements of a Successful Market Economy

4. While there appears to be a genuine commitment to the objective of transforming the Soviet economy into a market economy to improve efficiency, it is less clear that there is a common understanding of what this means. Key elements for the industrial sector are: allocation of resources on the basis of prices set by supply and demand; profits to help allocate resources; enterprise autonomy; competition, with new entry and mechanisms to facilitate exit; and supporting infrastructure and services, including information, finance and a cohesive legal framework. There is considerable potential for improvement in Soviet industry. Most raw materials are in abundant supply, the workforce is skilled, technicians and engineers are highly qualified, and the managers are capable of learning the techniques of a market economy. To realize this potential requires the dismantling of the (already ineffective) central allocation system, the removal of controls which have constrained initiative and supported inefficiency, acceleration of privatization, promotion of private sector development and the provision of the basic services which are essential for a working market.

III. Policies for Sustainable Improvement

5. Macroeconomic and Regulatory Framework. The enabling framework for industrial

efficiency generally coincides with the environment for overall economic efficiency which is discussed elsewhere in the report. In most respects, there is little to be gained by delaying the implementation of reforms as far as the industrial sector is concerned. In particular: all input and output prices, with the exception of certain prices (such as energy) which may need to be adjusted in stages towards market levels, should be liberalized, with imports and exports allowed subject to declining protective tariffs; pending full convertibility, access to foreign exchange should be widened through auctions; state enterprises should be corporatized to facilitate reorganization, restructuring and privatization; new entry to both production and distribution activities should be liberalized and direct budgetary supports ended to facilitate exit of uncompetitive firms from the market; appropriate banking and capital market structures should be developed, and the current practice of establishing banks owned by enterprises or branch ministries should cease; wage policies should be decentralized, at least to the Republic level, and wage control on private businesses lifted; and income taxes should be uniform for all types of industry.

6. Industrial Policies and the Role of Industry Ministries. With the dismantling of central planning and the allocation system, numerous branch ministries become redundant and should be dissolved. Instead, a ministerial structure is needed which will support and regulate industrial activity while being totally separated from production cycles. The most appropriate structure would appear to be one Ministry of Industry at Union level and single Ministries of Industries in each republic. Important functions of the ministries, in the long-term, would be to: formulate and administer industrial policy; review and monitor long-term trends and international developments, and disseminate information; promote Soviet industry abroad; develop and update product standards; work with concerned agencies in applying safety and environmental standards; and assist regulatory agencies in developing and monitoring controls on monopolies and anti-competitive practices.

7. There will be important additional functions during the short-term transition to a market economy. Specialized temporary agencies will need to be established to assist with programs of industrial restructuring which encompass six major elements. First, to increase competition and flexibility, most of the multi-plant large enterprises should be broken down into independent enterprises, and all state enterprises should be transformed to joint-stock companies. Social activities of enterprises should be separated from productive ones and transferred to local governments. Second, to privatize existing enterprises, recourse to several methods, rather than exclusive use of any one, will increase flexibility and the pace of the effort. Ownership rights must be clarified with a clear understanding that owners try to maximize returns to capital. Small enterprises and viable medium/large enterprises should be privatized as rapidly as possible, and emphasis should be placed on private sector development by fostering entry and growth of small businesses. Third, to minimize the inevitable drop of industrial output which the proposed reforms entail, there will be need for restructuring those enterprises which will remain in the state sector. Among these, some will adjust by themselves, a second group will need assistance in restructuring to become competitive, and a third group, which will never be competitive, must be liquidated. Certain industries (such as steel, petrochemicals and machine building) may be identified as facing critical adjustment problems, especially given the drastic changes in the composition of demand towards consumer goods and away from these subsectors envisaged in current reform plans. For these industries, subsector restructuring and downsizing rather than simply enterprise-specific restructuring may be required. Fourth, for restructuring to have a positive impact, there is urgent need to institute basic and follow-up specialized training courses for managers to expose them to the essentials of operating in a market environment. Fifth, although there is no justification for major state-financed investments in industries destined for privatization, the state has a responsibility in the interim to maintain certain productive capacities and assist enterprises to become profitable in the new environment. To the maximum extent possible, funding of such investments should be found by the enterprises themselves, and hence, the bulk of available state funds should be allocated to improve communications and transport. Sixth, restructuring will unavoidably result in layoffs on a large scale, because of liquidations and the restructuring of seriously overmanned enterprises. Programs for retraining, unemployment insurance and social safety net systems are essential to reduce the negative impact on the population and facilitate redeployment.

8. An Accelerated Program for the Delivery of Priority Goods. While all of the above measures need to be taken as a part of the comprehensive reform strategy, there is a particular need to improve the supply of consumer goods. Consumer durables, because of the ease of their segregation from other activities, offer an attractive starting point. The following measures, seen as a first phase of an overall reform program and proposed for immediate implementation, could eliminate the shortage in these products while at the same time demonstrating the responsiveness of a free market in a widening and important area of the Soviet economy. Many of the existing producers of such goods are departments of large enterprises whose primary products and main priorities are geared towards heavy and armaments industry. Such departments should be separated legally, financially, and if possible, physically from their parents, converted into autonomous joint-stock companies, and privatized or leased out as rapidly as possible. New entry, whether of domestic or foreign firms producing durables or their components, should be facilitated. Input and output prices should be freed, existing state orders eliminated in favor of market relationships, and freedom given to import final products or components, subject to tariff protection for a defined period.

IV. The Role of External Assistance

9. There is a tremendous need for material and technical assistance for the upgrading of the Soviet industrial sector, but at this stage, preference must be given to measures which support reform rather than investments in new machinery and equipment. In particular, assistance could be directed to: management training; private sector development; industrial restructuring; institutional support for the new Ministries of Industry; and environmental support to assist industries to address critical problems.

AGRICULTURAL REFORM IN THE USSR: CRITICAL ISSUES AND STRATEGIES

1. Agriculture is a key economic sector in the Soviet Union accounting for about 20 percent of GNP and 19 percent of employment. Over 100 million people or about one third of the country's population depend directly or indirectly on the sector for their livelihood. The area cultivated --from the fertile "black-soils" in the center of the country to poorer quality soils to the north and the irrigated lands in the south-- cover about 230 million hectares, giving the USSR the most extensive land wealth of any country in the world. Most of the land is planted in grains and fodder crops, while overall, half the value of production comes from livestock products. Ninety-seven percent of the land is farmed in the public sector, about equally in large state or collective farms. In spite of the highly favorable resource endowment, the USSR is a net importer of food, with imports averaging just under US \$20 billion per year, of which about one half is grains and sugar.

2. Entering the decade of the nineties, soviet agriculture is at a critical juncture. Recent deterioration in agricultural marketing has compounded the chronic problems of the sector: inefficiencies in production and processing, deficiencies in distribution and waste at all stages between producers and consumers, and low returns to investment. The deterioration in marketing is due in part to fragmentation of the political and economic linkages of the administrative command system, and in part to the decline in the willingness of farms and processors to accept fixed government prices and rubles for transactions. The result has been shortages in cities and the growth of autarky and barter. Availability of food in Moscow, Leningrad, and the industrial cities of the Urals is lower than average this fall, and supply can be expected to deteriorate further in winter and spring. Moreover the rupture of internal trade has interrupted delivery of packaging materials and loss of perishable crops has increased. These problems are compounded by inflationary pressures caused in part by the growth in food subsidies, which have now reached 12 percent of GDP and, with recent and planned procurement price increases, could, by some estimates, attain 20 percent of GDP in the coming year.

3. The visible worsening in the food economy comes paradoxically at a time when the grain harvest is exceptionally good (due to extremely favorable weather), estimated at between 230-250 million tons, compared to an average for the last five years of 204 million tons. This year's growing food shortages amidst unusually abundant supply and dramatic increases in food subsidies illustrate the extent to which the chronic problems of the traditional command structure have impacted the economy.

4. The problems in the food economy, although visible before, deepened in the 1980s. When corrected for fluctuations in weather, grain production in the late 1980s did not increased much above 1976-1980 average levels despite high levels of investment while the costs of production, even crudely calculated without true account of capital costs, have nearly doubled. Imports of grains have grown over the same period from about 22 million to just under 40 million mtons. Although difficult to estimate, agricultural GDP growth has been well below general economic growth and probably averages less than 1 percent during the 1980s. Losses are officially estimated to be between 20 and 30 percent of production for grains and to even exceed 40 percent for perishable commodities. In mid-1990, the poor financial status of most farms and processing units forced the government to forgive 73 billion rubles of debt to the agro-industrial complex and more debt forgiveness is expected shortly.

5. The chronic problems of the sector are rooted in the structure and incentives governing production and processing. Over the last 25 years, growth in production has occurred under the centrally planned system, but at high budgetary costs and increasing forfeiture of opportunities to produce and consume other goods and services. Because prices and costs have had little economic meaning, the command structure of managing agriculture has resulted in misallocation, waste, and

destruction of the environment through overuse of inputs. Neither managers nor workers on state and collective farms have strong incentives to improve productivity, reduce costs, or preserve capital and land. Wages are standardized and state quotas at fixed prices determine the allocation of resources. Furthermore, prices are set such to penalize low cost producers. Inputs are also assigned and farm managers have little choice over quantities, quality or timeliness of delivery. The state monopolies that supply inputs and process outputs have little incentive to serve either the farm's or the public's interest. If costs exceed earnings, the state usually offers financial relief either through the budget or the banks.

6. The Soviet government, having invested heavily in the sector for decades and experimented with various reforms --from brigades to leasing--, has come to the conclusion that the sector's problems cannot be solved under the current structure of central command. The solutions to the sector's and the food economy's problems lie not with tinkering with the existing system but in a radical restructuring of the agricultural economy and the economic incentives which govern it. In most circles of policy making, the debatable issue in the Soviet Union is not whether to reform the structure but on its sequencing and depth. Major issues being discussed are whether to continue to administer some prices or fully liberalize prices and whether to permit private land ownership.

7. The prospects for success in a radical reform of the sector are favorable. The natural resource base of Soviet agriculture is rich, the people employed in agriculture relatively well educated and skilled, and the physical infrastructure, although inadequate, provides a foundation on which improvements can be made. The potential for growth in the sector is very substantial through improving the use and allocation of existing resources. Moreover, agricultural growth may be achievable before improvements in industry are realized and may therefore provide early tangible evidence of the fruits of reform to a market economy. But the political problems are formidable. The steps needed to realize this potential challenge rooted beliefs on the role of the state and its ownership of land and industry. It would also require a major retail price reform that, during the transition, could potentially impact severely some segments of the population. But there are few, if any alternatives.

8. The proposed strategy focuses on three critical issues --price reform, privatization, credit and investment-- and suggests ways for dealing with these priority areas of policy. The strategy for these areas recognizes that Soviet's agricultural potential can only be realized through a decisive break with the past. Studies of the political and economic process of reform in other countries indicate that up-front action must be substantial to demonstrate to investors and the public that government's commitment to the reform process is strong. Fundamental to the proposed strategies is a dramatic severing with the inherited institutions of collectivized agriculture through the liberalization of prices, the ending of state orders and the establishment of full private ownership of land (or a form of user rights that equivalently bestows the rights of ownership). The state would however continue to play an important role --by providing and enforcing the legal framework to underpin a largely private agricultural economy, in reducing price uncertainty associated with the transition to a very different relative price structure in agriculture, in funding investments in public infrastructure, and in establishing a social safety net in rural and urban areas. In other words, the role of the state would be redefined from one of control and ownership of production, processing and distribution to one more of support for private farming and the market.

9. The proposed strategy for the agricultural transition shares many elements in common with the recent official plan. It deviates most from the current range of debate in the Soviet Union in the sequencing of price reform through emphasizing the immediate need for rapid liberalization of prices, including retail food prices. Retail price liberalization is proposed along with instruments to increase the acceptability of higher food prices to consumers, and to spare vulnerable groups of the population from hardship. The proposed strategy also differs in emphasizing the dependence of the sector's future growth on the introduction of full private ownership of land. The proposed land reform to private individual or cooperative ownership, however, is phased, and its pace, somewhat cautious.

10. The overall strategy for the agricultural transition includes the following elements:
- (i) Price liberalization and termination of state orders replacing them in part by selective purchases by the state.
 - (ii) Creation of a safety net to cushion the impact of higher food prices on vulnerable groups.
 - (iii) Demonopolization of agricultural trade and gradual removal of non-tariff barriers to trade.
 - (iv) Phased withdrawal of the state's role in direct provision of agricultural inputs and rural construction materials.
 - (v) Privatization (either through establishing individual, joint shareholding or cooperative ownership) of most processing, of wholesale and retail trade in food, and of small-scale transport (mainly trucks).
 - (vi) Land reform through the disbanding of state and collective farms and the establishing of private individual or cooperative farms with the legal rights of full private ownership of land. Includes establishing either separate cooperatives or joint stockholding companies for the service assets (tractors, buildings etc) or their sale to farmers.
 - (vii) Reform of agricultural credit and establishment of new criteria for agricultural investment and of procedures for evaluating alternative investments. Implementation of infrastructural investments and financial systems to recover at least partially their costs.
 - (viii) Creation of an inter-republic council with participation of the international community to monitor changes in food supply throughout the Soviet Union, and channel international logistical support (in the form of targeted commodity shipments) for the transition to a market oriented agricultural economy, if such support is needed.
 - (ix) Technical and financial assistance to the Union and Republics during the transition. Broad areas of technical assistance are in banking and credit, project and economic analysis, trade systems and policy, food monitoring, and management and marketing of agroindustry. Investments in rural infrastructure and agroindustry will need to be substantial. In particular, rural roads and communications are required for efficient distribution and marketing. Irrigation and drainage systems need to be upgraded and improved in efficiency. Priorities and directions for public investments will have to be established through a comprehensive review of investment needs.

The Sequencing of International Assistance for the Transition to A Market Economy

11. The international community and the Soviet citizenry have much to gain from a successful transition to a market oriented agricultural economy in the USSR. Several kinds of international assistance could contribute substantially to the effort, reducing both the time in transition and the disruption associated with it. The sequencing of assistance will be an important determinant of its productivity.

12. In the earliest stage, the international community can provide commodity assistance (donations, concessional sales, or financial assistance for food imports) tied to the liberalization of retail prices. The assistance would go to organized public feeding and direct distribution programs and to targeted areas with unusually high free market prices (to assist in buffering unusual overshooting of newly liberalized prices). The objective of commodity aid would be to facilitate retail price liberalization, and thus relieve a constraint on further policy reform. The commodity aid should be tied to full retail price liberalization, and would not be used to introduce a partial, administered

increase in food prices. The effect of the aid should be monitored carefully to ensure that it does not overly depress producer prices.

13. Technical assistance in evaluating agricultural financial institutions and investment criteria, monitoring food supply and setting the legal framework for land reform and privatization of farm assets would also be useful in the early period.

14. After the legal structure for private enterprise is in place and liberalization of prices (retail, wholesale, and producer) is well underway, investments in rural infrastructure and agricultural processing will be highly productive. Projects to rebuild rural infrastructure and modernize processing should follow, and not precede, price reform, land reform, and privatization of agricultural assets. The opportunity cost of investment funds, both domestic and foreign, during the transition is extraordinarily high. Projects should be undertaken only after rigorous analysis indicates that they will be productive in the new economic environment, and will contribute to further progress of the transition.

THE USSR HOUSING SYSTEM AND ITS REFORM

1. Widespread housing shortages and rigid allocation mechanisms in the USSR constitute an obstacle to labor motivation, mobility and productivity. While the state owns the physical assets, households save and accumulate liquid assets which they cannot use for housing; meanwhile, the state cannot muster the resources to produce suitable units and maintain them. Reorganization of the housing sector and the restructuring of the economy should be pursued in parallel since they will be mutually supportive.

1. Current Housing Conditions

2. With the neglect of housing during the Stalin era and war destruction, the USSR emerged with an extremely low per capita housing availability of 4 m² of usable space in the 1950s. Thanks to massive housing production efforts, especially in the 1960s the current level is now 15.8 m² of usable space per capita. This is still less than half of the space availability in Western Europe and with major quality shortfalls. The housing stock is estimated at only 18% of reproducible assets, about half of OECD levels. Housing availability differs between republics and, within republic, between cities. The Western and Baltic republics enjoy better housing. Large (especially capital) cities are better off than small ones and rural areas. Even so, the shortage of housing in major cities is such that prices per square meter as derived from exchanges exceed construction costs by a factor of four (in a balanced market this ratio would be close to one). Although this ratio would decline as the market broadened, it suggests that the economic return to additional investment is high.

3. The quality of new housing is low, and with the present nominal rents the existing housing stock is deteriorating steadily. Maintenance is heavily subsidized yet less than 40% of minimal levels. The rent control system is basically unchanged since 1928, and rent bears no relation to location or quality. Today households spend less than 3% of their income on rent and utilities which is less than their monthly expenditures on alcohol and tobacco. Rents would need to be raised over ten times to achieve economic cost recovery. Production and rent subsidies are linked to size, quality and location of apartment units and not to the socio-economic characteristics of households. Housing rather than wages is a major source of inequality. Some estimates suggest that about 45% of the population still shared facilities in 1984, and the ratio of new units to household formation (including divorces) has actually deteriorated, from 70% in 1975 to 60%, so that the backlog is expanding.

4. The financing and production of new housing is highly centralized and dominated by industrial housing monopolies using techniques abandoned in the West by the 1960s. They produce a very limited number of apartment types ill-matched to household diversity, and their high break-even output renders them especially unsuitable for rural areas. Individual housing has been marginalized to small cities and rural areas and its share of city floor space has fallen from 33% in 1970 to 22% in 1988, although almost 70% of rural housing is individual. The quality of individual housing is very low; for example, only 12% of such houses have a telephone. Recently, the share of private housing investment in rubles has risen to 13.1% in 1989, but it is still small.

5. Housing allocation mechanisms are unfair and increasingly corrupt. In 1988, the percentage of all families on waiting lists ranged from 12% to 36% according to city, even though registration is restricted by norms and residence permits or "propiska". Housing queues have been increasing lately and 18% of all Soviet families have been on the lists for 10 years. The liabilities accumulated by the government through the waiting lists and the principle of a "socially guaranteed housing minimum" are very important issues in considering housing reforms and privatization plans. The housing situation is a major obstacle to labor force mobility, stability (especially in new industrial cities and Siberia), and economic development.

2. Housing Reforms as Part of Structural Reform

6. Housing reforms are needed for macroeconomic stabilization, efficiency, equity and social stability. Macroeconomic stabilization requires the reduction of state deficits, including housing subsidies. The evidence available from other socialist economies in Eastern Europe and China suggests that housing subsidies in the USSR could easily range between 3% and 6% of GNP, and could be higher given the predominance of state housing. In 1989, financial assets per household averaged 5,170 rubles of which 4,070 rubles were held in savings account (equivalent to about 5 month of total income for worker households or 16 months of an individual cash wage). This compares with the official construction cost of a standard 55 m² urban housing unit of 16,500 rubles. Using an unspecified methodology, the Shatalin report estimated the effective demand for housing at 70-75 billion rubles, or somewhat less than half of involuntary savings, although only part of this demand appeared to be related to portfolio restructuring.

7. Regarding efficiency and equity, reform is needed to improve labor mobility and to restructure employment incentives toward productivity-related cash wages rather than access to housing. This requires that wage policy be reformed in parallel with rent and price reforms.

8. A diversified housing supply and an efficient housing industry must be promoted through competition among producers of housing and sources of construction materials. Changes in building techniques, faster completion schedules, more flexible urban planning and regulations and performance-oriented norms could cut housing costs by 30 to 40%. This would also free firms from providing housing, an activity in which they have no comparative advantage. Infrastructure use and energy efficiency in cities could also be raised.

3. Reform Strategy

9. Economic conditions in the existing stock and new housing production interact constantly. Market-oriented housing reforms must therefore deal with both simultaneously. There are four major areas of concern: (1) property rights, privatization and free exchange, (2) rents, sale prices, subsidies and fiscal policy, (3) financing, and (4) production. A fairly detailed framework for reform has been developed for other socialist countries, and it is generally applicable to the Soviet Union.¹

10. Property Rights and Privatization From an economic perspective, major increases in rents should precede change in property rights to create incentives to buy. However, from a political perspective, this may not be the shortest path toward successful market reforms and starting with property rights may be better. The World Bank's experience over two decades is that tenure security is the core component of a housing market system and that the clarification of property rights induces better pricing and cost recovery. In the housing area, property rights reforms imply at least three contemporaneous changes: (1) a strengthening of ownership rights; (2) in the opposite direction, the conversion of "permanent and guaranteed" administrative tenancy rights to fixed-term renewable rights; (3) the free and unrestricted exchange of existing units and leases, with monetary compensation permitted. Sound rules for listing, information systems, and brokerage services should be developed.

11. Rents, Prices and Subsidies Subsidies to production presently include subsidized loans and operating subsidies to builders, subsidized prices on building materials, underpriced or free land and subsidized infrastructure. These subsidies and allowances should be re-channeled away from the

¹ The Framework for Housing Reform in Socialist Economies, Report based on the proceedings of the World Bank Seminar of June 12-13, 1990, Washington D.C.

construction industry, directly to households as far as possible, and targeted to needy social groups. Rent increases moving toward full economic rent should be coordinated with both wage reform and the privatization of various segments of the state-owned stock. The sale of newly produced units should be started very quickly. Sale prices would take into account current shortage conditions, but could not be freed abruptly to short-term scarcity levels.

12. Financing Whereas many aspects of reform should be implemented in a decentralized way by lower levels of governments, housing finance must be developed from the national level as an integral component of financial sector reform. Particular attention must be given to the financial viability of long-term mortgage loans. During the transition toward market level wages, special mechanisms may be needed to improve affordability while minimizing subsidies.

13. Production Introducing competition among producers will be easier as households gain greater control over financing decisions, subsidies are redirected, markets for building materials develop, and access to land is facilitated by local governments. Preferential treatment for large state firms should be eliminated. Reducing the unit scale of urban planning, as well as significant changes in existing building codes is needed to accommodate greater diversification of housing types and smaller more flexible housing projects.

4. Organizing for Market-Oriented Reforms

14. The introduction of a market-based housing system will be a lengthy process for the Soviet Union. It has not begun to organize for the coordinated development of market mechanisms. Housing is managed as a social service subordinated to other priorities and with fragmented and uncoordinated administration. Nowhere are economic, financial, legal and technical issues related to housing considered together. The implications of housing reforms for the reorganization of central and local government institutions are major, and radical change cannot be attempted successfully without an appropriate institutional infrastructure.

15. In particular: Understanding of the implication of developing a housing market is uneven, including among reformers, and few appreciate the nature and magnitude of the legal, institutional, professional and financial infrastructure that must be developed to support a housing market. The assignment of responsibility and legal ownership of assets between different levels of government is unclear. Also, the analytical tools for policy analysis have to be developed and a suitable information base is not available to support decision-making and track the process of reform.



Office Memorandum

2/30

RECEIVED

90 OCT 25 PM 4:32

October 25, 1990

To: Mr. Flemming
Mr. Thalwitz
Mr. Zecchini

From: L.A. Whittome *LAW*

Subject: USSR--Gorbachev proposal

I attach an unofficial translation of the Gorbachev plan provided by Mrs. Ter-Minassian. It looks very similar to the translation obtained by Mr. Holsen yesterday, but may anyway be useful to circulate it.

Attachment

cc: Mr. Fitoussi
Mr. Holsen
Mr. Tuveri

3/30

SUPREME SOVIET OF THE USSR

In accordance with the decision of the Supreme Soviet of the USSR, I herewith send forward "The Basic Directions for Stabilization of the Economy and Conversion to a Market Economy"

M. Gorbachev

October 15, 1990

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The policy of perestroika, endured and approved by the Soviet people, has freed up powerful forces for renewing our society. Its implementation has wrested the country from torpor and stagnation. Fundamental progress has been made in international cooperation, and disarmament has started. As a result of political reforms at home, a wide-ranging process of democratization and glasnost is moving rapidly forward, the political rights of citizens have been broadened, and the sovereignty of the peoples has been strengthened. All this is laying the groundwork for lifting our entire society, and especially its economy.

At the same time, the painful legacy of the administrative-command system, the inconsistency and indecisiveness of the economic reform measures that are being taken, including mistakes in the conduct of the economy, and disrespect for the laws have provoked a deep economic crisis in the country.

The condition of the economy continues to worsen. Production volume is declining, and economic links are being broken. Separatism is intensifying. The consumer market has been devastated. The budget deficit and the government's solvency have reached critical levels. Antisocial phenomena and criminality are on the rise. People's lives are becoming more and more difficult, their interest in work is falling, and faith in the future is collapsing. The economy is in a very dangerous position: the old administrative system of management has been destroyed, but the new incentives for work in market conditions have not yet been created. Energetic measures, based on public agreement, to stabilize the situation and accelerate progress toward a market economy are needed.

I. The Choice Has Been Made

There are no alternatives to shifting to the market. The world's entire experience has demonstrated the vitality and effectiveness of a market economy. The conversion of our society to it is dictated entirely by the interests of the individual, and its goal is to create a socially oriented economy, to turn all production toward meeting the needs of the consumer, to eliminate shortages and the disgrace of lines, to make the economic freedom of citizens a reality, and to create conditions conducive to industriousness, creativity, initiative, and high productivity.

Conversion to the market does not conflict with our people's socialist choice. Only the market, combined with a humanistic orientation of the entire society, is in a position to satisfy people's needs, distribute benefits and social rights and guarantees equitably, and consolidate liberty and democracy.

The mechanisms of self-regulation that characterize the market promote economic equilibrium, with optimum coordination of the activities of all producers, and ensure the rational use of manpower and material and financial resources. The market requires a production apparatus that is flexible and receptive to the achievements of science and technology.

Conversion to an economic system based on market relationships will permit an organic linking of our economy with the world economy and will give our citizens access to all the achievements of world civilization.

The difficult but utterly crucial sea change which we must undertake is the replacement of state tutelage, dependency, leveling, apathy, and mismanagement, born of the administrative-command system, with freedom of economic activity and the responsibility of enterprise personnel and individual citizens for their wellbeing, well-organized and hard work, and compensation linked to results.

Through an all-Union market, a single economic territory will be created, integrating all of the country's republics and regions. And the shift to the market will establish an economic basis for sovereign republics to unite voluntarily in a renewed and strong federated Union.

An efficiently operating market economy requires the following basic conditions, which must be created in the course of the transition period:

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- maximum freedom of economic activity. The foundation of the economy is the free producer of goods multiplying his assets and, by that very fact, the national wealth. Recognition of the important social role of the most active, skilled, and talented people—workers, peasants, engineers, entrepreneurs, and organizers of production—and encouraging them in every way;
- the full responsibility of economic organizations, entrepreneurs, and all workers for the results of their economic activity, based on the equality of all types of ownership. The very meaning of the reform of property relations lies in its clear identification of those bearing material responsibility for the results of their management and in the search, as the economy develops, for the sphere in which each form of ownership works best;
- competition among producers as a major factor for stimulating economic activity, expanding the variety and improving the quality of production in accordance with the needs of the consumer, reducing costs, and stabilizing prices. For healthy competition to emerge, the economy must be decentralized and an appropriate production structure must be established;
- freedom of price formation. Market mechanisms can function effectively only if most prices are set freely by the market, balancing supply and demand. Government control of prices is permissible only in a limited sphere;
- renunciation by the government of direct participation in economic activity (except in certain special fields);
- expansion of market relationships to those fields in which they display the greatest effectiveness in comparison with administrative forms of control. At the same time, the economy will retain a significant nonmarket sector, embracing those types of activity in which commercial criteria alone are inadequate (defense, public health, education, science, and culture);
- openness of the economy and consistent integration of the economy into the world economic system. All economic organizations are entitled to conduct foreign economic operations. Foreign firms, on equal terms with all other producers, operate in the domestic market in accordance with the existing laws and generally accepted international rules;
- provision of social guarantees to citizens by all levels of government, which means both offering all citizens equal opportunity to achieve a dignified life through their own labor and savings and supporting the disabled and socially vulnerable members of society.

While the economy assures a high level of economic efficiency of production, however, it must be regulated by the state and society, chiefly from the standpoint of preventing such negative phenomena as inflation, unemployment, excessive differences in wealth, instability of production, and unequal regional development. With its macroeconomic policy, the state fosters a climate conducive to economic activity, above all in directions corresponding to the interests of society. The activities of state agencies regulating the economy are based on a clear demarcation of legislative, executive, and judicial powers.

The choice of converting to the market—a choice of crucial historical significance to the country—has been made. The whole question now is how to get there, how to choose the safest and most correct ways. The crisis is so acute that we must act without delay. We must show resolve and determination that is not reckless or adventurist, but rather based on realism and faith in our people.

These Basic Directions have been drawn up on the basis of programs developed by the Gorbachev/Yeltsin working group and the Government, taking into account suggestions made at sessions of the USSR and republic Supreme Soviets. The changed economic situation in the country has also been taken into consideration.

In actuality, without awaiting steps to rehabilitate its finances, the economy has begun the process of raising

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some republics and regions, the prices for certain categories of goods. This has given a push to inflation, which is spilling over into retail prices. In these circumstances, inflation must be curbed, particularly at the retail price level. Steps must be taken at the same time to rehabilitate the monetary and financial system quickly and, on that basis, to move further toward market prices.

These Basic Directions are intended as the basis for coordinated action by all republics and all Union agencies to stabilize the economy and shift to a market economy. In this process, every sovereign republic has the opportunity to develop and implement a package of concrete measures for conversion to the market in light of its own socio-economic situation and national and historical realities.

2. Economic Interrelationships in a Union of Sovereign Republics

The economic interrelationships among sovereign republics are built on a recognition of the state sovereignty and equality of the republics and, at the same time, of the integrity of the Union as a federation, with the understanding that the foundation of the economy is the enterprise and the task of the state is to create the most favorable conditions for the functioning of enterprises.

The republics regulate through legislation the ownership, exploitation, and disposition of all the national wealth on their territories, which constitutes the material base of their state sovereignty.

To carry out the tasks common to all the sovereign republics, joint property of all the republics (Union property) is set up, to be administered by Union agencies. They provide uniform regulation for the economic system on the basis of anti-monopoly legislation and of agreed measures to combat unfair competition, and they protect consumer interests and regulate and equalize the conditions upon which the republics begin their move to market conditions.

The republics bear the basic responsibility for developing their territories and conduct economic policy, independently shape their economic management structures and their systems of republic and local taxes, levies, and required payments, and decide how to regulate prices, income, and the social protection of the people.

The role of the autonomous republics and other national structures in the economy of the USSR and of the Union republics will grow considerably.

In their mutual interest and on a voluntary basis, the sovereign republics enter the Union and form a single economic territory and an all-Union market, carrying out an agreed policy for the support of free entrepreneurial activity, for the conduct of mutually beneficial economic relations, and for the defense of the market.

The republics belonging to the Union jointly develop the bases of their common economic policy and approve legislation regulating the system of inter-republic relations, determine procedures for resolving economic quarrels and conflicts, and conduct agreed policies on prices, income, employment, pension benefits, and social guarantees for the citizens. To administer jointly those areas of activity which require agreed policies, they create Union agencies of administration.

To create a single all-Union market, the republics delegate the following powers to the administrative agencies of the Union:

- Implementation of agreed credit, monetary, and foreign exchange policies, designed to enhance the purchasing power of the ruble as the only legal means of payment on the territory of the Union. Nonpermissibility of limitations on the movement of monetary resources within the Union;
- Union-wide regulation of the prices of those key raw materials, foods, goods, and services selected by agreement among all the sovereign republics;

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- development and implementation of uniform customs legislation to protect the all-Union market. Impermissibility of quotas, limitations, or customs barriers affecting the movement of an agreed list of goods within the Union;

- development of a strategy for foreign economic policy. Establishment and use of an all-Union monetary fund and fulfillment of the responsibilities of the USSR to the international community;

- establishment of single patent, weights and measures, and meteorological services, setting of all-Union standards and adoption of international standards, and organization of all-Union statistics and of a single accounting system.

In addition, in the common interests of the socio-economic development of the republics, the administrative agencies of the Union:

- draw up long-term forecasts of the country's economic and social development and establish and execute major economic programs of all-Union significance;

- develop and implement measures of all-Union significance for the ecological protection of the people;

- create the economic conditions for maintaining the ability of the Union to defend itself, guaranteeing its state security, and fighting organized crime.

All-Union administration is established for those spheres of activity and specific programs which, by their nature, require uniform management on an all-Union level. These are:

- major fundamental research and scientific and technological development projects;

- defense programs;

- the single fuel and energy system;

- transportation by main railroad line, by sea, by air, and by pipeline;

- atomic energy;

- space systems and research;

- the all-Union system of communications, information, and data processing;

- the state's all-Union system to prevent and act in emergency situations.

The powers delegated to the Union administrative agencies may not be changed without the agreement of the sovereign republics. At the same time, the sovereign republics are economically liable for violations of their accepted obligations.

The Union budget is based on Union (federal) taxes; the tax rates and taxable objects are determined by agreement with the republics. The Union budget revenues derive also from other receipts obtained through the Union's execution of its powers. This enables the Union to plan its expenditures on the basis of its anticipated revenue and to bear responsibility for its financial policies.

In addition to expenditures relating to the functions assigned to the all-Union level, the Union budget contains a regional development and support fund and provides resources to service the USSR's state domestic and foreign debt and for a reserve fund.

By mutual agreement, the sovereign republics may finance as well the execution of other economic, scientific-technical, social, and ecological programs on a bilateral or multilateral basis.

In order to finance the foreign economic activities of the Union relating to the powers delegated to it, a Union Monetary Fund is created with sufficient resources to service the USSR's state foreign debt, to conduct the agreed all-Union foreign exchange policy, to provide support for the functions assigned to the Union level, and to set up foreign exchange reserves at the Union level.

To coordinate measures carried out by all the republics, an Inter-Republic Economic Committee is established under the Council of the Federation.

and Conversion to a Market Economy

Emphasis must be placed from the very start of the reform on rehabilitating finances and the credit and monetary systems, while supporting the economic links and material flows that have come into being. At the same time, the rise in prices--the emergence of a spontaneous inflationary spiral--is held in check. On this basis, a broad transition to market prices that takes into account the then current social and economic conditions will be carried out in the future.

The indicated measures, combined with state support and the introduction of incentives for the production of consumer goods and services for the people and with growing imports of these goods, should bring about a normalization and revival of the consumer market and its saturation with goods and services. This would considerably alleviate the people's social dissatisfaction and greatly facilitate the subsequent steps in the conversion to a market economy, strengthen material self-interest, and promote economic and labor involvement.

Decisive steps must be taken at the same time to de-governmentalize and de-monopolize the economy and develop entrepreneurial activity and competition, so as to create the conditions within a short period of time for applying market mechanisms of self-regulation. Only they can be expected to limit inflation, encourage the growth of production in volume and variety, raise its quality, and reduce costs. Until they are sufficiently strong, financial and credit policy will have to remain tight and, in some spheres, direct administrative action will be required to prevent unmanaged inflation. Hence, during the transitional period, the structural reorganization of the economy will have to be limited to the most urgent measures.

This difficult path must be covered in the shortest possible time. Experience with the application of stabilization progress in other countries and the estimates and forecasts made regarding our own conditions indicate that about one and a half or two years could be required. This is the period of time for which the President of the country has been granted supplementary powers.

After this period, a full-fledged market and an active structural and investment policy would begin to develop and an upswing in production and in its efficiency would begin, laying the groundwork for a better life for the Soviet people.

During the relatively brief period in which the governing authorities of the Union, the republics, and localities can count on a mandate of public trust, the economy must be stabilized and the changes that open the door to market relationships and bring about a visible improvement in the economic situation and in people's living conditions must be implemented.

The tasks of stabilizing the economy and shifting to the market are carried out in four stages.

Stage I - Program of Emergency Measures

At the very start, the introduction of laws specifying the basic principles and directions of the economic reform is announced and, more importantly, a package of measures to stabilize the economy begins to be implemented, with a view to:

- rehabilitating finances and monetary circulation by curtailing the state budget deficit, controlling monetary issue, reorganizing the banking system, and rehabilitating enterprise finances;
- protecting the people's monetary savings through an increase in the interest rates paid by savings banks, balancing the people's income and expenditures, and supporting the production of consumer goods, thus reviving and normalizing the consumer market;
- stabilizing mutual deliveries and, insofar as possible, preventing a decline in production;
- de-governmentalizing and privatizing property and carrying out land reform;
- stabilizing foreign economic relations.

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The most difficult task at this stage is curbing the inflation that has started--limiting the rise in wholesale and purchase prices, gradually raising the state prices for fuel, raw materials, and construction materials, and controlling the level of state retail prices for mass consumption goods. All this will have to be done in such a way as to limit the rise in the budget deficit stemming from the increase in purchase and wholesale prices while at the same time preventing uncontrolled inflation, and to improve the equilibrium between goods and money for purposes of a subsequent accelerated transition to the market.

Stage 2 - Strict Financial Constraints and a Flexible System of Price Formation

This stage consists mainly of a consistent, gradual transition to market prices for a broad range of industrial and technical production and consumer goods. The measures taken in Stage 1 should prevent them from rising excessively. Subsequently, inflation is controlled by means of tight financial and credit policies.

Strict state pricing is maintained at this stage for no less than one third of all goods--fuel, raw materials, and [building] materials--which is important for regulating the overall price level, and retail state prices on the essential consumer goods making up the people's subsistence base.

At the same time, the de-governmentalization process is expanded, small enterprises are privatized, and a market infrastructure is developed.

Special measures are adopted to rechannel capital investment and other resources to industries producing for the people; incentives are strengthened for developing and expanding them.

The first result of the emergency measures and of the liberalization of prices will be seen in a marked improvement of the situation on the consumer market, especially with respect to goods sold at supply and demand prices. The more strictly and consistently measures are taken in the area of financial and credit policy and to eliminate price-fixing demand, the less prices will rise. Goods will appear for free sale. This is the first positive result that can be anticipated from the reform, and it must absolutely be achieved.

Special mechanisms for the social protection of people's incomes, including their indexation to retail prices, are introduced in the transition period. Steps to support the socially vulnerable segments of the population are begun at the same time.

In this regard, the Union republics and local governments can take various measures to regulate prices, including temporary price freezes on mass consumption goods if their prices rise excessively, rationing of certain goods, using their budgets to compensate producers and merchants for the losses suffered, and social protection of people's incomes.

In order to maintain production and economic links, a state contracting system is created to place state orders on a contractual basis, to distribute the production delivered under those contracts, and to regulate the prices for it.

Stage III - Formation of a Market

The main task at this stage is to achieve a basically stable market for both consumer and producer goods, broadening the domain of market relationships and refining the new system of economic links.

Conflicting processes will be taking place in the economy at this time. On the one hand, it can be anticipated that the market will be supplied more and more fully with goods. The market infrastructure will be taking shape at an accelerated rate, and the impact of the entrepreneurial spirit on economic activity will be growing. Material resources will be used more economically, and production stocks will be reduced. The resources thus released will help supply the market with means of production and stabilize it.

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The emphasis at this stage will be on development of the housing market, the reform of labor compensation, the reorganization of relations between enterprises and local soviets in the social sphere, and a further liberalization of prices.

The creation of a housing market is a necessary aspect of the transition to a market economy. It will bring into circulation one of the main commodities that can absorb a large part of the demand for which the population has means of payment, thereby helping to balance the consumer market and strengthen the incentive to work.

The system for compensating labor must also be reorganized. This will mean abolishing regulations and establishing a state minimum wage for all enterprises, regardless of type of ownership, based on the minimum consumer budget and taking account of the new level of spending on housing and, overall, on the wider range of goods and services obtained at market prices with one's own income. A realistic minimum wage will be a major instrument for the social protection of workers. At the same time, limits will be removed on the possibilities of earning money.

In conjunction with these measures, the republics and local authorities work to relieve enterprises of any excessive or unequally distributed burden relating to the maintenance of social facilities. This will facilitate the enterprises' entry into market relationships and strengthen their competitiveness.

With the successful implementation of the preceding stages, practically all of the essential conditions for a tably functioning economy will exist--budgetary and price equilibrium, a well supplied market of consumer goods and services, a modern banking system, and a foreign exchange market.

The conditions that emerge from the housing reform will promote the formation of a labor market. The unions will become stronger defenders of the workers' interests, and associations of entrepreneurs and managers will be formed. It will be possible, on the basis of agreements between them, and with the state playing a regulatory role, to set up a labor market and exercise public supervision over income and price developments.

Financial and credit constraints will be removed as competition, entrepreneurial activity, and price stabilization develop. Changes in taxes and interest rates will be made to promote business activity and investment.

Stage IV - Completion of the Stabilization Period

The main tasks of this period are to consolidate the stabilization of the economy and finances, to improve the consumer market, and especially to accelerate the development of the competitive market climate needed for the proper functioning of the self-regulatory mechanisms peculiar to a market economy.

Significant progress must be made in this period on de-monopolizing, de-governmentalizing, and privatizing the economy.

The groundwork must be laid for strengthening economic entities, especially in the branches of light industry, food processing, the agricultural sector, and services.

The predominance of supply and demand pricing, combined with a balanced budget, will create the conditions for essential part of the transition to a market economy--the problem of internal convertibility of the ruble. The at market rates, the currencies they need to carry on their current operations.

Internal convertibility of the ruble will create broad opportunities for an inflow of foreign investment, so sorely needed for our country's structural reorganization and technical renewal, and for the development of competition and elimination of monopoly conditions on the domestic market. It can be stated that, given the conditions in our country, this is a major prerequisite if the market mechanism is to operate at full power. The structural reorganization of the

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economy, relying for the first time on market mechanisms and attracted foreign investment, technology, and management experience, will take place.

4. Measures to Stabilize the Economy

These measures include rehabilitation of finances and of monetary circulation, support for production and material deliveries, normalization of the consumer market, and stabilization of the country's foreign economic position.

Rehabilitating finances and monetary circulation. This is a crucial part of stabilization. It consists of eliminating the excess money supply in circulation, bringing it in line with the supply of goods, and strengthening the ruble.

It is necessary first of all to reduce drastically the Union and republic budget deficits as from November and December of this year. In 1991, the combined deficit of the Union and republic budgets should not exceed 2.5-3 percent of the gross national product (no more than 25-30 billion rubles). A deficit of this size can realistically be financed by borrowing from individuals, enterprises and organizations, and abroad.

The extension of credit by the Gosbank of the USSR to cover the budget deficits is being eliminated. In exceptional circumstances the President of the USSR may permit short-term credits in limited amounts.

Budgetary expenditure in the last months of 1990 and in 1991 is being reduced by:

- a further reduction in industrial investment. Projects that are at a low level of readiness, other than those designed to broaden the production of consumer goods, housing construction, and development of the social sphere, are being stopped;

- a reduction in expenditures on the needs of the Ministry of Defense of the USSR and the KGB, in particular by reducing weapons procurement and military construction. It is expected that a portion of these savings will be used to raise the pay of armed forces personnel and build housing for them;

- the termination of financing for expenditures that no longer serve the purpose for which they were intended and were not used in the stipulated time period, including those from the centralized financing funds of the ministries; the curtailment of grant and subsidy payments to enterprises, except for a limited number on the agreed list;

- a reduction in outlays for the maintenance of the state apparatus and a shift of many organizations over and by the budget to a fully or partially self-financing basis.

At the same time, steps are taken to expand the revenues of the union and republic budgets. The procedure for calculating and collecting the turnover tax is to be changed and the number of goods on which it is levied is to be broadened.

The adopted all-Union tax legislation is retained for 1991. Individual amendments to the existing laws may be made, however, on the proposal of the republics.

The establishment of tax inspectorates is to be completed in order to provide for reliable supervision of budgetary receipts.

At the end of this year budgetary revenue is to increase through the growth of turnover tax receipts in connection with the shift to demand and supply pricing on a number of nonessential goods, including imports.

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Efforts are to be made to enlarge budgetary revenue by selling on the domestic market large quantities of military property with civilian uses, some of the trucks and passenger vehicles used by state organizations, and other state property and goods.

The reorganization of the banking system and emission of effective instruments for regulating the money supply will play a crucial role in rehabilitating monetary circulation, preventing inflation, and establishing stricter financial limits on enterprises.

To this end, the specialized state banks are to be transformed into joint-stock commercial banks, operating in equal conditions with other commercial banks. Their function is to provide direct credit and payment services to the economy. It will perhaps be necessary to retain one state bank, which with budgetary support would extend credit on preferential terms to stimulate economic activity in the interests of the state. The Sberbank (Savings Bank) retains its status as a state bank; the state guarantees the safety of deposits, if necessary through their indexation.

By this November, the state banking system of the USSR is to become the Reserve System of the Union, consisting of the Gosbank of the USSR and the central banks of all the Union republics, which establishes uniform, agreed, and universally compulsory rules for regulating credit and the money supply, including reserve requirements on commercial banks and a discount rate of interest. The monopoly on monetary issue and the uniformity of the principles governing bank supervision are to be retained. The loan fund is distributed among the banks, and there is a shift to a normal mechanism of monetary issue through the sale of banknotes by the Reserve System to commercial banks on a noncash payment basis. In this way, as the banking system is democratized, its nationwide unity is enhanced and the use of credit instruments for regulating economic processes is made more effective.

A change to regulation of total monetary circulation takes place at the beginning of 1991. The ineffective system of cash planning is terminated.

Bank interest rates are raised. The level of interest rates will henceforth be determined by supply and demand on the credit market and by the reserve system's policies. In this way, money becomes dear and acquires characteristics that the means of payment in a market economy must have.

As these measures are carried out, many enterprises are going to experience financial difficulties. To facilitate their adjustment to the new conditions and enable them to accumulate their own working capital and find ways to boost their efficiency:

- such enterprises will quickly be degovernmentalized, turned into joint-stock companies, and broken up;
- stabilization funds will be established;
- the practice of commercial credit between enterprises will be developed as an element in the new wholesale market, to reduce the reliance on bank credit;
- the practice of floating bonds to replenish working capital will be encouraged;
- irretrievably inefficient enterprises will be closed.

A significant role must be played by the stabilization funds, to be established as independent agencies at the Union and republic levels. They can provide enterprises with temporary financial assistance in the form of direct grants, subsidized loans, credit guarantees, etc. The stabilization funds obtain their resources from earmarked budgetary allocations, deductions from enterprises, some of the proceeds from the sale of state property, the sale of bonds, and other sources.

Financial assistance from the stabilization funds will be provided on certain conditions, such as requirements that the enterprises be reorganized, that their management be changed, that their nonproduction expenditures be reduced, that they change the focus of their business, or that they be broken up.

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1. Normalizing the consumer market. This is the most important part of the stabilization program from the social standpoint. To this end, effective uses must be found for the population's huge monetary overhang and the volume of goods and services entering the consumer market must grow.

To meet the first of these two needs, it is proposed that the range of paid goods and services be broadened. Sales of housing units, country cottages, building materials, and various types of state property to the people are to increase, and a fee will be charged for the long-term leasing of plots of country land. Through redistribution of the capacity of construction organizations and through the offering to them of further incentives, additional residential units and garages must be built in 1991, and several million plots of country land must be readied for sale to the people.

It is also planned to introduce municipal leasing loans for the acquisition in the near future (within fixed periods of time) by the people of material goods that are in short supply--passenger cars, personal computers, furniture, telephones, additional housing, garden cottages, garages, plots of country land, etc. This is done with state guarantees and at fixed prices.

It is extremely important also that the people be assured of the safety of their savings, that their confidence in the state be strengthened, and that money be diverted from the consumer market. To this end, interest rates will be raised, especially for time deposits at the Savings Bank (Sberbank).

At the same time, it is necessary to expand investment by the people in productive facilities--for acquiring means of production, stock and bonds, and enterprises.

And measures are to be taken to broaden the production of mass consumption goods and paid services. Further incentives, including tax advantages and assistance to enterprises in expanding their output, will be provided for the production of consumer goods.

The transition to market pricing--pricing by supply and demand--is to begin with nonessential goods, but with fixed prices being set temporarily for some categories of these goods. The share of consumer goods and of raw materials for producing them in total imports will rise, in part through purchases financed by earmarked borrowing on preferential terms. Normal commercial inventories will be enlarged so as to curb price rises and cope with demand surges when prices are freed.

Goods now in short supply, including imports, find their way largely into the hands of speculators. To prevent this, large-scale catalog sales of imports are planned.

The retail and wholesale trades, the restaurant trade, everyday services, and many of the enterprises from which they obtain supplies are to be de-monopolized and privatized. The work of consumer cooperatives, trading and purchasing cooperatives, and other commercial enterprises, particularly those engaged in the shipping and sale of goods in regions experiencing problems in supplying their people, is to be encouraged. Measures to combat the shadow economy and to defeat efforts by its representatives to prevent the development of competition on the consumer market are to be intensified.

The consumer market is especially sensitive to irregularity of supplies; special measures are needed to prevent such irregularity during the transitional period. The mechanisms of state purchase orders and state prices and the contractual system are to be used to this end. If needed, rationing of a limited number of essential goods may be undertaken by cities, regions, or republics.

Ensuring the Stability of Economic Relationships. This is especially important in the transition period, considering the unstable nature of the market relations that are emerging and the danger of disruptions of production.

Pursuant to a decree of the President of the USSR, the existing economic links are to be maintained in 1991, and severe penalties are to be introduced for violating them. Uninterrupted transportation services are also being assured.

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All necessary measures to find foreign exchange resources to pay foreign firms for deliveries and hasten the conclusion of contracts for the delivery of imported raw and other materials and finished products are to be undertaken.

It will be the task of the State Contract System, to be created through agencies of Gosnab [State Supply Committee], Mintorg [Trade Ministry], and Agrosnab [Agricultural Supply Committee], to supply production enterprises with sufficient material and technical resources to meet their state delivery obligations for 1991. Deliveries for the rest of their output will be arranged through direct economic relations or through middlemen, that is, commercial wholesale enterprises.

Strengthening the Foreign Economic Position of the USSR. This calls urgently for a rapid improvement in the country's foreign exchange position and for the attracting of foreign capital. To create conditions for this, there must be (a) a clear program for the stabilization of the political and economic situation, supported by the republics and the major social forces in the country; (b) a national program for cutting military spending, reducing the army and armaments, and converting military production; and (c) a new doctrine in foreign economic relations, with guarantees for foreign investors.

If these programs are adopted and implemented, possibilities will exist to:

- receive aid from the developed capitalist countries in various forms, including long-term loans on favorable terms;
- lease certain fuel and raw material deposits and forests and set up joint enterprises to process these natural resources with due attention to current environmental requirements;
- sell real property, including unfinished construction projects, at auction, or lease it;
- have the state sell securities guaranteed in various ways, as well as stock in enterprises and organizations of the USSR bought by foreign investors;
- begin to exploit many waste matter and used raw material depots with the help of foreign capital;
- attract foreign investment each year for establishing joint enterprises;
- attract foreign investment to create a modern tourist industry and infrastructure for business.

With the problem of foreign indebtedness becoming more severe, the "Basic Directions" call for measures to relieve it and to use foreign economic support for the Soviet market during its stabilization period. To these ends:

- by accelerating exports and rationalizing imports, the country is to pay off its overdue debt to foreign firms by the end of 1990; state orders for the basic Soviet export goods will be maintained in 1991 and 1992 at a level sufficient to meet the country's minimum foreign exchange requirements;
- arrangements will be made for certain Soviet imports to be paid for in rubles that can be reinvested in the country's economy;
- negotiations with the International Monetary Fund, the European Communities, and leading foreign governments on financial and economic support for the process of perestroika and market reform will be completed;
- settlements with CEMA countries will be at world prices and in freely convertible currencies as of January 1, 1991;
- the economic assistance provided by the USSR to foreign countries will be reduced and shifted to a commercial basis.

It is anticipated that the Supreme Soviet of the USSR will set a ceiling each year on the foreign debt of the USSR and adopt a budget to consistent with it.

The implementation of a package of emergency measures to prevent a decline in all production and curtail [Translator's note: a misprint for "maintain"?] the production of other export goods is vital to the stabilization of foreign economic relations. Considering the practical effectiveness of foreign trade, on the other hand, it is necessary to strengthen the incentives to export commodities and earn foreign exchange. The questions of mortgage law relating to

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enterprise assets and land must be resolved quickly, thus enabling enterprises to receive secured credits from foreign banks for the expansion of exports.

5. Measures to Establish a Market Economy

Support for entrepreneurship, de-governmentalization, privatization, and development of competition. It will be possible to convert to a market economy and expect the self-regulating mechanism of the market to operate effectively only when most producers of goods—enterprises, organizations, and citizens—enjoy freedom of economic and entrepreneurial activity. They must be free to use property belonging to them, leased to them, or transferred to them for their use, do their production planning independently, choose their suppliers and clients, set their prices, dispose of their post-tax profits, and decide other matters relating to their economic activity and the progress of their production.

This will make it possible not only to create the conditions needed for the market mechanism to function, but also to mobilize the potential of human involvement—one of the main resources which in our conditions can have a relatively rapid effect, based on people's desire to achieve proper living conditions through their labor and skills.

Freedom of economic activity and the development of entrepreneurial activity are to be proclaimed in the near future, with a view to enabling different organizations and citizens to conduct economic activities freely, permitting the establishment of enterprises upon their application-based registration, and forbidding agencies of the state to interfere in the work of the enterprises, regardless of their form of ownership and management.

These positions are to be adopted by decree of the President of the USSR, which will also contain positions supporting freedom of choice among forms of ownership and management and equality among all of them in their operations and in their access to material, financial, informational, and other resources on a competitive, paying basis. The republics give concrete form to these positions in light of their individual circumstances and, jointly with local authorities, implement measures to support and expand economic initiative and entrepreneurial activity.

The Union and the republics will at the same time adopt lists of types of activity that are forbidden, are deemed monopolies of the state, or are permitted only with a state license.

If free producers of goods are to emerge as a crucial element in the market economy, most enterprises must quickly be removed from state guardianship and privatization must be implemented. Privatization is understood to mean not only transition to private ownership, but a more general process of changing ownership by transferring or selling state property on various terms to groups of workers, cooperatives, stockholders, foreign firms, or private individuals. These management categories meet the requirements of a market economy most fully. They are not only independent in their activity, but economically responsible for its results, as regards both operating revenue and net worth. This fosters the rational use of resources and restrains their unjustified application to consumption rather than to the improvement of productive potential.

De-governmentalization together with transfer of ownership can be brought about in various ways, depending upon the conditions in the republic or region, the characteristics of the sector or branch of production, the size of the enterprise, the state of its resources, and other factors.

De-governmentalization programs will flow from Union and republic decisions in the form of decrees of the President of the USSR and of the supreme governmental authorities in the union republics. These documents will specify the goals, principles, and basic directions of de-governmentalization. They lay emphasis on the principle of equality of all forms of property laid down in the USSR law "On Ownership in the USSR." The right to private property is recognized. Guarantees are provided for the right of juridical persons and individuals, including foreigners, to own property.

At the Union level, all concrete work of de-governmentalization is the responsibility of the USSR State Property Fund. Similar agencies are established in the republics.

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The first de-governmentalization and privatization efforts are made in those fields in which it is most desirable to have nonstate entities. These include commerce, the restaurant trade, everyday services, repair and construction organizations, and small enterprises in other sectors. At the same time, the process of transforming large and medium-sized enterprises in various industrial and other sectors into stock companies will begin this year.

To prevent abuses, including the legalization of wealth obtained illegally, state organs and the public will strictly monitor the de-governmentalization process. Priority in the purchase of property and stockshares is to be given to worker groups and their members, and they are to be given assistance in various forms, particularly through use of the enterprises' funds, installment sales, offering of a discount, granting loans, etc.

Broad use should be made of competitions and auctions, always conducted openly. To protect the market value of the property being sold, this process will be carried out in stages, in light of supply and demand.

At the present time, the balance-sheet value of the country's main funds (excluding the value of land, underground resources, forests, and the personal property of citizens) totals some 3 trillion rubles, or about 2 trillion rubles if depreciation is taken into account. The working capital of enterprises and organizations amounts to 800 billion rubles. About 90 percent of the property is in the hands of the state.

Therefore, the de-governmentalization process can last a very long time. Various ways to accelerate it, in consideration of the interests of all citizens, will be sought and tested.

Special measures will be taken to de-monopolize the economy and strengthen competition. They will seek to prevent, limit, and halt the use by transactors of their dominant market position and to prevent unfair competition. This work will be the responsibility of a specially created Anti-Monopoly Committee. The union republics will establish similar anti-monopoly agencies.

At the same time as state ownership is being converted into other forms of ownership, the job of creating large numbers of small enterprise is being done.

Land reform and distinctive features of the formation of market relationships in the agro-industrial complex. The main lines of action needed to bring about a market economy in the agricultural domain are as follows:

- implementing land reform and creating conditions for the effective functioning of various forms of ownership and management, eliminating the monopoly on land ownership, and establishing a varied economy in the agricultural sector;
- eliminating administrative patterns of state control of agricultural production and halting the administrative setting of compulsory orders for agricultural commodities;
- boosting the practice of farm labor, strengthening the motivation of farmers, and encouraging in all possible ways both the initiative of commodity producers and healthy competition among them;
- designing and implementing specific programs for the development of villages' productive and social infrastructure with the financial support of the state;
- conducting social policies that meet the needs and requirements of villagers and creating socio-economic guarantees of a just status for farmers in the society. The union and autonomous republics adopt land codes and other legislative acts of direct effect that regulate land relationships with reference to the particular circumstances of the different regions of the country and that establish the terms for granting land to all those wishing and able to exploit it effectively for agricultural production. Republic authorities decide how to give effect to the worker's right of free departure from state, cooperative, or other types of enterprises (associations) with a parcel of land and share of the accumulated assets, provided he will engage in independent agricultural production.

The highest governmental authorities in the republics establish committees on land reform to inventory and evaluate the land, identify inefficiently used land, and carry out land organizing, consultative, and monitoring functions.

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Efforts are made to transform inefficient collective and state farms by granting their land in full or in part to cooperatives, lessees, peasant farms, or industrial or other enterprises for industrial farming, for use as personal plots, or for collective gardening or vegetable farming.

The executive agencies of the Union and of the union and autonomous republics and the executive committees of the Councils of People's Deputies implement packages of economic and organizational measures to stabilize the country's food supplies and to improve the management systems of the agro-industrial complex. To this end:

- by agreement with the union republics, new state procurement prices are set for the major agricultural commodities bought chiefly by the state. The conditions will be created for transition to free contract prices for the sale of other agricultural commodities. A mechanism is established for possible adjustments of procurement prices in order to maintain the required equivalency between agriculture and other sectors. Special funds are set up for the targeted financing of social and production improvements on farms operating in difficult natural and climatic conditions;
- the production relations of enterprises and organizations in the agro-industrial complex with enterprises in other sectors of the economy are maintained. Limits on the major material and technical resources centrally allocated to agriculture and the processing industry for specific uses are set for 1991;
- incentive measures for enterprises that conclude contracts for delivery of agricultural commodities to the state are implemented;
- sufficient capital investment funds and material resources are made available for the technical renewal of enterprises in the flour-milling, meat, dairy, and other processing sectors and for development of a storage system for grain, fruits, vegetables, and potatoes, preferably in the areas where they were grown;
- assistance is provided to citizens in the conduct of their private farm plots by offering them additional land, selling seed, planting material, young cattle and poultry, and animal feed to them, and by freely purchasing the industrial commodities they raise;
- for moderate payment, land for gardening or vegetable-raising is distributed to all city dwellers and village workers who so desire.

Since the union and autonomous republics, pursuant to the laws of the USSR, enjoy full power within their territories and are directly responsible for the condition and supplying of the consumer market, a fundamentally new procedure to be followed for the procurement of the state's food resources is being established for 1991.

The republic and local governmental authorities, on an economic basis, obtain food commodities to supply the populations of the territories under their control and to meet the delivery requirements of the all-Union level.

An all-Union fund is created to supply food for the army and other special consumers, for export under intergovernmental agreements, and for the establishment and replenishment of state reserve stocks.

Inter-republic shipments of food and agricultural raw material are effected under agreements between the union republics.

From the beginning of 1991, the republics, krays, and oblasts seek actively to promote forms of management that are effective under market conditions--agro-industrial combines, agro-firms, cooperatives, stock and leased enterprises, and peasant (farmer) farms. On collective and state farms, a far-reaching process of leasing is used to bring about new organizational structures with a high level of independent primary labor collectives. The cooperative nature of the collective farms is fully restored.

The republics carry out programs in support of industrial peasant (farmer) farms and other new forms of management in rural areas and provide them with economic and legal conditions of operation equal to those of other agro-industrial entities. Special attention is paid to their establishment in labor-short regions.

Measures are taken in the union and autonomous republics, krays, and oblasts to de-monopolize the purchase and

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located in the very areas where the commodities are produced. Processing enterprises will operate increasingly as free producers of goods, buying inputs and selling their products on market conditions. The governmental authorities will encourage in every way the establishment of cooperative wholesale intermediary firms and services, purchase and marketing associations, and trade-purchase cooperatives. Large processing enterprises will successively be converted to stock companies.

In market economy conditions, the role of consumer cooperatives will grow markedly as a socio-economic system in which market relationships are inherent. Limitations on the growth of consumer cooperatives in the cities, where they can become competitors of state and other traders, are to be removed.

As a component part of the overall employment program, purposeful measures are taken to foster the movement of families to regions where agriculture is suffering from a labor shortage. Settlers will be given material benefits for the move and for starting farming. Families establishing peasant farms will be exempted from taxes and from payment for the land for two to three years following the start of their work.

Policy in the area of price formation. Free market prices are an integral element of a market economy. To make the shift to such prices less painful, especially in connection with the prices for consumer goods and services, it is proposed that they be freed from administrative control in stages. In the first stage, the prices of a group of nonessential goods will be freed.

At the same time, to provide social protection for the people, state prices are to be retained for the goods and services making up the minimum subsistence basket of households (the choice of food items and manufactured goods for these purposes will be determined). Local price rises will also be permitted for certain goods if the republics so decide on the basis of local conditions. Republic and local agencies provide compensation, insofar as their resources allow, to protect people's incomes, place orders for additional production of such goods, and if necessary ration their distribution.

Subsequently, controls on retail prices are removed for successive groups of goods in light of concrete conditions and the market situation. In 1992, it is expected that prices will be controlled for only a small group of essential consumer goods (certain types of bread and bakery products, meat and dairy products, vegetable oil, sugar, basic medicines, school textbooks, certain children's goods, some transportation charges, and fees for certain local services).

The removal of price controls must be accompanied by tight financial and credit policies, accelerated de-governantalization and de-monopolization of the economy, and the development of competition, enterprise, and a market infrastructure.

If prices that have been decontrolled should rise excessively, republic and local agencies may decide to set temporary limits on them.

In the transition period, the state cannot immediately abandon its policy of supporting low retail prices on certain goods and, hence, of subsidizing prices. But the method of paying out the price subsidies on goods must be fundamentally changed, so that it becomes advantageous to produce and sell those goods and, thus, low-priced goods do not immediately find themselves in short supply.

Pursuant to the October 4, 1990 Decree of the President of the USSR "On Immediate Measures of Transition to Market Conditions," it is intended that the economy make broad use of contractual wholesale pricing. In the case of contracts for 1991, such prices are based on the wholesale prices drawn up pursuant to Decree No. 741 of June 14, 1988 of the Council of Ministers of the USSR, that is, the prices contained in the price lists given to enterprises.

In this way, the groundwork is laid for accelerating the conclusion of contracts and the arranging of economic links for next year. To limit price rises, it is proposed that a ceiling be set on profitability, with the understanding that profits exceeding that level will be seized from the enterprise and be credited in equal shares to the union and

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republic budgets. It is also expected that fixed wholesale prices will be applied to various raw materials, building materials, and other products for industrial and technical use.

In the present conditions of large-scale financial and monetary disequilibria, a shift to contractual wholesale pricing could cause excessive inflation, an intentional boosting of expenses (so as to contribute less to the budget out of profits), and a lack of interest in increasing production because profitability is low.

To prevent these negative trends:

- steps to rehabilitate the financial and credit system are to be accelerated in an effort to reduce sharply the money supply of enterprises and organizations. With severe financial constraints on consumers and with suppliers having trouble selling their products, the level of contractual prices would be significantly lower and the rise of inflation could be successfully curtailed;
- more valid state prices should be set as soon as possible on fuel and energy products, on the main types of raw and building materials, and on other production for industrial and technical use for which fixed pricing is to be retained.

The prices of fuel, energy, and raw material resources and of certain mass-produced items that are traded between republics are to be determined on the basis of multilateral agreements among the republics, taking into account the proposals of Union agencies, so that they can be sent to the enterprises as soon as possible. It is advisable to raise the prices of fuel, energy, and other resources gradually, thus preventing sudden rises in production expenditures and in expenditures in other areas and giving time for the implementation of resource-economizing measures;

- special methods of state control will be applied when enterprises set contractual prices above the list prices.

The formation of market prices should increasingly take place through commodity exchanges and trade fairs. The development of these components of a market infrastructure should be speeded up through use of tax and other advantages to encourage agreements on transactions on the exchanges and at the fairs.

Reform of the Banking System. A strong ruble is the key to any acceleration of the economic reforms. If the ruble is to become strong, there must be a single monetary system, and monetary and credit policy must remain centralized. This requires a prompt conversion of the USSR Gosbank system into a Union Reserve System. The Union Reserve System consists of a Board of Governors [Soviet upravlyayushikh], headed by a chairman appointed by the President of the USSR, and of the USSR Gosbank and the central banks belonging to the system. The Union Reserve System is a single legal person, that is, the monopoly on monetary issue and the uniformity of bank supervision principles are preserved.

The country needs a banking system of this sort because of the need for a centralized monetary and credit policy in a context of sovereignty of the republics and of a revitalized federated union based on them.

Under this approach, the republics adopt their own banking legislation, not conflicting with the agreement on the Union Reserve System. To participate in the system is to renounce any unilateral regulation or limitation of monetary circulation and credit. In the republics, the central banks are no longer subordinate to the governments; they report annually to the Supreme Soviets, which do not interfere in their current activities.

A key element in the credit reform is the commercialization of the specialized state banks. They become independent stock companies, with the broadest possible distribution of shares.

Commercialization assumes that the banks will operate within the limits of their own and attracted resources, will independently decide the purposes for which they will lend, at what interest rate and for what term, will be subject to the same taxes and regulations as all other banks, and will choose their own clientele.

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Monetary and credit policy assume fundamentally new characteristics in the context of transition to the market. To rehabilitate monetary circulation and credit, regulation of the total money supply will replace credit and cash planning. The key task in the first months will be to curtail credit sharply and limit the growth of the money supply.

In the initial stage, the basic component of the system for regulating money and credit will be the removal of a portion of the banks' funds and their deposit in the central bank. By modifying the reserve requirements, the Reserve System can regulate the credit resources of the commercial banks and, hence, influence both the supply of money in circulation and inflation.

Interest rate policy will be no less important. A new interest rate structure (long-term higher than short-term, loan rates higher than deposit rates) will be introduced administratively for the first 3-6 months, with a marked rise in the average rate level so as to curb credit demand and reduce noncash monetary issue.

A system of refinancing will take effect. The money removed from the banks in various ways will be lent back to them at interest rates set at levels that support monetary and credit policy; as a result, the banks are compelled to link their rates to the central bank's rate, which must be the base for all members of the Reserve System.

The ruble must be defined as the only legal tender on USSR territory. The issuance of other monetary symbols and surrogates and the circulation of foreign currencies as means of payment are prohibited in order to stabilize the purchasing power of the ruble. The ever wider presence of foreign currency in domestic circulation devalues the ruble.

Reorganization of foreign economic activity. Transition to the market requires an open economy in the USSR, operating in interrelationship and competition with the world economy. The "Basic Directions" therefore assume the unity of the customs territory, foreign exchange system, basic investment regulations, and foreign economic policy, together with a growth in the powers of the union republics in these areas. For these purposes, an all-Union agency to administer foreign economic relations, with direct representation of the union republics on its board, is created.

In the context of transition to the market, the enterprise becomes the main actor in foreign economic activity. Foreign economic activity is to be de-governmentalized and decentralized, with commercial operations being left to the enterprises, their independence in business matters being assured, and state agencies focusing on regulating and encouraging these operations.

Oil, gas, gold, diamonds, precious stones, special technology, and perhaps a few other goods on a list agreed with the union republics, are deemed all-Union export resources and are transacted separately.

Governmental foreign economic organizations become intermediary firms, in some cases on a stock-holding basis, and if necessary are broken up and diversified.

To stimulate and rehabilitate foreign economic activity:

new customs and foreign exchange laws are passed as directly enforceable rules, and the new investment legislation begins to take shape;

the differentiated foreign currency coefficients are abolished;

effective January 1, 1991, foreign exchange proceeds are credited directly to the enterprises' accounts; a portion must be sold to the union and republic budgets, pursuant to rules which foster the industrialization of exports;

to enlarge the independence of enterprises with respect to foreign exchange, a domestic foreign exchange market, on which foreign currencies may be freely bought and sold at market prices, is created; republic and some commercial banks begin to engage in foreign exchange and credit operations; enterprises are permitted to borrow abroad independently, using their own assets as collateral;

systems to insure enterprises against foreign economic risks is in operation by March 1991, a union system of foreign economic information is introduced, and the state certifies business schools and consulting firms in order to raise the quality of personnel training and professional services.

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Foreign economic activities are regulated chiefly through legal and economic instruments (customs duties, taxes, etc.). The number of centrally licensed export goods is reduced to a minimum. A comprehensive system for verifying the observance of the foreign economic laws and the rules of competition is established, and the customs and control measures are strengthened.

Efforts are made to attract an inflow of foreign capital for specific purposes. The possible forms of investment are broadened (including full ownership of enterprises, concessions, and free enterprise zones), and investment priorities are set. Foreign investment gradually becomes the main channel for attracting foreign funds.

Through the stabilization of domestic finance, new prices, and the ruble's exchange rate, and through achievement of domestic convertibility of the ruble on the domestic wholesale and foreign exchange markets, the ruble achieves convertibility with foreign currencies in stages. Beginning with foreign capital transactions, it later is extended to all current operations of the country's foreign exchange balance.

Measures to eliminate the shadow economy. The shift to the market is the most effective way to crowd out the shadow economy.

The chief measures for liquidating the shadow economy coincide with the chief directions of the reform. As the world's experience shows, over 90 percent of shadow economy volume can be eliminated rather quickly through measures to establish a market.

It is also proposed that steps be taken at the republic and all-Union levels:

- to set up a strong tax inspectorate;
- to provide legal and practical protection for the ownership of means of production by individuals and groups and for their income from those means of production;
- to overcome monopolism in the economy, chiefly by setting higher tax rates, controlling the prices charged by monopolies, and other methods specified in the anti-monopoly legislation;
- to introduce gradually the practice of having citizens file income returns each year with the tax inspectorate;
- to reduce as much as possible the use of special distribution systems (coupons, orders, clearance sales, etc.) and to keep any such systems completely open and under close control when they have to be used (for nursing infants or certain categories of ill people);
- to adopt new criminal, criminal process, civil, civil process, and administrative legislation, raising the level of criminal liability for the most dangerous forms of economic crimes.

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E. Social Policy in Conditions of Conversion to the Market

The socially oriented market economy which the "Basic Directions" are intended to create is an economic system in which every group and social segment of the population receives considerable opportunity to realize its abilities and aspirations through free labor and rising income.

For all those employed in the economy, the opportunity to choose freely where and through what forms of property or management to apply their knowledge and experience will become a major factor in raising the social tone.

The opportunity is emerging in the new economic system for those who so desire to start their own business--set up a cooperative, own a store, restaurant, or private taxi, or establish a small enterprise or other form of business.

The freedom to choose the form of work they prefer will be an important factor in improving the living conditions of peasants as well. They can choose between a large farm (a collective or state farm), a small leased group farm, or an individual farm. It becomes possible for peasants to raise their personal income rapidly, and their interest in doing so will be strengthened by the ever fully return flow of goods from the city.

The market economy will offer intellectuals considerable opportunity to apply their knowledge and skills. The strengthening of intellectual property rights will create conditions and incentives for the blossoming of true talent and originality. The freedom to choose how to organize the work needed by society and to establish a variety of unions and associations will expand.

A major aspect of the new social policy is the movement toward raising personal income from labor and strengthening the role of that income in satisfying the people's social and cultural needs and needs for everyday services, thus helping to eliminate the dependency syndrome. Social consumption funds will be used to guarantee what is deemed the minimum acceptable level of social benefits to all segments of the population. A higher level of consumption will usually be provided on a nonpaying basis to citizens who are still or now unable to work--children, the disabled, and pensioners. All people able to work should raise their living standards mainly by means of their own labor and personal income.

The term real income of the population takes on a fundamentally new meaning. The main acquisition of all segments of the population from the transition to the market is a full supply of various goods and services, the chance of any consumer to choose freely among them, and, hence, the opportunity to meet his needs as fully as possible (within the limits of his monetary means).

In addition, the range of goods and services that can be freely acquired with that income will expand significantly. The acquisition of quality housing, not only as one's primary place of residence but in the country as well, expenditure on recreation, etc. will play a growing role in the people's spending patterns.

The rise in the efficiency of the economy entails a constant improvement in the social circumstances of citizens who have become disabled or who for objective reasons (e.g., having many children) live in straitened circumstances. As we know, pensions and other benefits will soon begin to rise, pursuant to decisions of the Supreme Soviet of the USSR.

As the transition to market relationships is made, some population groups will have to be assisted by special social programs. The first of these groups is made up of aged and disabled persons living alone and independently, orphaned children, and families with large numbers of children. The programs should enable them to meet their vital needs--for food, housing, and medical and other services. Special services should be set up at the regional level (local Soviets) to implement such programs with significant help from public and religious organizations.

In actuality, only two kinds of people can really lose from the shift to the market--those who are lazy or disorganized, whom the market will force to do better, and people engaged in the shadow economy, which is going to lose much of its economic base as the market takes shape.

In concrete terms, it is proposed that the following changes be made in the methods and instruments of social policy as conducted until now:

Reform of labor compensation. A major result of the new social policy will be a consistent growth in the cost of manpower. Wages will more and more fully reflect the real cost of producing a qualified labor force; this will make investments in education, training, and the cultural and social development of the individual as effective as possible. As the reform of labor compensation is implemented, state wage scales are intended to indicate minimum guaranteed wages for workers at given skill levels. Hence, they are compulsory throughout the Union and in all enterprises, regardless of type of ownership. Republics and enterprises may set other compensation rates, based on their own funds, if they so desire, but not below the wage scale rates.

In this way, the state wage scale system will be a factor in the social protection of workers and a powerful incentive to raise productivity.

The new wage scale system should cover both the industrial and the nonindustrial sectors of the economy, so that workers in culture, health, and education have the same labor compensation guarantees and do not fall behind industrial workers.

A new system for the hiring of enterprise managers under contract is introduced at the same time, with the state wage scale again applicable for setting the floor rate.

All other questions of labor compensation, such as the form and system of payment, bonuses, awards, and raises, are decided independently by the enterprises, without interference from state agencies. Individual wages are not limited, and they are regulated only by the income tax.

Dividends on stock in enterprises and other income from property constitute new sources of income. By acquiring stock, workers become owners of their plants, factories, state farms, and other enterprises, creating an additional incentive to work productively.

Enhancement of social support for those unable to work and for students. A Law on the Pensions of Citizens, to be implemented in 1990-1993, has been passed.

An important distinguishing feature of the new pension system is its link to the minimum consumer budget and to the changing conditions of the market economy. The measures that change the pension system will permit the average pension to rise about 1.5 times.

As the economy becomes more efficient, there will also be centralized increases in various allowances connected with childbirth and child raising and for the disabled. State funds will be used to raise student grants significantly.

The republics may view the centrally set pensions, allowances, and grants as minimum guarantees for the maintenance of the citizen categories concerned. They are entitled to raise the payments to a higher level if they can locate the necessary funds.

The system of pensions, allowances, and study grants can be supplemented by voluntarily introduced payments by enterprises to their former employees, women, and young people who wish to pursue their studies.

Minimum consumer budget and mechanism for social protection from inflation. As an important instrument of the new social policy, the minimum consumer budget indicator will be actively used. Families with an average per capita income below the subsistence minimum will be eligible for immediate help from local and state agencies.

At the same time, the main means of assistance in conditions of the market economy will be the creation of more favorable conditions for enlarging one's own labor income. For such families, the priority will be to allot land to them

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for use as their own auxiliary or peasant farms, to extend loans to them on preferential terms, etc. Only in special cases will they be given direct material assistance and support. The minimum consumer budget will consist of selected goods, services, and other benefits required by an individual to live; it must offer not simply a minimum subsistence, but a chance to grow and improve and some freedom of consumer choice.

It is not immediately possible to introduce such a minimum consumer budget at this time. The reason is not just a lack of funds. The country today lacks the conditions required to guarantee it without interrupting the consumer market is riddled with deficits, prices with different prices and many other "deficiencies" the system is still seriously underdeveloped, and housing is not freely built.

The minimum consumer basket will subsequently be revised in accordance with the economy's possibilities.

The minimum consumer budget adopted will serve as the starting point for similar calculations in the republics, which will adopt their own minimum consumer budgets in light of local conditions.

The transition to a market economy in our country is taking place in circumstances of a general consumer goods shortage, particularly with respect to state commerce at state prices. Six months to a year will be needed to normalize the consumer market by saturating it with goods. In some republics, regions and cities, to assure the guaranteed level of consumption of essential goods, it will be necessary in this period to resort to rationing, as determined by Soviet governmental authorities. In the interests of the people, the state will maintain relatively low fixed prices on essential goods during that time. At the same time, if price rises are not to worsen people's situation, a system for protecting their income from inflation will be required. This is to be done through various kinds of compensation, mainly the indexation of income to the index of retail prices for goods in the "consumer basket." This will be done openly.

For pensions, grants, and allowances, indexation will be at the rate of 100 percent. For workers with fixed salaries or wages (military personnel, teachers, doctors, scientific workers, white collar workers, etc.), it will be at a rate of up to 70 percent, taking account of the level of their pay. For self-financing enterprises, indexation will be done through the labor compensation fund.

The indexation system will be governed by laws of the USSR and the republics.

Employment policy. The increase in production efficiency, the liquidation of hopeless and low-earning enterprises, and the creation of new industries and branches will lead to a redistribution of manpower, chiefly into the services sector, in which new jobs will be created, and into cooperatives and the private sector. In this process some workers will temporarily find themselves outside the sphere of social production. The task is to keep their unemployment as short as possible.

A special state employment service will be established in the local soviets not only to look for vacancies but to help arrange new jobs and re-education and retraining, give vocational guidance, and provide material assistance for people temporarily without jobs. Local soviets will arrange paid public work for the temporarily unemployed. It is of fundamental importance that the employment service provide its services to people without charge.

Special employment programs will be implemented at the all-Union and republic levels, especially in labor surplus areas. An employment assistance fund will be established.

In addition to the currently existing system of material support for unemployed persons, a system of direct unemployment benefits is to be introduced for workers who for certain reasons cannot quickly be given jobs or retrained.

Housing reform. A labor market based on the free movement of manpower within the country and beyond in accordance with supply and demand cannot function properly if there is no housing market.

The principles and conditions for implementing a housing reform, now being worked out pursuant to a decree of the President of the USSR on this subject, will be issued for public discussion in the near future.

The social domain under market conditions. A crucial task in the transition to a market economy is support by the Union and the republics of the nonmarket sector of the economy, that is, of those branches and types of activity which in principle cannot be guided by commercial criteria. They include a large part of public health, education, culture and art, environmental protection, fundamental science, etc. The branches and types of activity composing the nonmarket sector play a vital role in the society: they create the scientific, social, and cultural potential for its future development and preserve the historical and moral traditions of the peoples inhabiting our country.

This is the only sector of the economy to which financial and other constraints are in principle not going to be extended, even in the period of economic stabilization.

In the area of public health, the principle to be followed consistently is that of universal availability of the necessary preventive and curative assistance, and a network of state medical establishments that will provide their services without charge is to be developed.

For other medical services, the policy should be to combine noncommercial institutions and commercial medical enterprises, which will provide higher quality services for pay, engage in all types of "medicine for the healthy," and serve those who need care rather than cure.

Medical insurance will be developed to pay for curative, prophylactic, and care services out of special insurance funds financed by budgetary allocations and by the contributions of enterprises and citizens.

In the area of science, the state assumes responsibility for financing fundamental research, as well as promising development projects (jointly with interested parties) that could revolutionize technology in important economic sectors.

The lion's share of applied research and development will be conducted on a commercial basis. A market for scientific and technical production will be formed; the research and development institutions will be reorganized by being broken up to eliminate the monopoly position of the head institutes and expand entrepreneurial activity and competition. The creation of small scientific and engineering firms will be encouraged through financial support for innovative and risk capital.

In the area of education, the state will finance a network of general and specialized secondary educational institutions and, to a considerable degree, vocational and technical training institutions, retraining of personnel, and higher educational institutions. Local authorities will be given the power to impose specific-purpose taxes on the people for educational purposes. Contributions of enterprises' resources for these purposes must also be encouraged.

Together with free state institutions, the network of commercial-type schools that offer especially high-quality education and vocational training for a fee will be expanded.

In the area of culture and art, the policy will be to support the preservation and revival of the cultural and historical heritage, esthetic education, the creative quest, and the development of amateur cultural activities.

The role of economic support by society and the state for socially significant kinds of cultural and artistic activity must be strengthened. The budget of this branch of endeavor will be the main indicator of the real attitude of society and legislators to the preservation of culture. In addition to budgetary financing, everything will be done to encourage spending for culture by nonbudgetary sources.

In the area of environmental protection and ecological security, our country faces especially difficult and urgent tasks. Restoring a fundamentally sound environment in the country will require a radical renewal of the production apparatus and necessitate that direct expenditure on ecological needs become one of the main burdens on the economy.

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A package of measures to boost the environmental reliability and safety of economic facilities must be developed and implemented without delay. The priority that must be given to this task results from the high probability of a growing accident rate due to the anticipated aging of facilities and production surges.

The local soviets will play a vital role under market conditions as they set environmental pollution quotas (at the lowest level actually achievable by existing enterprises), require payments for discharges within the quota, initially at a low level (taking into account the enterprises' ability to pay) but rising rapidly based on the level of actual damage when the deadline set for terminating environmentally intensive facilities has passed, and set fines for above-quota discharges at a level equal to all the earnings obtained by violating the quotas set.

To improve radically the use of the environment, a payment (tax) must be prepared and introduced on the use of environmental resources—land and nonrenewable natural resources—and the payments for water use and forest exploitation must be raised to an economically justifiable level. A legislatively earmarked share of the tax on use of nonrenewable natural resources is to be allocated to the local budgets.

7. Structural and Investment Policy in Conditions of Conversion to the market

The creation of a modern economic structure is a prerequisite to conversion to a market economy and to its successful functioning. The drama in the present situation is that the existing distortions are so deep that every effort to shift to an economy founded on market mechanisms is virtually doomed unless the market is reformed structurally at the same time.

The key directions of structural reform are:

- creating an advanced industrial consumer sector as a necessary basis for mobilizing the social reserves for economic growth;
- overcoming the structural and technological disequilibrium of the economy—a major reason why the economy continues to be so wasteful of resources.

Priority on development of the consumer sector of the economy. Structural investment policy should reduce inefficient construction while concentrating effort and resources in those fields where they yield the greatest return and contribute most to the social reorientation of the economy.

If commodity resources are to be released rapidly for the consumer market, it is crucial that the demands placed by enterprises and capital construction on material and monetary resources be sharply reduced. To this end:

- investment programs now under way that do not meet economic needs must be halted;
- many industrial construction projects that have been started should be halted to force a structural turnabout and normalization of the construction sector;
- construction projects which lack sufficient resources for their completion in the scheduled time period be halted;
- construction must be de-centralized, encouraging the splitting off of independent building organizations that focus on nonindustrial and housing construction.

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released should be sold. A portion of this capacity may immediately be put to use to produce goods and services for the population.

Moreover, limits on enterprises' use of their own funds will have to be imposed for some time. This can be done through special taxes on investments. At the same time, interest rates on loans for investment purposes should be raised to at least 15 percent (the efficiency norm). Also, raising interest rates on bank deposits and differentiating them in accordance with the term of the deposit would limit enterprises' demand for resources and boost the efficiency of investments.

The estimated overall effect of the above measures is that it will cut the budget deficit by 30-40 billion rubles. Some decline in the value of construction and machine-building output can also be expected, but that is a natural symptom of true structural change.

Savings of energy resources are vitally important. The task is to reduce losses and improve the depth of resource processing, thus stabilizing the volume of resource use for 5-10 years. The practice of expanding exports of energy raw materials must be stopped.

It can be anticipated that the policy of restraining the growth of the fuel and energy industries and of keeping domestic energy use almost stable will ultimately hold the annual growth of our country's capital investment in those industries to a moderate level.

The industrial infrastructure--transportation, communications, and the storage of material assets--must play a special role in structural investment policy. Not only could their present state become a bottleneck in the formation of the market, but it jeopardizes the functioning of the major branches of our economy. Investment in this field must have the same priority as the production of consumer goods.

Straightforward assessments of the possible reduction of investment resource use in ineffective areas by branch and complex, in light of the significant progressive changes in the technological structure of capital investment and of the anticipated effect of conversion in the defense industry and economic reform in construction, indicate a slight reduction in the volume of industrial capital investment in the economy to the level of the twelfth five-year plan. At the same time, capital investment for the implementation of social programs will grow.

Conversion of the military-industrial complex. The conversion program must be developed as a general economic program whose content is deeply intertwined with all elements of the strategy of structural change in the country's economy.

As a result of its implementation, new industries catering to meeting the economy's needs for civilian production (technological equipment for the agro-industrial complex, light industry and trade, medical technology, and construction of civilian airplanes and ships) will come into being.

Utilizing the powerful scientific and technical potential of scientific research institutes and design organizations, as well as the existing experimental base, the process of reorienting the defense branches of industry should yield modern, new industries that make it possible to carry out the task of strengthening the social orientation of the economy and fostering the scientific and technological progress of key industrial branches should emerge.

The exploitation of the scientific and technical potential of the defense branches of industry and the industrial application of fundamentally new techniques, resource-saving technologies, and promising new materials are major components of the integration of these branches' potential with the civil branches of Soviet and foreign industry.

This will make it possible to bring various types of high technology to world markets and supply the domestic market with especially complex, science-intensive consumer goods and civil production.

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Effective conversion will be possible if the barriers separating the defense complex from the rest of the economy are dismantled. This can be combined with the retention as Union property and highly centralized management of the enterprises most closely connected with the country's defense capabilities.

In connection with the curtailment of military procurement, the enterprises in the defense complex will experience difficulties in using and selling previously delivered goods and materials, in using and converting their production capacity, and in implementing the major investments this requires. These problems will have to be solved in conditions of tight financial and credit policies, with less reliance on the state budget and more on the creative search for sources of money and for markets, perhaps abroad. At the same time, the contribution that conversion will make to the rehabilitation of the economy should lie chiefly in promoting large-scale savings of resources in the civilian sector. (Translator's note: I am not sure I have understood these last two lines.)

State regulation of the structural reorganization of the economy. The driving force of the economic restructuring process must be the economic initiative of enterprises and the entrepreneurial activity of the population, which require effective legal and economic guarantees. Supported by the state regulatory process, this powerful force must be channeled chiefly to supplying the consumer market.

Targeted state programs, especially investment programs, both centralized and decentralized, must play a special role.

Centralized targeted state programs (such as in defense and space) should be based on rigorous program documents approved by the Supreme Soviet of the USSR (lists of titles, estimates, basic government orders, etc.). For decentralized programs (food, housing, environmental, health protection, etc.), the principles governing them (including the basic economic regulators and benefits, if they are under the jurisdiction of Union agencies) and the amounts to be allocated from the Union budget are approved at the all-Union level.

Initially, under conditions of the deficit, it will be necessary, simultaneously and on an agreed basis, to carry out the budgetary financing and material and technical supplying of state programs.

B. Reorganization of the Management System

The transition to market relationships and their effective functioning will be possible only if state power is strong and efficiently organized. This is clear from the experience of all countries that have managed to establish an advanced market economy and high living standard for their people.

In light of the deep crisis besetting the country and of the spread of destructive processes, the path to establishment of an authoritative, strong government lies in achieving public agreement and uniting all social forces that hold dear the fate of the country and its people.

We must move decisively toward new structures of state and economic management, directed at forming a market-type economy and fostering the effective interaction of union, republic, and local agencies. To this end, the designing and implementation of the economic reforms and of the programs of transition to market relationships must without delay be made a special function of state administration.

In this regard, maximum use must be made of the powers recently granted to the President of the USSR by the Supreme Soviet of the USSR. The role of the Council of the Federation, which must draw up and implement decisions agreed to among the republics through all-Union and republic agencies of government, should be enlarged. To this end, an Inter-republic Economic Committee, composed of plenipotentiary representatives of the republics along with specialists and scientists, is to be established under the Council of the Federation.

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The structure and functions of the executive power, both at the highest level and elsewhere, must be interpreted in light of the new tasks and expanded responsibilities of the President of the USSR and the Council of the Federation. The structure of the state's power and administration at the Union level will be decided through the conclusion of the Union Agreement. The government of the USSR should use its powers to carry out measures for stabilizing the economy and shifting to a market economy. Some renewal of the structure and composition of the government will be needed for this purpose. Above all, the republics must be represented in the executive agencies of the USSR to create an indissoluble link between the all-Union and republic governmental authorities.

A vertical chain of command should promptly be restored among the various executive organs, making the governments and executive committees of the soviets [councils] at the different levels responsible to both their own soviets of workers deputies and to superior executive agencies. Decisions made by superior agencies in matters of their competence are binding on lower agencies. A law to this effect, as we know, was recently adopted by the Supreme Soviet of the RSFSR. A similar law, amending earlier legislation of the USSR on local self-government, is being considered in the Supreme Soviet of the USSR.

Things must be done in such a way that the new structures consistently and irreversibly replace those organs that do not meet the requirements of a market economy. A dual job needs to be done--forming the structures of the market economy and using them to ease out gradually the agencies of the administrative system, yet not anticipating events or breaking existing links without considering the extent to which the prerequisites for doing so have come into being in the economy.

A number of all-Union and republic agencies will have to be created in the near future to carry out the new functions emerging from the shift to the market. A state contracting system must be developed--a complex of organizations that place orders for goods needed by the state, select contractors, and draw up and conclude contracts. Also needed are a State Property Fund of the USSR, a State Supervisory Inspectorate of Securities, a State Inspectorate of Prices and Standards, a Regional Development Investment Fund, an All-Union Foreign Exchange Fund, an Economic Stabilization Fund, a Fund to Promote Employment of the Population, an Anti-Monopoly Committee of the USSR, a USSR State Office of Insurance Supervision, a Pension Fund of the USSR, a Committee to Promote Small Enterprises and Entrepreneurial Activity, and similar organizations in the Union republics.

With the support of the state, programs must be pushed to establish stock and commodity exchanges, insurance, auditing, holding, and brokerage companies, commercial banks, trading houses, commercial middleman firms, commercial centers and companies, auction houses, fairs, etc.

In the crucial period while the country's economy is being stabilized and the market economy is coming into being, the role of the highest governmental organs of the USSR and of the republics as legislators of the new economic conditions will grow.

Bills have been introduced in the Supreme Soviet of the USSR to create systems of social guarantees, index monetary income, restructure the banking system and administer monetary circulation, and create a Customs Code. They are scheduled for consideration in the current and next sessions of the Supreme Soviet.

To implement the agreed guidelines for the functioning of the all-Union market, the Supreme Soviets of the union and autonomous republics and their governments must effect a comprehensive series of measures, in particular the following:

- de-governmentalizing and privatizing republic and local property;
- expanding and supporting entrepreneurial activity;
- de-monopolizing the economy and reorganizing the existing structures;
- creating organizational and economic conditions conducive to the development of a market infrastructure;
- pursuing structural investment policies;
- liberalizing the system of price formation;
- regulating the income and social support of the population.

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The highest legislative bodies in the union and autonomous republics must also set up their own regional systems of subordinate administrative organs to coordinate the implementation of the program of transition to a market economy at the actual work site.

The republics also have the major job of identifying and appraising all state sector property. They must arrange auctions for the sale to citizens of such property, in particular unfinished construction projects, uninstalled equipment, building materials, means of transportation, and enterprises and organizations engaged in commerce, the restaurant business, or the provision of everyday services.

It is a special task of republic agencies to draw up the basic guidelines for land and housing reform and implement them and to put into practice the program for support of entrepreneurial activity, the agro-industrial complex, and the non-market sector of the economy.

Guided by the uniform principles for the functioning of the all-Union market, and in order to achieve the prompt, coordinated implementation of the financial rehabilitation measures, the Council of Ministers of the USSR and the governments of the union republics must shortly make the decisions called for by the program:

- tightening monetary, credit, financial, and foreign exchange policy, mainly to curtail the budget deficit, stabilize monetary circulation, and strengthen the ruble;
- setting forth the principles underlying state regulation of prices for the main goods and services;
- requiring strict observance of the uniform customs rules and forbidding the use of quotas and other limitations on the free sale of goods within the country;
- establishing uniform methodological bases for accounting and record-keeping.

Measures to rehabilitate the economy and shift to the market and the timetable for carrying them out are directly linked to the political stability of the society and the proper functioning of the organs of government and administration. The actual state of affairs calls for prompt changes in the mechanisms for making and implementing decisions and in the forms and methods of operation at all levels of the legislative and executive structure, and for a heightening of the personal responsibility of officeholders involved in the implementation of these program measures.

EUROPE

May the best team win

IN A dacha outside Moscow a team of eight economists has been eating, sleeping and working six days a week on a new reform strategy for the Soviet Union. Most mornings, the team has travelled to report to Mr Nikolai Ryzhkov, the Soviet prime minister. The result is to be a modified version of the programme Mr Ryzhkov failed to get approved by parliament earlier this year. If Mr Boris Yeltsin, the president of the Russian republic, has his way, all this work will be for nothing.

Mr Yeltsin has his own, bolder reform plan. Enter a second team of economists, this one headed by Mr Stanislav Shatalin, a father figure among Soviet reformers. Mr Shatalin has a weak body (one lung missing, a recent heart attack) but an energetic mind which darts nimbly between his twin passions: economics and soccer. He also plays a skilful midfield role between the two star players in Soviet politics, Mr Yeltsin and President Mikhail Gorbachev. He has the respect of both. Mr Gorbachev has appointed him to his 16-member Presidential Council; Mr Yeltsin was happy to have him head the team that is revising his pro-

gramme for Russia's "500-day" rush to a market economy and adapting it for the entire Soviet Union. This week the Shatalin team's programme was presented to the Russian republic's parliament.

Which team will Mr Gorbachev support? He has spent the past week trying to find a way of backing both—first meeting Mr Yeltsin and apparently veering towards him, then talking of the desirability of combining the best elements of both teams' work. But the time for such compromises is running out. Mr Yeltsin declares the two approaches to reform to be incompatible, and calls again for the resignation of Mr Ryzhkov's union government. He has started the countdown for conflict: if Mr Gorbachev does not accept the Shatalin programme, he says, the Russian republic will press ahead with it regardless, starting on October 1st.

It might not be the only republic to do so. Presenting the Shatalin programme to Russia's parliament on August 3rd, Mr Ivan Silaev, the Russian republic's premier, stressed that other independent-minded republics had helped the team's work (unlike

central bodies such as the defence ministry, Gosplan and the foreign-trade bank, which had refused to co-operate). The idea is that a Soviet-wide market should be created by an "economic alliance of sovereign states". The republics, rather than the central Soviet authorities, would be the leading actors. This shift in emphasis would be institutionalised right from the start of the 500-day programme, which would look roughly like this:

Days 1-100. An "inter-republican economic committee", reporting to President Gorbachev, would be set up to co-ordinate reform. It would stand above the myriad Moscow ministries, most of which would be phased out of existence. The sale of state property would begin. Farmers would have the right to leave their collective farms with an

allotment of land and assets. There would be big spending cuts: foreign aid would be reduced by 76%, the defence ministry's budget by 10%, the hitherto untouchable KGB's by 20%. A two-tier banking system would be introduced: a federal reserve made up of the republics' central banks, and commercial banks formed from specialised state banks. During 1991 many prices, though not those of basic commodities, would be freed. There would be a single exchange rate for the rouble, which would be the only legal tender in the Soviet Union.

Days 100-250. Price liberalisation and spending cuts should be bringing some balance to the market. Wage indexation would begin from mid-1991. The number of joint-stock companies formed out of large state enterprises would grow to 1,000-1,500. About half of all small shops and cafes would be privatised.

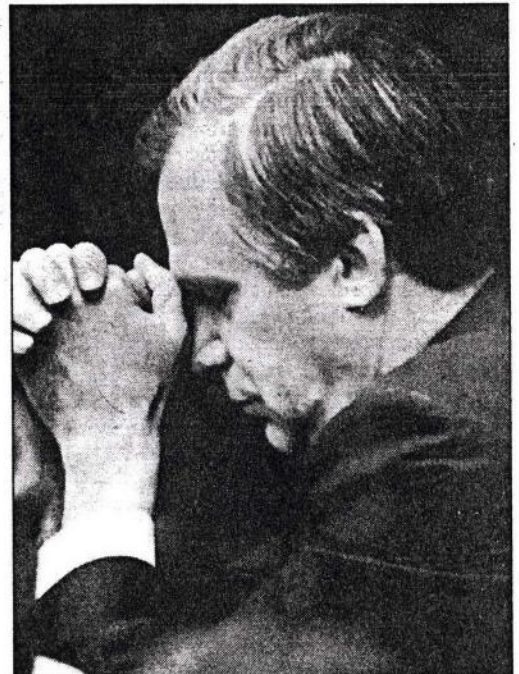
Days 250-400. Towards the end of this period about 40% of manufacturing industry, half of the building industry and 60% of trade should have been turned into joint-stock companies, sold off or leased. A currency market would be set up with a view to making the rouble convertible.

Days 400-500. The economy should be picking up. By the end of the 500 days, 70% of industrial enterprises, up to 90% of the building industry and retail trade should no longer be in state hands.

This schedule is staggeringly ambitious—which is one of the three main ways



Russia's Yeltsin is in a hurry



Ryzhkov's Soviet speed is slower

in which the Shatalin programme differs from Mr Ryzhkov's. The Ryzhkov version begins with macroeconomic stabilisation, partly through price rises, and would put off the removal of many central controls until 1992. The revised Ryzhkov plan, it seems, fully accepts the reintroduction of private property, but lacks the uninhibited push towards market economics of the Shatalin programme. That is the second main difference between the two.

Mr Gorbachev might fancy his chances of reconciling the two programmes were it not for the third and trickiest difference. This concerns the relationship between the centre and the republics. Under the Shatalin plan, the republics would delegate—probably rather limited—economic authority to the centre; Mr Ryzhkov envisages keeping more power with the central agencies. Much as he might like to side with his prime minister in this, Mr Gorbachev may in the end have to give way. In the tug-of-war between the centre and the republics over control of prices, taxes, the rouble and "strategic" resources such as oil, Mr Yeltsin can probably tug hardest. His strength comes from his personal popularity and the sheer size of the republic in which he is

threatening to apply the Shatalin programme regardless.

Unless Mr Gorbachev can reach a quick agreement with Mr Yeltsin, the Soviet economy is set to explore new depths of confusion from next month. If the Russian republic and the central government are issuing conflicting laws, whose rules will factories obey? Who will control sales of Russia's oil, or its gold or diamonds? Foreign bankers and businessmen are liable to find their dealings with Moscow horrendously complicated by the legal limbo.

Even if the two men do manage to settle for a common programme, the outlook for Soviet consumers this winter is bleak. The latest addition to the list of shortages is bread, that trusty staple of the Soviet diet. Nobody quite knows why bread is suddenly hard to get; the blame is variously put on bad distribution, panic buying and farmers' failure to deliver enough grain—either because they are trying to get better prices or because they are using it as animal feed, which is also in short supply. Whatever the reasons, it is a measure of what is wrong with the Soviet economy that the bread shortage is happening just as the country is experiencing a bumper harvest.

for the Soviet embassy in East Berlin.

Meanwhile the morale of the Russians in East Germany is sagging badly. Reports abound of growing alcoholism and petty crime among the lower ranks, unrest among officers. Small wonder, for nowhere else in the ex-Soviet empire is the evidence of ideological and economic defeat so blatant.

The Soviet forces will soon find themselves "guests" on territory which, as Mr Gorbachev agreed in July, is to become part of NATO, hitherto the arch-enemy. That thought is hard for military minds to get used to. And the Russians now see western goods pouring into East Germany, where even before the communists were booted out the living standards were higher than those in the Soviet Union.

Officers can afford some of the new goodies too, thanks to monthly pay of around DM1,000 (\$630) which they collect in hard D-marks since German monetary union in July. Housing is decrepit and cramped, but at least they have roofs over their heads. In the Soviet Union, because of competition for accommodation from other army divisions trekking home from Eastern Europe, they cannot even be sure of getting that. Hence a recent sit-down strike near Magdeburg by officers and wives who got wind of a scheme to send them to live in tents in the Caucasus this winter. Wives were stopped from sending an appeal to Mr Gorbachev from a military post office, but got it away all the same from a local East German one.

Some Russians have bolted across the (almost non-existent) border to seek political asylum in West Germany. So far only a few such cases have been reported, but Soviet and West German officials fear the numbers could jump after the Germanies merge on October 3rd. Neither side wants that embarrassment, nor still greater friction between civilians and soldiers. Such things could unsettle the atmosphere for the planned German-Soviet efforts to intensify economic ties.

Could the Soviet pullout be squeezed into, say, two years instead of four? West Germans reckon that would make the logistics of getting people and equipment out a problem, but hardly an insuperable one. They also agreed in talks with the Russians in Bonn on September 5th to arrange a rapid building programme for the returning forces and their families, and to retrain Soviet soldiers for civilian jobs. But there is no full accord yet on who should pay what. The West Germans, via the East German exchequer, are already paying DM1.25 billion to cover the

Soviet troops in Germany

Bringing the boys home

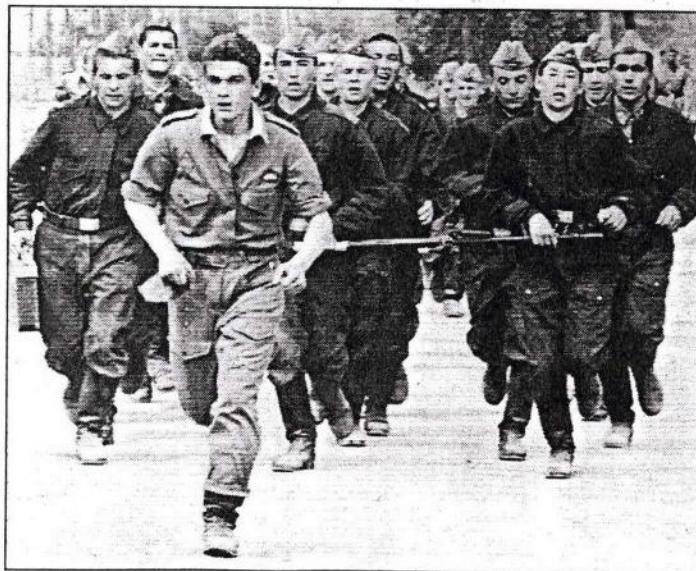
FROM OUR BONN CORRESPONDENT

A LOT of them will not like it, but Soviet soldiers in East Germany may be on trains home to an uncertain future sooner than they think. Officially, President Mikhail Gorbachev and the West German chancellor, Mr Helmut Kohl, have agreed that the Russians will be out within four years. That is pretty quick, considering that the Soviet army has been on German soil for 45 years and there are more than 500,000 people (around 350,000 military men plus dependants) to shunt back east. But probably not quick enough. Worried officials on both sides fear there will be big trouble if the Russians are not gone soon.

Already some East Germans are using their newly-won freedom to let off steam against their erstwhile "protectors". They have daubed barracks' walls with *Russen Raus* (Russians Out), barred Russians from local shops, even in some cases roughed them up.

Some gratitude, Russians moan, for the Gorbachev policy which made bloodless revolution in East Germany possi-

ble. But the locals have suffered for years from the nastiness of occupation: requisition without compensation, low-level flights, late-night manoeuvres, wild shooting practice causing even distant civilians to scurry for cover. Now at last the aggrieved can make their voice heard, even—unthinkable a year ago—in open demonstrations be-



Double time, out of step, going home

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

AK
SS/om

INTERNATIONAL BANKING CORPORATION
WASHINGTON, D.C. 20541

CORRESPONDENCE DATE : 90/08/10 DUE DATE : 00/00/00
LOG NUMBER : 900813017 FROM : Michel Camdessus
SUBJECT : Enclosing a copy of his letter to the Prime Minister re contacts
with territorial subdivisions of the U.S.S.R.
OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

- APPROVED
- PLEASE HANDLE
- FOR YOUR INFORMATION
- FOR YOUR REVIEW AND RECOMMENDATION
- FOR THE FILES
- PLEASE DISCUSS WITH _____
- PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- AS WE DISCUSSED
- RETURN TO _____

COMMENTS :cc: Messrs. Qureshi, Stern, *Fischer, Holser*



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

August 10, 1990

Dear Barber,

I am sending you, for your information, a copy of a letter I sent to the Chairman of the Council of Ministers of the U.S.S.R. regarding contacts with territorial subdivisions of the U.S.S.R.

With best regards,

Sincerely,

Michel Camdessus

Attachment

Mr. Barber Conable
President
The World Bank
Washington, D.C. 20433



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

August 9, 1990

Dear Mr. Prime Minister,

I should like to inform you that I have received several requests for informal meetings from officials of Republics of the U.S.S.R. These requests are generally to discuss the economic situation in the Republic and possible reform projects.

I have replied in all cases that, as an intergovernmental organization, our contacts, even informal, take place with the national authorities of a country; in the present case, this would be the Government of the U.S.S.R. Contacts with other authorities within the country would need to be established at the initiative of, or through the national authorities of that country. In the context of the study of the economy of the U.S.S.R. which we are conducting, we would be interested in such contacts and the possibility they offer to increase our knowledge and understanding of the Soviet economy, but I leave it to your discretion whether such contacts should take place.

I am sending a copy of the letter to Mr. Sitaryan and I am advising the World Bank, the EC, the OECD, and the President-Designate of the EBRD of our position on this matter.

Sincerely yours,

Michel Camdessus

cc: Mr. Sitaryan

Mr. Nikolai I. Ryzkov
Chairman of the Council of Ministers
of the U.S.S.R.
Moscow, U.S.S.R.

8 August 1990

Mr. Henning Christophersen
Vice President of the
Commission of the European Communities
Rue de la Loi 200
B-1049 Brussels, Belgium

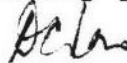
Dear Mr. Christophersen:

Thank you for your letter of July 17 to Mr. Conable regarding cooperation between the Commission and the Bank in connection with the studies of the Soviet economy.

As you may know, Messrs. Attali, Camdessus, Paye and Mr. Conable met with Mr. Lamy in New York on July 21. Mr. Lamy brought them up to date on the status of the Commission's work and they agreed that they would fully share information in the future.

I understand that the Commission's mission will complete its work in Moscow in early September, so the meeting now scheduled to take place in Washington in mid-September should be a good opportunity for us to be brought up to date on the Commission's work. We agree that the Annual Meetings also offer a good opportunity for further discussions, since Messrs. Attali and Paye will be in Washington as well as, of course, Messrs. Camdessus and Conable.

Sincerely yours,



D. C. Rao
Acting Vice President,
Development Economics

cc: Mr. M. Qureshi, OPNSV
Mr. E. Stern, FINSV
Mr. S. Fischer, DECVP
Mr. J. Holsen, PADSS
Mr. A. Khanna, EXC
Ms. L. McLaughlin, EXC

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/08/10

DUE DATE : 90/08/28

LOG NUMBER : 900820013

FROM : Sylvia Jay

SUBJECT : Requesting clearance of Mr. Attali's reply to Mr. Christophersen
on the collaboration of the EC & 4 Institutions study on USSR

OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

- _____ APPROVED
- _____ PLEASE HANDLE
- _____ FOR YOUR INFORMATION
- ✓ _____ FOR YOUR REVIEW AND RECOMMENDATION TO EXC (A. Khanna)
- _____ FOR THE FILES
- _____ PLEASE DISCUSS WITH _____
- _____ PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- _____ AS WE DISCUSSED
- _____ RETURN TO _____

COMMENTS :cc: Messrs. Qureshi, Stern, Fischer, Holsen, Sandstrom o/r; Khanna



① Anupam:

② LM

A recommendation was expected from Mr. Thalwitz to you on the attached yesterday *8/28). Have you heard anything yet???

Pls. let me know the status and pls. return this copy to me.

We received OK yesterday and I talked to Linda who may just call Mrs. Jay today. So it is done. Anupam.

③ CP (8/29)
(FF)

10 August 1990

E.B.R.D.
28 Avenue Hoche 75008 Paris
Tel: 42 89 10 26
Fax: 42 89 34 83
42 89 35 22

To the Personal Secretary of Mr. Conable, President of the
World Bank

Mr. Christophersen, Vice-President of the Commission of the European Communities wrote to the President designate of the European Bank for Reconstruction and Development on 17 July (copy attached) about collaboration on the EC and the Four Institutions studies on the Soviet Union. At the end of his letter Mr. Christophersen says that he intends to write to Mr. Conable, Mr. Camdessus and Mr. Paye along the same lines.

Mr. Attali would like to reply positively in the draft attached but he would like to be sure that his three colleagues in the study have no objections before he does.

Would you be kind enough to let me know as soon as possible whether Mr. Conable has any objections to the draft reply?

Many thanks

Sylvia Jay

Mrs. Sylvia Jay
Directeur Adjoint
of the Cabinet of
the President Designate

Secretary of Mr. Conable
1818 H. Street N.W.
Washington DC.
20433 USA

Jacques ATTALI

S. JAY

EBRD

28, Avenue Hoche

75008 PARIS

Tel. 42.89.10.26

Fax 42.89.35.22

3 August 1990

Thank you for your letter of 17 July with your helpful suggestions for collaboration on the two studies of the Soviet Union. These seem to me to be very sensible and I shall be glad to cooperate in the ways you suggest.

Jacques ATTALI

Mr. HENNING CHRISTOPHERSEN
Vice-President of the Commission
of the European Communities
Rue de la Loi
B1049 Brussels
Belgium

II/USSK



HENNING CHRISTOPHERSEN
VICE PRESIDENT OF THE COMMISSION
OF THE EUROPEAN COMMUNITIES

Brussels

17 July 1990

633

Dear Mr. Jacques Attali

The European Council at its meeting in Dublin on 25 and 26 June requested the Commission, in consultation as appropriate with the international financial institutions, to analyze the possibility and desirability of extending short-term credits and longer-term support for structural reform in the Soviet Union. These proposals will be based mainly on an economic report by the Commission services. Also, the Houston G-7 summit of 9-11 July has asked the IMF, the World Bank, the OECD and the EBRD to undertake a detailed study of the Soviet economy, in close consultation with the Commission.

It is clear that in dealing with the Soviet Union our approach will be different from the one used in our work on Eastern Europe. It rather needs to be along the lines of how the Soviet Union can be integrated into the world economy. The Soviet Union and the West would have to work closely together. In this way discussions on internal reforms in the Soviet Union and on how possible assistance can be provided most effectively could go hand in hand.

We would plan to use the same network for the purposes of our consultations as is already in place for Eastern Europe, linking the Commission with the EIB, the IMF, the OECD and the World Bank, to which will be added the EBRD.

We have drawn up provisional plans which include a mission to Moscow in late August and the preparation of our economic report by the end of September. In the work of our respective organisations on the USSR we should like to exchange information and data resources. We would also hope that the meeting of our network of correspondents scheduled to take place in Washington in mid-

Mr Jacques Attali
Président
BERD
28, avenue Hoche
Paris 8ème
FRANCE

September could be the occasion not only for our usual exchanges on Eastern Europe, but also for a discussion of the main issues concerning the Soviet Union. I would also suggest that we meet in the margin of the annual meetings of the IMF and the World Bank in Washington.

The economic analysis of the Commission services will be carried out by the Director-General for Economic and Financial Affairs, Mr Giovanni Ravasio.

I am writing in the same terms to Mr Broeder, Mr Camdessus, Mr Conable and Mr Paye.

Yours sincerely

Harry Christophersen

THE WORLD BANK
Washington, D.C. 20433
U.S.A.

→ LM-tips
file

BARBER B. CONABLE
President

August 7, 1990

Mr. Jean-Claude Paye
The Secretary General
Organization for Economic
Cooperation and Development
2, Rue André-Pascal
75775 Paris CEDEX 16
FRANCE

Dear Mr. Paye:

Thank you for your letter of August 2nd, I am entirely in agreement with the principle that we should utilize the best staff available in the respective institutions, or obtainable through consultant contracts, to work on the study of the USSR. No single institution has a monopoly of expertise in any sector, and I am sure we all recognized this when we allocated the assignments.

I appreciate that in the spirit of our mutual cooperation you will not re-open the work program assignments. We would have been pleased if Professor Simantov could have joined the World Bank group working on Agriculture as part of the cross-institution assignments we had agreed on, but I understand that will not be feasible. However, we welcome the assignment of an OECD staff member, Mr. Kuba, to work with us on the sector.

I look forward to seeing you in September.

Sincerely,

Barber Conable

3-054
8-3-90

AK

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/08/02 DUE DATE : 90/08/16
LOG NUMBER : 900803001 FROM : J.Blundell-Wignall
SUBJECT : Fax letter transmitted by OECD Sec-Gen. Blundell-Wignall from
Jean-Claude Paye re Econ. for Agr. Study part of USSR Eco. Study
OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

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- FOR YOUR REVIEW AND RECOMMENDATION
- FOR THE FILES
- PLEASE DISCUSS WITH _____
- PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- AS WE DISCUSSED
- RETURN TO _____

COMMENTS :cc: Messrs. Qureshi, Stern, Fischer, Holsen, Shakow

John Helsen, cc Presidents' Office, S. Fischer,
A. Shalov

ORGANISATION DE COOPERATION ET DE DEVELOPPEMENT ECONOMIQUES
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Centre pour la coopération avec les économies européennes en transition
Centre for Co-operation with the European Economies in Transition

2, rue André-Pascal, 75775 PARIS Cedex 16

Téléfax : (33.1) 45 24 91 77

Téléphone : (33.1) 45 24 93 36

DESTINATAIRE/ADDRESSEE : MR. BARBER CONABLE, PRESIDENT
FAX N° : (19 1 202) 477 0174
DE/FROM : SECRETARY-GENERAL
ENVOYE PAR/SENT BY : J. BLUNDELL-WIGNALL
NOMBRE DE PAGES/NUMBER OF PAGES : 3. (y compris cette page/including this page)

PLEASE FIND ATTACHED A TWO-PAGE
LETTER FROM THE SECRETARY-GENERAL.

OCDEORGANISATION DE COOPERATION ET
DE DEVELOPPEMENT ECONOMIQUES**OECD**ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENTLe Secrétaire général
The Secretary-General2, rue André-Pascal
75775 PARIS CEDEX 16
Tél. 45 24 82 00

JCP/90.252

Paris, 2nd August 1990

Dear Mr. Conable,

I feel it is necessary to write you these few lines after yesterday's meeting in Paris of the Committee of our personal representatives for the study on the USSR economy. In that meeting, your representatives were unusually firm in claiming for your Institution the sole leadership of the task force dealing with the agricultural sector of the Soviet Union.

In this respect, you might recall that in our discussions in New York on Saturday morning two weeks ago, I explicitly referred to agriculture as one of the subjects where I thought the OECD had a comparative advantage. In the afternoon meeting that day, Mr. Zecchini, my personal representative, reconfirmed the OECD interest in that sector and mentioned that we were in the process of contacting an outstanding expert who retired from the OECD a few years ago. At the end of that afternoon session, it was understood by both our representatives that your Institution and mine would share the responsibility of that specific task force.

In the following days we succeeded in contacting Professor Simantov, the former Director of the OECD Directorate for Agriculture, who is a very well-known expert in agricultural economics and who also has a long experience in managing study projects. Furthermore, he has already started preparing a framework for the analysis of this sector. In this respect, it is our view that the selection of the leaders of the various task forces should not be based on their belonging to one or the other of the four institutions participating in the study, but on their merits as economists as well as managers of study projects.

Mr. Barber Conable
President
International Bank for Reconstruction
and Development
1818 H Street
Washington DC 20433

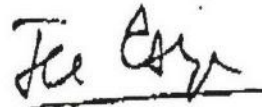
JCP

In the light of all this, it came as a surprise to see that your representatives were claiming the sole leadership of the task force for an economist who is not an expert in agriculture, and that they plan to put in charge of the sub-group dealing with agriculture another economist who does not have qualifications which approach those of our candidate.

In the meeting of yesterday, after an uneasy discussion on this point, Mr. Zacchini did not wish to pursue this argument at length in order to avoid difficulties in the extensive collaboration that has to be firmly established among the participating institutions in order to ensure a successful completion of this study. We accepted the position of your representatives in a spirit of co-operation between our two institutions that has to extend beyond this study. In any case, as we agreed with J. Attali and M. Camdessus, all parts of the report, including that on agriculture, must be of high quality and will have to be fully endorsed by the four participants.

We will again have an opportunity to discuss our work in Washington next September and in the meanwhile I wish you a pleasant summer.

Yours sincerely,



Jean-Claude Paye

WORLD BANK OTS SYSTEM

CORRESPONDENCE DATE : 90/08/03
LOG NUMBER : 900803002
SUBJECT : Study of Soviet Economy

DUE DATE : 00/00/00
FROM : Mr. Picciotto

OFFICE ASSIGNED TO FOR ACTION : (01) ADMIN OPERATION ~~Mr. COARABLE~~

ACTION:

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COMMENTS :

* AK

file - USSR

BBC has
authorized,
per Ak.

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8/10

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION
OFFICE MEMORANDUM

DATE: August 3, 1990

TO: Mr. Barber B. Conable

FROM: R. Piccioro, CPBVP

EXT: 30202

SUBJECT: **Study of Soviet Economy**

1. PRE, in consultation with PBD, has estimated the cost of the study at \$750,000. Taking account of internal redeployment of \$100,000 I recommend that you allocate \$650,000 from your Contingency to fund the study. This is acceptable to Mr. Fischer.

2. The work schedule remains as you outlined to the Board on July 31, 1990.

OFFICE MEMORANDUM

DATE: August 3, 1990

TO: Mr. Barber B. Conable

FROM: R. Piccioro, CPBVP

EXT: 30202

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2. The work schedule remains as you outlined to the Board on July 31, 1990.

STANLEY FISCHER
Vice President Development Economics
and Chief Economist

Confidential

AK
SS (o/r)
~~BPR~~

DECLASSIFIED

SEP 04 2019

WBG ARCHIVES

August 3 1990

Mr. Ernest Stern

Ernie:

In case I don't get to speak to you before leaving this afternoon, I want to list a few issues arising out of the USSR study.

1. John Holsen will report to you every few days to keep you informed. // JV NOTGD
2. There are clear signs the Fund and the USSR are exploring membership. First, some of the reports on Fund meetings in Moscow say the Soviets are interested in membership. Second, and making the issue more immediate, the Fund "statistical" mission leaving in the next week or two looks -- according to John Holsen -- very much like a membership mission. I suppose senior management had better think about our reactions to an application for membership.
3. The Soviets mentioned during their meetings with the Fund last week that they would like both the IBRD and EBRD missions to start looking for projects on which we could base lending. This study is hardly the vehicle to do that, but we can anticipate more such requests while our people are in the USSR and should decide how to instruct them to respond.
4. John Holsen is having a little bureaucratic trouble negotiating the terms on which Enrique Lerdaun would join our group. Given the importance of our having a grizzled veteran on the Fund side of the study, I hope that you will help John make sure we get Enrique on board. I've told John to ask you for help if he gets stuck.

My office will know how to reach me during the next two weeks.

Stan

✓
cc: Messrs Conable, Thalwitz (o/r), Holsen

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

File
Soviet

~~AK~~
~~JWS~~
~~SS O/H~~

CORRESPONDENCE DATE : 90/07/31 DUE DATE : 00/00/00
LOG NUMBER : 900801005 FROM : Teresa Ter-Minassian
SUBJECT : Minutes of the Meetings with Soviet Officials - copy for info.

OFFICE ASSIGNED TO FOR ACTION : ^{seen} Mr. B. Conable (E-1227)

ACTION:

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COMMENTS :

cc: Fischer, Holsten

done
Pgl



Office Memorandum

To: Mr. Conable, President
IBRD

July 31, 1990

From: Teresa Ter-Minassian, Leader of IMF Task Force on Soviet Economy Study *T.M.*

Subject: Minutes of Meetings with Soviet Officials

The Managing Director has asked me to send you a copy of the notes on the meetings he held with Soviet officials in Moscow last week.

Attachment

cc: The Managing Director
The Deputy Managing Director
Mr. Andrews

Meeting with Mr. Sitarian, July 27, 1990

This was the opening meeting and after an exchange of courtesies and a listing of further appointments, Mr. Sitarian said that the Government was seeking a professional paper setting out views on the economy. The M.D. said that it was the firm intention of the four organizations to meet that request but for this all of us would need the assistance of the Soviet experts and an open dialogue. Mr. Sitarian said that at a later stage, a joint task force of the four staffs and his own people might need to meet together to consider recommendations.

Mr. Sitarian briefly outlined his understanding of the E.C. study and timetable. He said that missions from the E.C. would be in Moscow for much of August. He assumed that the information made available to the E.C. would be fully passed on because he wished to avoid any duplication of questions. We explained the cooperation that had been agreed between the E.C. on the one hand and the four organizations on the other. Mr. Sitarian then said that the U.S.S.R. hoped to "partake better in the work" of the four organizations and stated that Soviet membership of the Bretton Woods institutions was on the agenda. They were as interested in "in-depth long-term cooperation" as in assistance.

Lastly Mr. Sitarian said that the Government had "radically" changed its earlier views on the Fund.

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Meeting with Mr. Arbatov, Academician, July 27, 1990

Mr. Arbatov gave his personal views in a very unrestrained manner. He was extremely critical of the slowness with which the present Government had approached economic reform. He thought that the lead taken by the Russian Republic would now force the Union to speed up reform. If it did not do so then in his opinion the present Government could not last.

He recited at length various examples of the inadequacies of present policies and gave several main examples of these inadequacies. The central government would have to learn to negotiate with the Republics; it could no longer dictate. The army would inevitably shrink in size despite its strong protests, but special efforts would have to be made to absorb ex-officers (he said some 200,000 would account for the core group) into meaningful work.

Mr. Arbatov gave as his priorities:

(1) action to deal with the present monetary situation by, e.g., sales of land or houses, high initial deposits for durable goods at guaranteed prices, etc.;

(2) action to improve the food situation where the difficulties were due much more to inadequate transport and distribution than to inadequate output. He gave several colorful examples of waste;

(3) action to improve the supply of consumer goods.

Possibly changes in all these three areas might be more easily obtained by working through the Republics rather than the Union.

Technology was now inadequate, stocks and investment were excessive and inefficiency pervaded the system.

4/14

Meeting with Mr. Ivanov, of the Gosplan, July 27, 1990

Mr. Ivanov confirmed that they expected the technical experts of the E.C. to be in Moscow most of August.

He also asked that the four organizations get all relevant information from the E.C. to avoid duplication. He looked for final session(s) in Washington.

The M.D. said that we would do our best to fit in with these requirements but stressed that the four organizations would need to cover issues that might not be fully covered by the E.C. We raised the possibility of more small technical visits in August.

Mr. Ivanov then said that the U.S.S.R. hoped for was:

- (a) support for market reform and the strengthening of market mechanisms;
- (b) help on technological matters and on management issues;
- (c) that any "program" of recommendations should be jointly managed or agreed.

He said that they might arrange for occasional meetings with members of Parliament but that they themselves would arrange this. He said that they would consider whether meetings with the Governments of some Republics might be useful but gave the impression that the answer was likely to be negative. It was agreed to confirm the New York decision on the contacts with the press though they later suggested a TV interview; the M.D. declined. However, in meetings with the Prime Minister and the Foreign Minister, press photographers were present but no questions were put or statements made. Nevertheless, they clearly made statements to their own press.

9/14

July 30, 1990

USSR: Meeting with the Central Committee on Statistics

The Soviet representatives said that they had begun an effort in recent years to make their statistics conform to international standards. This effort had been concentrated in the areas of the national accounts and of trade statistics. Specifically, aggregate figures for GNP had been calculated since 1987. A more comprehensive effort was underway to shift from the MPS to the SNA system. Data on an SNA basis were expected to be collected for 1991, and would be published, hopefully, in 1992 but perhaps 1993. Thereafter, efforts would be made to reestimate the national accounts for previous years in the SNA framework.

Trade statistics had been collected traditionally according to the classification scheme common to CMEA countries. The decision had been made to shift to the Harmonized System, and the conversion key between the two schemes had been prepared. Trade statistics would be collected in the new format beginning in 1991; data for the CMEA would be similarly treated.

The Government representatives said that the quantitative data that they published were reliable but existing price indices (consumer and producer price indices) suffered from serious shortcomings. The controlled nature of most prices implied that underlying inflation was reflected in shortages rather than price increases. They had attempted a rough measurement of this "repressed inflation" by reference to the rate of growth of savings deposits in excess of the rate of increase in consumer prices. According to this methodology, overall inflation in 1989 had been on the order of 7 1/2 percent (versus a recorded increase of CPI on the order of 2 percent).

The Soviet representatives provided the mission with a list of their statistical publications. They said that they would need special authorization to release data on the balance of payments, external debt and reserves, and monetary and fiscal statistics.

The Managing Director indicated that financial and external statistics would be essential for the successful completion of the study and that he would seek such an authorization from the Prime Minister. He also suggested that a small team from the IMF and the other organizations visit Moscow in early August to gather the needed data, and work with the authorities in the Statistics Committee in sorting out any conceptual and methodological differences. The Soviet representatives agreed to this proposal, and suggested that the staff be in touch with them soon with specific proposed dates for the mission.

Finally they said that they expected soon (undefined) to publish the results of the last census.

July 30, 1990

USSR: Meeting with Central Committee on Prices

A meeting of the IMF team with the Central Committee on Prices was held on July 27. The Chairman of the Committee provided a description of the main features and weaknesses of the existing system of price determination.

The Soviet representatives explained that in the determination of wholesale prices (for industrial products) and of producer prices (for agricultural products) the interest of producers were primarily taken into account, while the interests of consumers weighed heavily in the setting of retail prices. The budget through subsidies shouldered the burden of reconciling these diverging interests. The longstanding policy of heavy subsidization of basic goods meant that consumers did not know the true cost of producing the subsidized goods, on the one hand, and that domestic prices of basic commodities were much below world prices. For example, the world price of a ton of coal was around the equivalent of Rbl 28, the domestic price Rbl 10.6; for oil the corresponding figures were Rbl 72 and Rbl 30, respectively. The domestic price of gas was less than half that prevailing on world markets; similarly, the domestic prices of most minerals were much lower than foreign prices. This, of course, opened possibilities for smuggling abroad and leakages to the black market.

The Soviet representatives noted that wholesale prices had not been changed since 1985, transport prices since 20 years, and also retail prices of staple foods such as some types of bread, had not been increased for several years. As a result, budget subsidies had been climbing steadily, to Rbl 115 billion in 1990. A major policy issue now facing the Government was whether to liberalize prices in the near term. Some argued that, without supporting measures, notably a tightening of financial discipline and a breakup of monopolies, price liberalization would ignite an inflationary spiral. The Price Committee by and large shared this view. They felt that, while a significant spate of increases was unavoidable in the short run, liberalization should proceed very cautiously and be selective, beginning with products of higher quality.

The Managing Director stressed that price liberalization should be part of a broader policy package aimed at establishing more appropriate macro-economic conditions, and at opening up markets to domestic and foreign competition. He felt that liberalization should begin in earnest in the agricultural sector, where supply response was likely to be more rapid.

July 30, 1990

USSR - Meeting with the State Planning Committee (GosPlan)

Mr. Grigov, Deputy Chairman of the Committee, welcomed the mission on behalf of Mr. Maslukov, the Chairman, who was indisposed. He said that he expected the GosPlan to be a key interlocutor to the mission for the study on the Soviet economy.

He then listed a number of crucial questions facing the Soviet policy makers during the planned transition to market economy: how should a privatization program be designed and implemented? What were the appropriate extent and pace of price reforms? What mechanisms of the central control should remain in the framework of a market economy? How much decision making power in the economic sphere should be transferred to the local and regional authorities? What were the feasible and appropriate steps to reduce the budget deficit of the State to the equivalent of about 2 1/2 percent of GDP by 1993? What should be the main features of reform for the central bank and the commercial banks? How much should interest rates be increased? Mr. Grigov noted that the Government had made a firm commitment to introduce more wide-ranging and stronger reforms than in the recent past. Mr. Abalkin was working on the design of such a program which would be presented to the Supreme Soviet by September 10. A series of draft reform bills had been, or were in the process of being, prepared which would spell out the legal framework of the proposed reforms. These draft bills included: a new statute for enterprises, a law on privatization, an anti-monopoly law, a central banking reform law and a new law on social welfare benefits (to cushion the impact of price reforms on real incomes of the population). As regarded price reform, it was still being debated. One could expect political and social difficulties, as a result of increases (or the liberalization) of consumer prices.

The mission was provided with an organizational chart of the GosPlan, and promised the latest report on the plan. At a subsequent meeting with Mr. Sitarian the mission was also promised copies of the draft reform laws as soon as they are presented to Parliament.

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July 30, 1990

Meeting with the Prime Minister, July 28

The introduction explicitly put future relations of the Bretton Woods Institutions on the agenda.

It was said that the Russian side would contribute in all possible ways to the study. The Government was making a sharp political and economic turn. The moving of the economy from "one model to another" was a more laborious and more difficult task in all respects than had been anticipated. The change had been made more difficult by the falling away of the rate of growth, the introduction of incentives in a less than fully coherent manner, and the psychology of dealing with a population which both wanted yet feared the unknown.

Now time for a resolute forward move. It was important to remember how low were living standards in the U.S.S.R.--approximately one third of the level of other East European countries.

The U.S.S.R. wanted no charity, but help and advice. The move to international market prices in CMEA trade on January 1, 1991 will produce some pain but was a necessary step. Convertibility (undefined) remained the goal; at some stage, a formal devaluation would be necessary.

The Prime Minister went on to say that it was in the U.S.S.R.'s interests that the report should be solidly based; they would do all that was necessary on their side. A crucial immediate problem was that of pricing. Any move would be most unpopular but it had to be done, else the logical alternative was full rationing. Rationing has always existed through the allocation of inputs, but confusion had increased with the effective liberalization of incomes. Now the rouble had lost its value, even its meaning.

A fundamental issue was "social welfare". A safety net was essential; uncontrolled inflation had to be avoided. Much work had been done on studying the experience of other countries, especially in East Europe, and wide discussions had been held with American, Japanese, and German representatives.

Lastly, the Prime Minister stressed that it was essential that the study's recommendations be discussed with his people before being finalized. The Managing Director stated that this was the agreed position of the Heads of the four organizations.

July 30, 1990

Meeting with the Minister of Finance

The Managing Director, Mr. Whittome and I met with Mr. Pavlov, Minister of Finance of the USSR on July 27. The meeting focused on the prospects for the state budget in 1990 and the scope for reducing the budget deficit over the medium term.

The Minister said that in 1989 the budget deficit (at around Rbl 82 billion) had turned out substantially lower than the initial budget estimate (on the order of Rbl 121 billion). The initial budget for 1990 projected a deficit of around Rbl 60 billion; the expected outturn was now also lower (on the order of Rbl 50 billion, given the recorded deficit of Rbl 20 billion in the first six months). This had required a very strong effort, and it was difficult to see how the deficit could be reduced further in the short run. The Minister recognized, however, that at the equivalent of 6-7 percent of GNP, the deficit remained too high. The medium-term objective was to reduce it, to the equivalent of about 2 1/2 percent of GDP without imposing wholly new taxes.

The Minister said that the growth of deficits owed much to mismanagement and the poor utilization of resources. More recently, planning had effectively collapsed and more independence had been given to enterprises, with the result that investments and wages grew. The attempt to maintain the relics of the planning system, while delegating power to enterprises, had resulted in a fall in revenues and a rise in expenditures. At the same time, important expenditures such as housing, remained untouchable.

In his view, there was room for improvement in the fiscal performance, both on the expenditure and the revenue side, especially the former. He said that subsidies to inefficient public enterprises and to consumers were very high, and had grown rapidly in past years. The restructuring of public enterprises, and consequently a reduction of subsidies, was an essential element of perestroika. The Minister recognized that this restructuring would involve additional social expenditures, to support the rising number of laid off workers and retrain them, but these additional costs would be significantly lower than the subsidy cuts. It was also necessary to trim back investments of public enterprises, although a greater effort would be needed to build essential infrastructures. He saw scope for foreign assistance in this area, where improvements would facilitate the functioning of the markets.

On the revenue side, the Minister referred to the recent efforts towards tax reform. On July 1, a new personal income tax with a progressive rate schedule had come into effect. It envisaged an exemption level of Rbl 70 per month, a flat rate of 13 percent for incomes between Rbl 70 and 700 per month, and a progressive schedule of higher incomes, with a top marginal rate of 60 percent for incomes above Rbl 3,000 per month. The Minister noted that since the average wage is around Rbl 250 per month, the flat rate of 13 percent applies to the vast majority of workers. The new tax rate expected to generate approximately 1 1/2 million returns and the tax administration was

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- 2 -

gearing up to enforce it by hiring a substantial number of new tax officers, who now numbered about 65,000 and who would be paid relatively well.

A new profit tax on enterprises was to be levied beginning in 1991 at a combined flat rate of 45 percent (22 percent for the central government and 23 percent for the republics). On the question of sharing of fiscal responsibilities between the state and the republics, the Minister thought it essential for financial discipline that the access of the republics to credit by the banking system should be strictly controlled. Therefore, he was opposed to any concession of monetary autonomy to the republics. On the prospects for introducing a general sales tax, the Minister felt that a reform of indirect taxation (away from the existing turnover taxes and towards a general sales tax, coupled with selected excises) could only take place in the context of a major reform of price setting mechanisms, on the extent and speed of which there was no consensus yet within the new Government.

The Minister said that it was the Government's intention to move to financing the budget deficit through bonds. For 1990 sales of bonds had already reached the targeted level of Rbl 10 billion.

In response to a question by the Managing Director, the Minister agreed that a technical team could visit the Ministry of Finance in the first half of August to review in detail the tax system, tax administration and budgetary matters.

13/14

July 30, 1990

USSR - Meeting with the State Bank (Gosbank)

The Managing Director, Mr. Whittome and I met on July 28 with Mr. Geraschenko, Chairman of the Gosbank, and other members of the Governing Council of the Bank. In response to a question by the Managing Director on the progress to date in banking reform, Mr. Geraschenko began by reviewing briefly the current structure of the banking system. Since 1987 the Gosbank did no longer engage in commercial banking activities, which were taken over by the specialized state banks: (a) the Promstroibank for industry and construction (with assets currently on the order of Rbl 100 billion); (b) the Zilsotsbank for housing and trade sector loans (with assets of about Rbl 400 billion); and (c) the Agroprombank for financing of agriculture and food processing, the largest with assets of about Rbl 260 billion. In addition, there is a savings bank, which provides consumer loans (Gberbank) and a bank for foreign trade (Vresheconombank). The Gosbank issues currency and finances the Government; it also provides general guidance to the other banks and supplements their funding which for the Promstroibank and Zilsotsbank comes largely from deposits (which, on the contrary, account for only 15 percent of the funding of the Agroprombank).

Mr. Geraschenko noted that interest rates were very low (2-3 percent) and their structure quite artificial. He felt that it would be necessary to raise them to at least the rate of inflation (which the Statistics Committee had estimated at 7 1/2 percent for 1989), but he did not think that interest rate move could precede price reform, as it would have a devastating effect on enterprises, which are heavily indebted to the banking system.

Turning to the problem of excess liquidity, Mr. Geraschenko recognized that the monetary financing of large budget deficits in recent years, and the accommodating attitude of the banking system towards credit demands by public enterprises, had been responsible for the large overhang of liquidity. Currency in circulation was estimated at about Rbl 1,100 billion. He did not favor the absorption of the excess liquidity through a currency reform which would be costly (it would cost Rbl 5 billion just to replace the old notes and coins) and could not be prepared with the necessary secrecy. He felt that a way to absorb this liquidity would be sales of properties, but, for this work, first rents, which had been frozen for 27 years, would need to be updated.

Mr. Geraschenko attributed large responsibility for the deteriorating economic performance, especially in terms of inflation, to the fact that wage increases had been substantially higher than productivity gains since 1985. In the first six months of 1990 alone, wages had risen by over 8 percent. Mr. Geraschenko recognized that a less accommodating attitude of banks and more realistic interest rates would be necessary to reestablish

14/1

come financial discipline on enterprises, curbing both excessive wage increases and stock accumulation.

Mr. Geraschenko said that two draft laws for reform of the Gosbank and of the banking activities were currently under preparation. A difficult political issue was the degree of autonomy in monetary management to be granted to republics. In this context, the Chairman expressed concern at the local authorities' attempts to control the allocation of credit in their respective towns. Also debated was the issue of whether the Gosbank should respond to the Government or to Parliament. Mr. Geraschenko favored the latter, provided that Parliament authority would be limited to setting broad guidelines for the conduct of monetary policy, avoiding interference in its actual implementation.

In a subsequent discussion over lunch, it became clear that the Gosbank had very little responsibility in the conduct of foreign exchange policy (setting of exchange rates, administration of exchange controls and preparation and implementation of the foreign exchange allocation plans).

5/14

Meeting with Mr. Sitarian & Team, July 28, 1990

There was a final wrap-up meeting with Mr. Sitarian and his team on the evening of July 28. A wide variety of points were covered:

(a) The task force on the Soviet side for macro-economic questions would be as follows:

Mr. Bezrukov / Gosplan
Mr. Ulanov / State Price Commission
Mr. Baranovsky / State Labor Commission
Mr. Ulansky / State Statistics Commission
Mr. Golovatiy / Finance Ministry
Mr. Mozhaïskov / State Bank of the USSR
Mr. Nosko / Bank for Foreign Economic Affairs
Mr. Chestnoy / Foreign Ministry
Mr. Yasin / State Commission on Economic Reform
(ABALKIN's Commission)

Technical Coordinator: Victor V. Rakov
Manager, State Bank of the USSR
12, Neglinnaia str.
Moscow, USSR
Telephone: 923.1870
Telex: 411283
Fax: 923.8196
921.6465

(b) Messrs. Sitarian, Ivanov and Obminsky (who speaks English) would act as coordinators for this group:

Mr. Stepan A. Sitarian - Overall leader
Mr. Ivan D. Ivanov, Deputy Chairman,
State Foreign Economic Commission
Mr. E. Obminsky, Deputy Minister for Foreign Affairs

(c) The Soviet side would be prepared to provide all necessary data including the figures for total military expenditure. If data was requested that was regarded as particularly confidential such requests would be carefully studied.

(d) They said that they presumed that the OECD would continue to use its own direct contacts with the Soviet Foreign Ministry for issues relating to energy and the environment; they would be welcome to do so.

(e) They suggested that the IBERD and EBRD should use Mr. Obminsky as their initial point of contact. Some of their queries could be dealt with by the members of the task force who would have full access to the institutions they represented, others would be dealt with by specialist agencies.

- (f) The Gosbank would provide office accommodation in Moscow.
- (g) Communications to Moscow should be channeled through the embassies in London, Paris and Washington, who would be instructed to forward them without delay.
- (h) There was a core of independent interpreters in Moscow who were of high quality. They could be hired by the four organizations. Arrangements could be made through Mr. Obminsky; payments would need to be in foreign exchange.
- (i) Visits to other organizations, for instance, the economic institutes, could be arranged.
- (j) No final answer was given to a query as to whether contacts should be established with any Republics, though for the time being the answer is firmly negative.
- (k) Small data collecting teams would be welcome in August. From the Fund side we arranged for one to visit the Ministry of Finance and Central Bank. Note that with Parliament convening on September 10, late August and early September will be particularly hectic for the Ministry of Finance.
- (l) Teams for policy discussions should please not arrive until September given that a team for the EC would arrive in Moscow on July 30 and remain all August and that a small Italian group might visit Moscow also in August as a follow-up to Mr. Andreotti's visit.
- (m) They hoped that discussions on possible recommendations could begin in October and it was left open as to whether these might (at least in part) take place in Washington.
- (n) They stressed that any significant differences between the conclusions of the EC study and that of the "four" would much weaken the impact of both in the USSR and they presumed outside.
- (o) They would wish to discuss any immediate balance of payments problems in a strictly confidential manner.
- (p) They hoped that the IBRD or EBRD would be able to move quickly to identify promising areas for project financing as they understood that the EC would be looking for some input for its own study. We said that we would pass this message on; it was not our direct responsibility but in all fairness it seemed to us that the EBRD and IBRD might find it extremely difficult to meet such a timetable.
- (q) They said that they hoped that the OECD would be able to provide advice on training and education, for these were areas where help was needed with some urgency.

OFFICE MEMORANDUM

Date: 23 July 1990

To: Mr. Conable

From: Stanley Fischer, DECVP *Sf*

Subject: Arrangements for Joint Study of Soviet Economy

1. By the time we left the Air France lounge at 4:15 Saturday afternoon, we had reached agreement with our IMF, OECD and EBRD colleagues on a broad division of responsibilities for the detailed studies that are needed in connection with the joint work on the Soviet economy.

2. The Bank will take the lead in the work on the "financial system" and on "marketization and privatization." We will also take the lead in the work on agriculture, manufacturing industry and housing. The IMF will take the lead in the short and medium-term macroeconomic work and in that related to public finance. The OECD will have lead responsibility for the external sector (trade and capital flows), the employment and social safety net area, and energy and the environment; they will also do some macroeconomic modeling. EBRD asked for the lead in some of the sector work, including transport and telecommunications. The details are shown on the attached sheet.

3. Organizations will provide cross support in the areas in which they are interested but do not have lead responsibility. Thus we will get support from the EBRD for the marketization/privatization work and from the OECD for both the financial sector and the agricultural work. We expect to give support to the IMF on macro work, to the EBRD for the transport/telecommunications work and to the OECD for the trade, employment/safety net, and energy studies.

4. The next questions concern timing and staffing. We are thinking of having our main missions in the field at the beginning of September. The teams would have to prepare preliminary findings for use at the mid-October meeting of the heads of agencies; draft "chapters" for the final report would be needed in mid-November. Preparatory work, which should include a small, short mission to Moscow to make arrangements for the September mission, will keep us busy in August. The Fund would like to get into the field by mid-August, but I believe our schedule is more realistic given the need for preparatory work. On staffing, it now looks like we will need a

minimum of 10 staff for the Bank-led teams who will make this study their main concern from mid-August to the end of November. We will need another 5 staff to support work done by the IMF, OECD and EBRD; the time commitment is not clear in these cases, but should be somewhat less than in the case of the 10 involved in the Bank-led work. In addition, we will want to call upon some consultants (particularly for the preparatory work in August) and to coopt some other Bank staff for short periods of time.

5. We need to make decisions on the resources to be allocated to this study and possible separate funding for travel and consultant expenses. We are not waiting for these decisions, however, to begin making arrangements for consultants to assist us in the preparatory work in August. There is a lot of knowledge available that we need as a input into our September mission.

cc: Messrs. Qureshi, Thalwitz, Wapenhans, Lari, Holsen

[80072303.DOC]

Staffing of Teams Led by World Bank:

| | <u>Bank</u> | <u>Support</u> |
|---|-------------|----------------|
| Team Leader | 1 | |
| "Economic Organization" Team: | | |
| Banking and financial system | 1 | 1 |
| Market system, competition & prices | 1 | 1 |
| SOE management & restructuring | 1 | |
| SOE privatization; new private activities | 1 | 1 |
| Legal framework for market economy | 1 | |
| (sub-total) | (5) | (3) |
| "Sector" Team: | | |
| Sector-Macro Integration | 1 | |
| Agriculture | 1 | 1 |
| Manufacturing Industry | 1 | |
| Housing | 1 | |
| (sub-total) | (4) | (1) |
| Total staff for Bank-led work | 10 | 4 |
| Support to Others: | | |
| To IMF for short/medium-term macroeconomic work | 1 | |
| To OECD for labor/employment/safety net work | 1 | |
| To OECD for external sector (trade) | 1 | |
| To OECD for energy sector | 1 | |
| To EBRD for transport/telecommunications sector | 1 | |
| (sub-total) | (5) | |
| Support from Others: | | |
| From OECD for financial sector work | | 1 |
| From EBRD for "economic organization" work | | 2 |
| From OECD for agricultural sector work | | 1 |
| | | (4) |

Note: The ten major participants in Bank-led activities will have substantial report writing responsibilities (as will the team leader). The commitment that will be required from the five Bank staff who will provide support to others is less clear (except in case of the IMF, where the Fund has asked essentially for a secondment for the period of the study).

23 July 1990

AGREED "LEAD ORGANIZATION" WORK AREAS:

Short and Medium-Term Issues:

IMF Demand & supply balance; macro indicators
IMF Budget (consolidated)
IMF Trade, payments, X-rate and debt
IMF Money, credit and prices
IMF External financing requirements

Longer-term/Systemic/Structural Issues:

IMF Public finance

WB Financial system

Enterprise reform; "marketization"

WB Competition; price liberalization

WB Public sector institutions, SOE mgt.

WB Privatization of SOEs

WB New private sector activities

WB Legal system, judiciary (added)

WB Bureaucracy problems (added)

The external sector

OECD Trade expansion & policies

OECD Capital flows

OECD Labor markets; wages & employment;
social safety net and retraining

OECD Environment

Sectors:

WB Agriculture

WB Manufacturing Industry (included in above)

WB Housing (added to OECD agenda)

OECD Energy

OECD Environment (to be merged with energy)

OECD Retraining (as part of labor, social, etc.)

EBRD Other "primary industries" (mining)

EBRD Transport and telecommunications

EBRD Distribution infrastructure

EBRD Role of information

Other Work Areas:

OECD Macro projections

The Managing Director of the International Monetary Fund, Mr. Michel Camdessus
The President of the World Bank, Mr. Barber Conable
The Secretary General of the OECD, Mr. Jean-Claude Paye
The President-Designate of the European Bank for Reconstruction and
Development, Mr. Jacques Attali

July 21, 1990

Dear Mr. President:

Following the message that you had addressed to the President of the United States, the Houston Economic Declaration of the 1990 Economics Summit welcomes your suggestion for a sustained economic dialogue. It also supports the efforts under way in the Soviet Union to liberalize and to create a more open democratic and pluralistic Soviet society and to move toward a market-oriented economy.

The Declaration has also called on our respective organizations to undertake, in close consultation with the Commission of the European Communities, a detailed study of the Soviet economy, to make recommendations for its reform, and to establish the criteria under which Western economic assistance could effectively support this reform.

We, the heads of the concerned organizations, confirm our readiness to undertake this study.

We hope that you will find this study of real value and that it will contribute to the process of integration of the U.S.S.R. in the world economy. Given its complexity and the short period available for its completion, we are ready to begin the study immediately.

We are prepared to devote the best professional resources of our institutions to the task of undertaking an effective economic dialogue with your government during the coming months in order to reach an understanding of the problems that face your economy, and to help as much as we can in their resolution.

We will be in contact with the officials from your government that you will designate to discuss the structure, timetable, and other aspects of the study.

We look forward to your reply.

Accept, Mr. President, the assurance of our highest consideration.



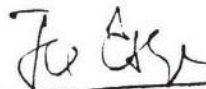
Jacques Attali



Michel Camdessus



Barber Conable



Jean-Claude Paye

Mikhail S. Gorbachev
President of the U.S.S.R.

The Managing Director of the International Monetary Fund, Mr. Michel Camdessus
The President of the World Bank, Mr. Barber Conable
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We are prepared to devote the best professional resources of our institutions to the task of undertaking an effective economic dialogue with your government during the coming months in order to reach an understanding of the problems that face ~~your~~ economy. ~~Each of us has appointed a personal representative~~ *and help as much as we can in their resolution.*

We will be in contact with the officials from your government that you will designate to discuss the structure, timetable, and other aspects of the study.

We look forward to your reply.

Accept, Mr. President, the assurance of our highest consideration.

Jacques Attali

Michel Camdessus

Barber Conable

Jean-Claude Paye

Mikhail S. Gorbachev
President of the U.S.S.R.

DRAFT

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We are prepared to devote the best professional resources of our institutions to the task of undertaking an effective economic dialogue with your government during the coming months in order to reach an understanding of the problems that face the economy.

~~Our joint team of experts, will be ready to come in ()~~ ~~Each of us has appointed a chief of mission, the list of which is attached.~~ ~~We~~ ~~They~~ will be in contact with the officials from your government that you will designate to discuss the structure, timetable, and other aspects of the study.

We look forward to your reply.

Accept, Mr. President, the assurance of our highest consideration.

Jacques Attali

Michel Camdessus

Barber Conable

Jean-Claude Paye

Mikhail S. Gorbatchev

B - In case raised by Attali in NYC

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 20-Jul-1990 12:27pm

TO: Sven Sandstrom (SVEN SANDSTROM)

FROM: Bilsel Alisbah, PAAVP (BILSEL ALISBAH)

EXT.: 80161

SUBJECT: EBRD

Sven:

Mr. Pissaloux doesn't seem to receive all the messages I sent him. He called again today to discuss assignments of Bank staff to EBRD.

I again explained that visits and very short-term missions are fine and can be worked out bilaterally with the units concerned in the Bank. Anything longer will require reimbursement but we can provide bridging arrangements. I also explained that we can not use trust funds for this purpose.

He gave me the impression that Mr. Attali may still write to Mr. Conable requesting some gratis assistance.

He also mentioned that in addition to Mr. Jahr, they would also like to have Thierry Baudon for about 4-6 months.

Bilsel

cc: Mr. Wapenhans (re Thierry Baudon)

CC: W. A. Wapenhans (W. A. WAPENHANS)
CC: Richard Lynn (RICHARD LYNN)

The World Bank
Washington, D.C. 20433
U.S.A.

BILSEL ALISBAH
Vice President
Personnel & Administration

① Mr. Conable
O/R
② CP-file

July 12, 1990

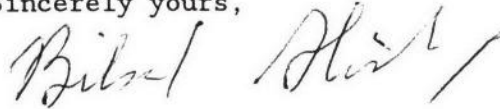
Mr. Pierre Pissaloux
EBRD
London, England

Dear Mr. Pissaloux:

As I mentioned over the 'phone yesterday, the World Bank looks forward to continued collaboration with EBRD. To this end, we will be happy to assist any of your teams which visit Washington to explore specific topics with us. Very short term assignments, of the type that Mme. Bendjouya has undertaken, can be arranged by EBRD directly with the Vice Presidential Unit concerned in the World Bank. Longer term assignments of two to twelve months should also be feasible but would need to be on a reimbursable basis and would, of course, depend on the availability of the individuals concerned. As I indicated, to the extent that payment is an issue of timing, we should be able to work out a satisfactory arrangement.

I am looking into the issue of Trust Funds and the availability of Mr. Karl Jahr, and I will get back to you early next week.

Sincerely yours,



cc: Members of President's Council
Mr. Kohli



INTERNATIONAL MONETARY FUND
WASHINGTON, D. C. 20431

MANAGING DIRECTOR

CABLE ADDRESS
INTERFUND

July 19, 1990

Dear Barber:

I would like to confirm the place and timing of our meeting this coming Saturday to discuss the preparations for the study of the Soviet Economy. I propose that we first meet among ourselves for about one and one-half hours for an initial exchange of views on how to organize this complex project. Afterwards, we would meet with Mr. Lamy for a first consultation with the Commission of the European Communities. In the afternoon, our personal representatives would continue the meeting to agree on the concrete aspects of the organization of the work. There will be numerous matters to discuss and it would be desirable that they be prepared to continue the meeting on Monday, July 23, at Fund headquarters if this should prove necessary.

For purposes of our work, I am in broad agreement with the tentative list of topics sent by Mr. Paye, which could be taken as the starting point of our discussion. In that specific context, however, I will raise a few concerns that we will need to address for purposes of organizing the study and you may wish to do the same.

For our first meeting, I suggest we focus and decide on the following four subjects: (a) distribution of tasks among our institutions; (b) work methods; (c) possible timetable; and (d) draft of joint letter to President Gorbachev.

In order to expedite matters, I am attaching a draft of a letter to President Gorbachev and a proposal for work methods. The tentative timetable proposed by Mr. Paye will need modifications in light of distribution of tasks and of my proposed work methods.

Finally, we will need to discuss modalities for each of us to secure the endorsement of our respective Boards or Governing Bodies to a final report that we shall prepare, and for its transmittal to the G-7 and the Soviet authorities.

Sincerely,

Michel Camdessus

Attachments

Mr. Barber Conable
President
International Bank for Reconstruction
and Development
Washington, D.C.

DRAFT
July 21, 1990

Dear Mr. President:

Following the message that you had addressed to the President of the United States, the Houston Economic Declaration of the 1990 Economic Summit has called on our respective organizations to undertake, in close consultation with the Commission of the European Communities, a detailed study of the Soviet economy, to make recommendations for its reform, and to establish the criteria under which Western economic assistance could effectively support this reform.

We, the heads of the concerned organizations, confirm our readiness to undertake this study. We have met today in New York to discuss the modalities for carrying it out and the possible distribution of work on the basis of our respective experience in dealing with macroeconomic, structural, and other economic reforms. Given its complexity and the short period available for its completion, we are ready to begin the study immediately.

In order to fulfill this responsibility, we will need the full cooperation and support of the Government of the Union of Soviet Socialist Republics. We therefore ask you, Mr. President, to inform us of the views of your Government.

For our part, we are prepared to devote the best professional resources of our institutions to the task of undertaking an effective economic dialogue with your Government during the coming months in order to reach an understanding of the problems that face the economy. To set the stage for our work, we have asked Michel Camdessus to be prepared to

travel and meet with you and such officials as you designate for discussions on the structure, timetable, and other aspects of the study.

We look forward to your reply.

Accept, Mr. President, the assurance of our highest consideration.

Michel Camdessus

Barber Conable

Jean-Claude Paye

Jacques Attali

Mikhail S. Gorbachev

Working Methods for Soviet Study

I. Considerations

1. Clear need for cooperation among all participants (institutions and individuals) in seeking common objectives.
2. Argues for the closest cooperation among the institutions and some central coordination of activities of individual missions and working groups.
3. The political nature of many of the issues, the sensitivities of the authorities, and the public attention that will be focused on this effort all argue for maintenance of the highest degree of confidentiality.

II. Coordination of activities

1. The organizational structure to be put in place to carry out the mandate of the Houston summit has to be decided on the basis of an agreed distribution of tasks. The Heads of the four institutions (the Fund, the World Bank, the OECD, and the EBRD) must retain final responsibility for all aspects of this exercise, including the adoption of joint policy recommendations and strategic conclusions. Coordination could best be carried out through a committee of personal representatives (the Committee)

appointed by the Heads of the four institutions. The Committee would coordinate the activities of the institutions and of the various task forces set up to carry out clearly specified terms of reference for conducting this study as agreed by the Heads of the four institutions.

2. The Committee would advise the Heads of the institutions on the establishment of task forces to implement specific components of the study.

3. Each institution would be entitled to be represented on each task force. Moreover, each institution could be represented in any mission where participation was appropriate and helpful to the institution in carrying out the primary responsibilities it had accepted for the conduct of the study. However, each institution will exercise restraint in its mission participation so as to help limit the size of missions and will conduct its business as expeditiously and efficiently as possible so as to facilitate the conduct of the study, and to assist the Committee in carrying out its responsibilities.

4. Each task force and any mission it organizes will operate under the instructions of a briefing document. This will identify the head of the task force or mission, the other members of the

group, the time frame for the group's activities, the subject matters to be covered, the objectives of the group's work, and the approach that will be taken.

5. Briefing documents would be reviewed and approved as appropriate within each institution but then assessed by the Committee to assure that they conform to the agreed distribution of responsibilities, avoid duplication, and leave no important issue untreated.

6. During missions, the mission chief would be responsible for the activities of the mission. Mission members will not be authorized to undertake independent activities without prior approval of the mission chief.

7. Each task force would report to the Committee on a periodic basis, and also after each mission and on the completion of their activities. Reports would cover the progress achieved with respect to the objectives established in briefing documents and would explain departures from the briefing, if any. Each report following a mission should provide a frank appraisal of the mission's views and the risks associated with any recommendations made.

8. All data and other information collected by mission members should be made available to the relevant task force on a timely

basis. Mission members are also responsible upon request to explain their analytical work to the task force.

9. The leaders of the task forces will be responsible for putting together the draft report and ensuring the consistency of the specific proposals and conclusions.

10. The Heads of the four institutions will meet for final adoption of the report.

III. Confidentiality

1. All data and other information collected in connection with this study should be considered as confidential and would be made public only upon completion of the final report and its submission to the Group of Seven and the authorities of the USSR and with their consent.

2. All local contacts by mission members in the field would be subject to clearance by the mission chief, in consultation with the relevant authorities in the USSR.

3. Missions should avoid contact with the press; when faced with such situations in the country, questions should be directed to the relevant USSR government authorities.

4. The Heads of Institutions will decide on the form of contact with and material for presentation to the press.

OCDE

ORGANISATION DE COOPÉRATION ET
DE DÉVELOPPEMENT ÉCONOMIQUES

Le Secrétaire général
The Secretary-General

JCP/90.229

OECD

ORGANISATION FOR ECONOMIC
CO-OPERATION AND DEVELOPMENT

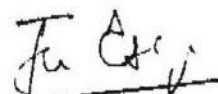
2, rue André-Pascal
75775 PARIS CEDEX 16
Tél. 45 24 82 00

19th July, 1990

Dear Mr. Conable,

To contribute to our discussions on Saturday, I thought it useful to send to you, as well as to Jacques Attali and Michel Camdessus, our preliminary thoughts on an outline for the USSR study.

Yours sincerely,



Jean-Claude Paye

Mr. Barber B. Conable Jr.,
President,
World Bank,
1818 H Street, N.W.,
Washington, D.C. 20433.

- 25C
steps
1. Fact finding - Aug
 2. Reform Package - mid Sept.
 3. Conclusion - effective res.

} all by Oct 27

Sitarian -
Abalain

18th July 1990

Study of the USSR Economy

Tantative Table of Contents

- A. Introduction
- B. Overview of the economic situation and prospects under current policies:
- (a) Demand and supply developments (including analysis of output, income and demographic trends)
 - (b) Prices - shortages - liquidity overhang
 - (c) Public budget
 - (d) Money and credit
 - (e) External trade, exchange rate and balance of payments
 - (f) Prospective evolution of income, external account, etc.
- C. The macroeconomic imbalances and policy measures:
- (a) Fiscal policy
 - (b) Monetary policy (including monetary reform)
 - (c) External policy (including the issue of convertibility and trade in Comecon area) and external financing
- D. The systemic and structural issues:
- WB - (a) Market-based competition, market structure, decentralisation of microeconomic decisions, ownership change
- WB - (b) Restructuring of the enterprise sector (including the promotion of small- and medium-sized enterprises)
- WB - (c) Price liberalisation and deregulation
- OECD } (d) The reallocation of labour, unemployment and the social security system
- WB } (e) Wage reform
- WB } (f) The reform of public economic institutions
- OECD + IMF } (g) The reform of the public budget and finances (including decentralisation of expenditure and revenue decisions)
- IMF OECD } (h) The taxation system
- WB + IMF } (i) The banking system
- WB + IMF } (j) The financing of investment and the promotion of saving; the financial markets
- OECD } (k) External trade, foreign direct investment
- (l) Sectoral issues:
- OECD 1) Agriculture
- OECD 2) Energy
- 3) Other primary industries
- EDB - WB 4) Transport and telecommunications
- EDB - WB 5) Other infrastructure (the distribution system)
- EDB - WB 6) Environment
- 7) Role of economic information in the development of market behaviour (including accounting standards, disclosure of market-relevant information, etc.)
- OECD + WB 8) Education, training.

- ✓ E. Medium-term prospects under alternative scenarios for few crucial variables such as income, balance of payments, external debt, etc.
- F. Main requirements in a policy approach:
 - (a) Priority areas for reform
 - (b) Interconnections between macroeconomic adjustment, structural reform and microeconomic changes
 - (c) Role of external capital.
- G. Conditions for effective, external assistance.
- H. Conclusions.

Tentative Timetable for the Study on the Economy of the USSR, its Reform
and Criteria for Western Support

1. Preliminary meeting to agree on the general outline of the study, on the repartition of tasks among institutions, and possibly on setting up joint task forces. Choice of the structural aspects that need to be particularly explored (21st July 1990).
2. Preparation of a detailed table of contents; collection and exchange of available information among participating institutions (PIs); drafting of one questionnaire which incorporates the contributions of all PIs; option; short exploratory mission to Moscow to establish contacts and collect information (by first week of August 1990).
3. The questionnaire is sent to the Soviet counterparts after agreement among PIs. Request of statistical information to the USSR (by 10th August 1990).
4. Technical, joint mission to Moscow to discuss, on the basis of the questionnaire, economic situation, policy issues, reform of economic institutions and structural reform. Exploration of USSR economic information (by end of August or beginning of September 1990).
5. Progress report to the G-7 (around 21st September 1990).
6. Drafting of the parts of the study dealing with the assessment of the economic situation, analysis of the various issues, and possible solutions. Circulation of drafts among PIs for comments (by end-October 1990).
7. Option: a brief mission to Moscow to verify our analysis with the Soviet counterparts (beginning of November 1990)
8. Meeting of PIs to assess the work done and to consider the final part of the study dealing with recommendations to the USSR for economic reform, criteria for Western assistance and conclusions. Repartition of the task of drafting these parts of the report (first week of November 1990).
9. Completion of the draft report, its circulation for comments, and its revision in light of comments (by end of November 1990).
10. Adoption of report by PIs. The possibility of a meeting is left open if it is necessary for the adoption of the report. Completion of the work on 20th December 1990.

Short and Medium-Term Issues:

- IMF {
- Demand & supply balance; macro indicators
 - Budget (consolidated)
 - Trade, payments, X-rate and debt
 - Money, credit and prices
 - External financing requirements

Longer-term/Systemic/Structural Issues:

- B Public finance (with IMF participation)
- B Financial system
- B Enterprise reform
 - Competition; price liberalization
 - SOE management
 - Privatization of SOEs
 - New private sector activities
- B The external sector
 - Trade expansion & policies
 - Capital flows
- O Labor markets; wages & employment
- O The social safety net
- O Environment

Other Needed Work Areas:

- O Statistical data
- O National accounts; macro projections
- B Sectors (industry, agriculture, energy, infrastructure)

Joint Study of the Soviet Economy

We need an integrated study. But for practical reasons, some division of labor is needed in preparing the detailed analyses. We suggest:

A. Detailed Team Reports: The Fund, the Bank and the OECD would each take the lead in producing detailed team reports covering an agreed set of topics. The suggested division of labor is:

Fund: Recent trends and the near-term outlook (2 or 3 years) in the major macroeconomic variables (particularly the fiscal, balance of payments and monetary system accounts); macroeconomic policies supportive of reform effort.

Bank: Economic organization (role of market-determined prices, private economy, state enterprise management, financial sector, more open economy) and sectoral issues (in industry, agriculture and economic infrastructure).

OECD: Historical and projected longer-term (e.g., 5 years) national accounts (output, trade, investment, consumption, savings) and balance of payments trends; analysis of the potential role of external assistance in the reform effort.

B. Integrated Main Report: There are substantial overlaps between these areas of concern. The results of the three teams would have to be integrated into a "Main Report" which would be drafted jointly by the team leaders and their deputies. This integrated "Main Report" would also outline the minimum package of reform measures needed to ensure the success of the Soviet economic reform efforts.

C. Coordination of Work: To provide the necessary coordination of the agency efforts we suggest:

Cross-membership of teams (each organization would have one person on teams led by the other two organizations).

Working level Coordinating Committee consisting of the three team leaders and their deputies (plus, if possible, EBRD).

Senior Coordinating Committee (at SVP or equivalent level) to come in if issues are not resolved at the working level.

The role the EBRD can play remains to be determined; it should be as active as its staffing permits. It should, of course, participate fully in drafting the "Main Report" and, if possible, should be represented on each of the proposed three teams.

OFFICE MEMORANDUM

DATE: July 18 1990

TO: Sven Sandstrom

FROM: Stanley Fischer *SF*

PHONE: 33774

SUBJECT: USSR Study

1. As you know, Messrs. Qureshi and Thalwitz met to discuss the study of the USSR economy proposed by the G-7. They agreed that the Bank's part of the study would be headed by John Holsen.
2. Attached is a proposal written by John Holsen on how to organize the overall study, and within it, how to organize the Bank's contribution. We propose a team of about ten from the Bank to undertake the actual study, and then a cross-complex director-level coordinating committee to provide general guidance for the team.
3. It appears likely that David Henderson, who heads research at the OECD, will be leading their study. He is a former Bank staffer, a good friend of the Bank's in general and John Holsen in particular. With his involvement, collaboration with the OECD should be very smooth.
4. We have not yet contacted our colleagues in the Fund, but would like to do so as soon as the President gives the word. Please let me know when we can proceed.

cc: Messrs. Thalwitz (o/r), Qureshi, Isenman, Holsen.

Suggested Arrangements for the
STUDY OF THE SOVIET ECONOMY
Requested by the G-7

1. Purpose: The study is (i) to provide background information and analysis of the Soviet economy and recent economic reforms; (ii) to make recommendations regarding further economic reforms, particularly those needed to establish a more market-oriented economy; (iii) to determine the likely needs for external economic assistance; and (iv) to establish criteria under which Western economic assistance could effectively support the recommended institutional and policy reforms.

2. Proposed Scope: The study should analyze (i) the short and medium-term macroeconomic outlook and appropriate policy measures; (ii) the longer-term structural and organizational reforms that would contribute to increased economic efficiency and, in particular, further integration into the world economy; and (iii) medium to longer-term projections of trade, payments and the national accounts with particular attention to the potential role of external economic assistance.

3. In the first area the report should focus on recent developments in the basic macroeconomic indicators (the budget, the balance of payments and the monetary accounts) and should outline a financial program and supporting policies for the next two or three years.

4. In the second area the report should devote attention to the use of market-determined prices to guide the allocation of resources, to the expansion of the private economy, to the management of state enterprises, to the organization of international trade, and to the role of the financial sector. The report should also analyze the policies, institutional changes, technological improvements, and additional capital requirements needed for the efficient expansion of industrial and agricultural output. Environmental concerns and issues in the development of the energy sector should also be considered. It should also discuss the policies, institutional changes, technological improvements, and additional capital requirements for basic economic infrastructure needed to support the projected level of economic activity.

5. However, it will not be feasible to complete a thorough analysis of all of the above -- and especially of the sectoral and environmental issues -- and still meet the end-of-the-year deadline. Consequently it is proposed that preliminary analyses should be made for inclusion in the December report and then, if desired, further work could be done later (see paragraph 12 below). This approach will mean, in particular, that the estimates of additional investment requirements in the principal sectors will be tentative and based heavily upon aggregate analysis. (Also

because of time and staff constraints, the study should not attempt to cover the social sectors and social infrastructure, including in this water, sanitation and urban development.)

6. The study should include (i) medium-term (e.g., 5-year) trade and balance of payments projections that will illustrate the potential role that external capital might play in an accelerated economic reform process and (ii) medium-term national accounts projections including overall trends in output, consumption, investment, exports, imports and saving. Attention should be given to the need for and potential role of different kinds of capital flows -- particularly direct private investment, export credits, investment financing, and balance of payments support assistance.

7. Organization: The G-7 Communique asks the Fund to convene the study, but it is to be conducted jointly by the IMF, World Bank, OECD and EBRD. In addition, the study is to be coordinated with the on-going report on the Soviet economy by the European Commission.

8. Work on the study could logically be divided into three teams. The IMF could take primary responsibility for preparing the analysis of the short and medium-term macroeconomic outlook (see paragraph #3 above). The World Bank could take primary responsibility for the analysis of the real economy including its principal productive sectors (see paragraphs #4 and #5 above). The OECD could then take the lead role in the trade, payments and national accounts work (see paragraph #6).

9. As there is a good deal of overlap between these three areas, and to ensure the necessary coordination between the suggested three teams, each of these three organizations should contribute at least one member to the two teams managed by the other organizations. Given that it is still in the early phases of its organization, the role the EBRD could play is not now clear; however, given its important anticipated role, it should at the very least be a full participant in the review of the work of the teams and in the drafting of the Main Report. If possible, it would be desirable for the EBRD to designate individuals to participate in the work of the Bank, IMF and OECD teams.

10. The World Bank Team: The World Bank should appoint a team of approximately ten staff members to prepare its contribution to the report. It should be led by John A. Holsen, Principal Adviser in the Office of the Vice President-Development Economics, who would work under the overall guidance of Stanley Fischer, Vice President-Development Economics and Chief Economist. Since the report is to be completed before the end of calendar 1990, the team members would have to be available substantially full-time during most of the coming months. They should, in addition, be able to call upon outside consultants and to coopt other staff members for short periods of time. Although this is still under consideration, the possible composition of the Bank team is:

| | |
|-------------------------------------|----------------|
| Team Leader | John A. Holsen |
| SOE Management; the Private Economy | _____ |
| Industrial Sector | _____ |
| Agricultural Sector | _____ |
| Financial Sector; Capital Markets | _____ |
| Environmental Issues | _____ |
| Energy Sector | _____ |
| Transport & Communications | _____ |
| Support to Others: | |
| Liaison with IMF Team (macro) | _____ |
| Liaison with OECD Team (BOP & NA) | _____ |
| Support from Others: | |
| IMF (wages, prices & subsidies) | _____ |
| OECD (trade policies/institutions) | _____ |
| EBRD (if possible) | _____ |

11. The Bank's team should work under the general guidance of a Coordinating Committee that would be established at the Director/Chief Economist Level. This committee should include one member from Finance, two from Operations and two from PRE; in addition, the Team Leader would be an ex-officio participant in the Coordinating Committee. The other suggested members of the coordinating committee are:

| | |
|------------|--|
| Operations | Parvez Hasan and Fred Levy |
| Finance | Stoutjesdijk/Kavalsky (to be determined) |
| PRE | Paul Isenman and Francis Colaco |

12. Possible Phasing of the Bank's Work: The time schedule has been fixed by the G-7. Assuming that serious, full-time work begins in September, and that the month of December is required for interagency discussions, for clearances and for preparation of the Executive Summary, then the end-of-the-year deadline is likely to leave no more than three months for the detailed work on the report (including discussion of the draft conclusions with the Soviet authorities). Given the nature of the task, this will leave inadequate time for the detailed information collection and analysis that would be desirable -- particularly regarding environmental issues and the agricultural, industrial, energy and economic infrastructure sectors. However, since the deadline is fixed, the scope of the initial report must be limited by what can be done in this short period. We should cover the indicated areas to the extent feasible in the time available, but recognize that the subject really calls for substantial additional work. If desired, the latter could be undertaken in a second phase of the Bank's contribution which would be carried out in 1991.

WORLD BANK PARTICIPATION IN A STUDY OF THE SOVIET ECONOMY

Proposed statement to the Board under Agenda Item 4 (Other Business) on Thursday, July 19:

As you have seen in the Declarations of the 1990 Economic Summit of Industrialized Nations (the "Houston Summit"), the World Bank, the IMF, the OECD and the designated president of the EBRD have been asked to undertake a study of the Soviet economy. The work is to be completed by year's end and will be convened by the IMF.

The scope of the study and the exact role of each institution has not yet been worked out. Michel Camdessus and I will meet this afternoon to discuss how to proceed. This coming Saturday Mr Camdessus and I will also meet with the Mr Paye of OECD and Mr Attali of EBRD. I will come back to the Board when more is known about the study and the Bank's participation.

U.S.S.R.

The World Bank

Washington, D.C. 20433
U.S.A.

MOEEN A. QURESHI
Senior Vice President, Operations

July 18, 1990

Mr. Conable

Lunch with Richard McCormack

I had lunch with Dick McCormack, Under-Secretary at the State Department and we discussed the Houston Summit meeting. The following points may be of interest:

- (i) Mr. McCormack said the study on the Soviet Union was not a mere fig-leaf for the German assistance package to the Soviet Union. There was a general recognition on the part of the Summit leaders that the economic and political situation in the Soviet Union was deteriorating rapidly. There was a serious risk of a political hiatus emerging with Gorbachev being supplanted by someone from the Army. This would clearly be a very dangerous situation and there was thus a genuine desire on the part of the Summit leaders to identify the major problems facing the Soviet economy, and to provide advice and counsel to Gorbachev on how the economic transformation to a market-oriented economy could be made. Given the diversity of the Soviet Union, most recognized that such a transformation would necessarily be a relatively slow and phased process as compared to, say, Poland where a much more rapid reform was under way. A thoroughly professional assessment of the situation was required and this was the reason for asking the Fund together with the Bank, OECD and EBRD to do the study.
- (ii) There was a great deal of interest in, and concern about, the macro-economic situation of the Soviet Union. The problems of the Rouble - both in terms of excessive domestic liquidity creation and an overvalued exchange rate - had geopolitical implications and could make the Soviet Union vulnerable to "power grabs" by some of its neighbours, such as China and Japan and others. It was therefore very opportune to provide Gorbachev with some sound technical advice. His advisers on the economic side were not an impressive group and they badly needed intellectual reinforcement. McCormack admitted that the basic economic issues confronting the Soviet Union were of a long-term nature relating to structural change but he clearly gave priority to re-establishing a sound macro-economic framework without which nothing else would work.

- (iii) On the issue of the environment, he indicated that President Bush had successfully deferred the issue of a global facility at this time. It was recognized that they had the Montreal declaration to help resolve the problems relating to the ozone layer, and that constituted a beginning. They did not believe that they had the necessary information at the present time to determine whether a more global approach to the environment problem was required - that might come later when the results of the extensive research programs on environment became available. He noted that there was a general concern amongst all participants about rain-forests, and they hoped that the World Bank could proceed with the preparation of a pilot program for Brazil. There was, however, no commitment at the present time to providing concessional financing for the Brazil program, or for any other global program at this time, other than for the Montreal Convention.
- (iv) On the debt of middle income countries, he said that the matter had been put in the lap of the Paris Club to review the situation and work out some solutions. No specific approach was either discussed or agreed, other than the feeling that some additional action would probably be required. However, no concessional relief of debt was envisaged, at least by the U.S.



Moeen A. Qureshi

A.S.S.R.

The World Bank

Washington, D.C. 20433
U.S.A.

MOEEN A. QURESHI
Senior Vice President, Operations

July 18, 1990

Mr. Conable

Study of the Soviet Union

Mr. Camdessus called me on the telephone on Monday morning to discuss this subject. He made the following points:

- (i) He had just returned from a visit to Europe where he had discussed the issue of the Soviet Union's Study with various governments. He had also called you in Tokyo and now wanted to convey to me some of his impressions. He looked forward to meeting with you on Thursday to prepare for the Saturday meeting in New York. The Saturday meeting would include Messrs. Paye, Attali, Camdessus and yourself. They hope to agree on the approach to the Study and on a division of labour based on the areas of specialization of each institution. After these were agreed between the four institutions, Camdessus intended to contact the representative of the EEC to discuss coordination with the work that the EEC was doing.
- (ii) I inquired whether he had received any indications about the attitude of the Soviet Union to the Study. Mr. Camdessus said that he had "contacted" the Soviet Union but had received a cautious and rather ambivalent answer. The Soviets wished to study the matter further and would want to know the terms of reference of the Study and the criteria that would be used for the Study, prior to giving any reactions. Mr. Camdessus had told them that given the short time in which the Study had to be completed, the full cooperation of the Soviet Union would be essential for the Study to be expeditiously undertaken and completed.
- (iii) Mr. Camdessus confirmed that there were barely five months for the Study to be done, and therefore it was clear that it would not be possible to go very deeply into many areas and issues. Perhaps the best approach would be to undertake a diagnosis and identify the main issues that the Soviet economy confronted, rather than attempt something more prescriptive.

- (iv) We discussed the nature and the scope of the Study. I pointed out that in so far as the macroeconomic dimensions of the Study were concerned (which Mr. Camdessus said would be the focus of the Fund's work), it should be possible to get sufficient information fairly quickly and to draw certain broad conclusions. In so far as the structural adjustment problems of economic transformation to a market-oriented economy were concerned, it would be difficult to go beyond an identification of the existing problems confronting Perestroika, and the critical areas where priority corrective action needed to be taken. Mr. Camdessus agreed that even this would be a major task for all the institutions concerned. He noted that while the EBRD did not have much staff and would not be able to contribute substantively to the study, OECD was very keen to make contributions on both macro and micro issues. It would be particularly important to work out with Mr. Paye from OECD, an appropriate division of work.
- (v) Mr. Camdessus added that he had received a number of phone calls from various leaders asking for his personal leadership in the Study and for a high quality, professional product. Mr. Wilson from Canada had called him that morning to suggest that he personally involve himself in the preparation of the Study. Furthermore, he had visited Mr. Brady earlier that morning. Mr. Brady had congratulated him on taking up such a monumental task, looked forward to receiving a highly professional document, and wished Mr. Camdessus good luck.

Further Steps

We shall provide you with some thoughts on the Study for your meeting with Mr. Camdessus. I have met with Wilfried Thalwitz and Ernest Stern to discuss this issue. I have suggested to Wilfried that he take the lead in organizing the Study within the Bank, and assured him of full support from Operations. Wilfried intends to ask John Holsen to lead the study. On my side, I will put two of my best senior people (Parvez Hasan and Fred Levy) to devote a good part of their time in the next few months to overseeing the Study. It has been pointed out to me by both Willi Wapenhans and Wilfried Thalwitz that substantial additional resources will need to be devoted to this task.



Moeen A. Qureshi

AK

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/07/17

DUE DATE : 90/08/07

LOG NUMBER : 900801020

FROM : H. Christophersen

SUBJECT : Re main issues on the Soviet economy linking the Commission, EIB,
IMF, OECD, WBank, now EBRD. Req. mtg during the 1990 Annual Mtgs. &

OFFICE ASSIGNED TO FOR ACTION : Mr. Thalwitz (D-1202)

ACTION:

- APPROVED
- PLEASE HANDLE
- FOR YOUR INFORMATION
- FOR YOUR REVIEW AND RECOMMENDATION
- FOR THE FILES
- PLEASE DISCUSS WITH _____
- PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- AS WE DISCUSSED
- RETURN TO _____

COMMENTS :cc: Messrs. Qureshi, Stern, Fischer, Holsen, AK, LM

pls. provide Mr. Conable a copy of resp. by c.o.b. 8/9/90.

JVolk (schedule)

EXPEDITE



Dear Mr. Barber B. Conable Jr.

The European Council at its meeting in Dublin on 25 and 26 June requested the Commission, in consultation as appropriate with the international financial institutions, to analyze the possibility and desirability of extending short-term credits and longer-term support for structural reform in the Soviet Union. These proposals will be based mainly on an economic report by the Commission services. Also, the Houston G-7 summit of 9-11 July has asked the IMF, the World Bank, the OECD and the EBRD to undertake a detailed study of the Soviet economy, in close consultation with the Commission.

It is clear that in dealing with the Soviet Union our approach will be different from the one used in our work on Eastern Europe. It rather needs to be along the lines of how the Soviet Union can be integrated into the world economy. The Soviet Union and the West would have to work closely together. In this way discussions on internal reforms in the Soviet Union and on how possible assistance can be provided most effectively could go hand in hand.

We would plan to use the same network for the purposes of our consultations as is already in place for Eastern Europe, linking the Commission with the EIB, the IMF, the OECD and the World Bank, to which will be added the EBRD.

We have drawn up provisional plans which include a mission to Moscow in late August and the preparation of our economic report by the end of September. In the work of our respective organisations on the USSR we should like to exchange information and data resources. We would also hope that the meeting of our network of correspondents scheduled to take place in Washington in mid-

Mr Barber B. Conable Jr.
President,
The World Bank
1818 H Street NW
Washington DC 20433
U.S.A.

September could be the occasion not only for our usual exchanges on Eastern Europe, but also for a discussion of the main issues concerning the Soviet Union. I would also suggest that we meet in the margin of the annual meetings of the IMF and the World Bank in Washington.

The economic analysis of the Commission services will be carried out by the Director-General for Economic and Financial Affairs, Mr Giovanni Ravasio.

I am writing in the same terms to Mr Attali, Mr Broeder, Mr Camdessus and Mr Paye.

Yours sincerely

Henry Kissinger

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

file Mr. Conable 012
35 JWS
AK

| ROUTING SLIP | | DATE: |
|---|-----------|----------------------|
| | | July 11, 1990 |
| NAME | | ROOM NO. |
| Members of | | |
| The President's Council | | |
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| | | |
| APPROPRIATE DISPOSITION | | NOTE AND RETURN |
| APPROVAL | | NOTE AND SEND ON |
| CLEARANCE | | PER OUR CONVERSATION |
| COMMENT | | PER YOUR REQUEST |
| FOR ACTION | | PREPARE REPLY |
| INFORMATION | | RECOMMENDATION |
| INITIAL | | SIGNATURE |
| NOTE AND FILE | | URGENT |
| REMARKS: | | |
| Final version of the statement on the Soviet Union. | | |
| FROM: | ROOM NO.: | EXTENSION: |
| Tim Cullen <i>TC</i> | E 8-059 | 81357 |

USSR

STATEMENT IN RESPONSE TO HOUSTON SUMMIT PROPOSAL THAT
THE WORLD BANK PARTICIPATE IN A STUDY OF THE SOVIET ECONOMY

(For attribution to Mr. Barber B. Conable)

The proposed evaluation of the Soviet economy is a very positive move by the Summit leaders. The World Bank is currently active in helping a number of countries, notably in Eastern Europe, restructure their economies to become more market-oriented. The experience that our staff can bring to such an evaluation of the Soviet economy would be very valuable. The World Bank will be pleased, with the support of our members, to participate in such an effort.

July 11, 1990

U.S.S.R.

WORLD BANK OTS SYSTEM
OFFICE OF THE PRESIDENT

CORRESPONDENCE DATE : 90/07/18 DUE DATE : 00/00/00
LOG NUMBER : 900718005 FROM : Stanley Fischer
SUBJECT : Briefing: meeting on USSR Study - July 19, 1990 and
July 21, 1990 (New York)
OFFICE ASSIGNED TO FOR ACTION : Mr. B. Conable (E-1227)

ACTION:

- APPROVED
- PLEASE HANDLE
- FOR YOUR INFORMATION
- FOR YOUR REVIEW AND RECOMMENDATION
- FOR THE FILES
- PLEASE DISCUSS WITH _____
- PLEASE PREPARE RESPONSE FOR _____ SIGNATURE
- AS WE DISCUSSED
- RETURN TO _____

COMMENTS :cc: SS, JWS, AK, Linda (briefing book)
JV (follow file)

BBC - An additional briefing note for
your mtgs. on Thursday and in NY on
Saturday.
L-

OFFICE MEMORANDUM

DATE: July 18 1990

TO: Sven Sandstrom

FROM: Stanley Fischer *SF*

PHONE: 33774

SUBJECT: USSR Study

1. As you know, Messrs. Qureshi and Thalwitz met to discuss the study of the USSR economy proposed by the G-7. They agreed that the Bank's part of the study would be headed by John Holsen.
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Requested by the G-7**

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5. However, it will not be feasible to complete a thorough analysis of all of the above -- and especially of the sectoral and environmental issues -- and still meet the end-of-the-year deadline. Consequently it is proposed that preliminary analyses should be made for inclusion in the December report and then, if desired, further work could be done later (see paragraph 12 below). This approach will mean, in particular, that the estimates of additional investment requirements in the principal sectors will be tentative and based heavily upon aggregate analysis. (Also

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Transport & Communications

John A. Holsen

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BC-SUMMIT-TEXT-POLITICAL

POLITICAL COMMUNIQUE ISSUED AT THE HOUSTON ECONOMIC SUMMIT
HOUSTON, July 10, Reuter - The following is the political
declaration issued on Tuesday by G-7 leaders at their summit
meeting in Houston.

POLITICAL DECLARATION
SECURING DEMOCRACY

1. We, the Leaders of our seven countries and the
Representatives of the European Community, salute the men and
women around the world whose courage and wisdom have inspired
and brought about the historic advances of democracy we have
witnessed over the past year. As we enter the final decade of
this century, which we intend should be a Decade of Democracy,
we reiterate our commitment to support the strengthening of
democracy, human rights, and economic reconstruction and
development through market-oriented economies. We emphasise the
important opportunity provided in this forum for representatives
from Europe, Japan, and North America to discuss critical
challenges of the coming years.

2. Europe is at the dawn of a new era. We welcome
enthusiastically the profound and historic changes sweeping the
continent. The London Declaration on a Transformed North
Atlantic Alliance provides a new basis for cooperation among
former adversaries in building a stable, secure, and peaceful
Europe. We are determined to seize all opportunities to achieve
a Europe whole and free and recognise the European Community's
contribution to that effort. We applaud the unification of
Germany, which is a tangible expression of mankind's inalienable
right to self-determination and a major contribution to
stability in Europe.

We welcome the replacement of repressive regimes in
Central and Eastern Europe by governments freely chosen by their
peoples. We applaud the introduction of the rule of law and the
freedoms that are the bedrock of a democratic state. We urge
Romania, following recent events, to adhere to the positive
trend taking place in other countries of Central and Eastern
Europe.

3. We welcome the intention of the Soviet Union to move
toward a democratic political system, as well as Soviet attempts
to reform their economy along market principles. We commit
ourselves to working with the Soviet Union to assist its efforts
to create an open society, a pluralistic democracy, and a
market-oriented economy. Such changes will enable the Soviet
Union to fulfil its responsibilities in the community of nations
founded on these principles. We are heartened by indications
that a constructive dialogue is underway between the Soviet
government and the Baltic states, and we urge all sides to
continue this dialogue in a democratic spirit.

4. The advance of democracy accompanied by market-
oriented economic reforms is not just a European phenomenon.
Since we last met, we have witnessed the spread of democratic
values in many parts of the world.

In Asia, there are encouraging signs of new political
openness in Mongolia and Nepal. In the Philippines, the
government continues to engage in courageous efforts to
consolidate democracy.

We acknowledge some of the recent developments in China, but believe that the prospects for closer cooperation will be enhanced by renewed political and economic reform, particularly in the field of human rights. We agree to maintain the measures put into place at last year's Summit, as modified over the course of this year. We will keep them under review for future adjustments to respond to further positive developments in China. For example, in addition to existing lending to meet basic human needs, we will explore whether there are other World Bank loans that would contribute to reform of the Chinese economy, especially loans that would address environmental concerns.

5. In Africa, we hope that Namibia's attainment of independence and democracy will be a positive example for freedom, pluralism, and market-oriented economic reform throughout the continent. We also welcome the positive developments that have taken place in South Africa, especially the launching of talks between the government and representatives of the black majority. We hope this will lead to a peaceful transition to a non-racial democracy and the complete dismantlement of the apartheid system. We will continue to support this process and we call on all parties to refrain from violence or its advocacy.

6. In Latin America, we welcome the re-establishment of freedom and democracy in Chile. We applaud the recent fair and free elections in Nicaragua, as well as progress on the path to peace through dialogue in El Salvador and Guatemala. We encourage the efforts of the Panamanian government to reestablish democracy and the rule of law. We note with satisfaction the positive evolution in Haiti. We hope that Cuba will take steps to join the democratic trend in the rest of Latin America.

7. While we applaud the reduction of ideological conflicts that have divided much of the world since the end of the Second World War, we note with deep concern the reemergence of intolerance affecting ethnic and religious groups. We agree that such intolerance can lead to conflicts, which can threaten fundamental human rights, as well as political and economic development.

8. We reaffirm our commitment to the fundamental principles we seek to realize in our own societies, and we underscore that political and economic freedoms are closely linked and mutually reinforcing. Each of us stands ready to help in practical ways those countries that choose freedom, through the provision of constitutional, legal, and economic know-how and through economic assistance, as appropriate.

In drawing from our different constitutional and historical experiences, we stand ready, individually and jointly in relevant fora, to:

- assist in the drafting of laws, including bills of rights and civil, criminal, and economic framework laws;
- advise in the fostering of independent media;
- establish training programmes in government, management, and technical fields;
- develop and expand people-to-people contacts and exchange programmes to help diffuse understanding and knowledge.

In the same spirit, the recent G-24 Ministerial agreed to extend its assistance in Central and Eastern Europe in parallel with progress in political and economic reform.

We agree the challenge facing the industrialised democracies is to continue the effort already underway in Europe while expanding efforts to support political reform and economic development in other parts of the world. We call on our people and the people of other democracies to join in this great endeavor.

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REUTER

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Richard N. Gardner

Aid the Soviets Can Really Use

The seven industrialized democracies have an opportunity at the Houston economic summit to help the reformers in the Soviet Union who want to make their country a free-market democracy. What is needed are two initiatives for coordinated Western aid—one economic, the other political.

The first element is an economic package that should not start with large-scale loans, which in the present disorganized state of the Soviet economy would bring no lasting benefits and could not be repaid. What the Soviet Union most urgently requires is a credible program to transform it into a market economy, coupled with the building of the necessary institutions to carry such a program out. These institutions must include laws that create and protect private property rights, a stock market, a private banking system, anti-monopoly legislation and an organized process of privatizing state enterprises.

A week of economic discussions in Moscow last month with senior Soviet officials and academics reinforced my conviction that the Soviet Union cannot devise and carry out such a program on its own. It lacks people with the necessary knowledge and experience in free-market economics, and it badly needs Western advice and technical assistance.

Nor can these needs be supplied by occasional brief visits of Soviet delegations to the International Monetary Fund and the World Bank in Washington, to the Organization for Economic Cooperation and Development in Paris or to the European Commission in Brussels. What the Houston economic summit should offer Mikhail Gorbachev is the establishment in Moscow as soon as possible of an international team of experts—selected by these organizations—who could work with Gorbachev's economic advisers and those of Boris Yeltsin at the Russian republic level.

The purpose should not be to impose a Western design upon the Soviet Union but rather to help it fashion a program that would provide the basis for a subsequent package of financial aid.

Since the IMF, the World Bank, OECD and EC cannot finance such a joint mission for a country that is not a member, a modest technical assistance trust fund of, say, \$5 million could be created in the United Nations Development

Program on behalf of non-market economies in transition, for which these organizations could serve as executing agents. There is reason to believe that Gorbachev and Yeltsin would welcome such an initiative provided it were clear that it was intended as a consultative mission and not as an infringement on Soviet sovereignty.

But it is obvious that a program of economic liberalization in the Soviet Union cannot succeed without a parallel program of political liberalization. The latter process requires an alliance between Mikhail Gorbachev, Boris Yeltsin and those reformers on their left who want to transform the Soviet Union into a real free-market democracy. Such reformers include such men as Anatoly Sobchak, the mayor of Leningrad; Gavril Popov, mayor of Moscow; Sergei Stankevich, Moscow's deputy mayor; and Viktor Aksyuchits, leader of the new Christian Democratic Party.

Western governments cannot help such reformers directly without risking the charge of interference in the U.S.S.R.'s internal affairs. But they could agree at Houston to encourage a coordinated program of aid on the part of their political parties, trade unions and civic groups. In the United States, a leading role could be taken by the National Institute for International Affairs of both the Democratic and Republican parties, which already have a successful track record of assisting democracy in such countries as Chile, Nicaragua and Czechoslovakia. Together with European groups, they could offer advice on the drafting of the U.S.S.R.'s new constitution, on the effective operation of the Soviet and republic parliaments, and on the creation of an independent judiciary.

A popular election for president of the Soviet Union is now scheduled for 1994, and Gorbachev will be under pressure to advance that date to 1991 or 1992. By providing the non-Communist forces with needed hardware (computers; fax machines, and publishing equipment) as well as advice on running political campaigns, the West can help them—and perhaps reform Communists as well—to compete in these elections on the basis of equality.

The skeptics will say that a liberalized Soviet Union is a chimera and that the country's future holds nothing better than chaos followed by repression. It is true that in the light of Russia's tragic history, an orderly transition to free-market democracy is a long shot. But the seven leaders at Houston should make a prudent investment in that long shot, given what their countries and all humanity have at stake.

The writer, a former U.S. ambassador to Italy, recently led a private delegation to Moscow for talks on U.S.-Soviet economic cooperation.