Folder Title:	Soviet File - General - October 1990 - Volume 2
Folder ID:	30382292
Series:	Subject Files of the Director, Policy and Review Department (PRDDR)
Dates:	10/18/1990 - 10/31/1990
Subfonds:	Records of the Office of the Vice President, Development Economics and Chief Economist and later Senior Vice President, Development Economics and Chief Economist (DECVP)
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PRD:
Soviet file (general)
October 17-31,'90

don 11/1

October 31, 1990

Paul Isenman,

Attached is an extract of the Conclusions from the European Council meeting in Rome on October 27-28, 1990 on EC relations with USSR. [For your information I also enclose the part of the conclusions dealing with Central and Eastern Europe.] As you will see the text is pretty vague as to what concrete actions the EC will take in support of reform in the USSR. There are probably two reasons for that: (i) the meeting took quite another turn than expected -- enormous "progress" on Economic and Monetary Union, and (ii) a sense that it is too early to decide on assistance for USSR -- it appears that the Commission did not submit proposals to the European Council for decision as expected.

What does this mean for the financing of the TAPSU (assuming that the USSR is in agreement with the proposal and wants external financing)? Clearly, we do not want to be seen as tailing the EC by asking for funding for our program after the EC has announced its program for USSR which supposedly has a TA component. This suggests early launching and sounding out of potential donors. However, if there is a feeling among EC members that it is too early to be specific about assistance, it would make it difficult for us to raise funds in that part of the world -- at least in the short run.

There is a couple of things the Bank could do:

- Seek collaboration with the EC in this area. There is enough work to be done, thus there is probably no risk of competition. But sharing of information -- as (I suppose) we do with the Fund -- about which areas, sectors, and levels each institution plans to work would look good in the eyes of potential donors.

- Seek informal contacts with potential donors in the coming weeks. One possibility would be to meet with EDs from potential donor countries to inform them about and sound them out on the prospects for Bank involvement in TA to the USSR. This would also prepare the ground for possible future fund raising. Is this a FINCOM task?

Susan

CC: Geoff Lamb

cc
D Beck
J Holsen
S Mink
c Mikhalopoulos

EUROPEAN COMMISSION
WASHINGTON DELEGATION
Telecopier (202) 429.1766
Telephone (202) 862.9573

TELECOPY No. 8548

Cover page
plus 17 page(s)

TO:	Ms. Susan ULBAEK THE WORLD BANK Fax No. 477-0954	FROM:	Jennifer TUFTS JT
		DATE:	October 31, 1990

As promised.

Rome, 28.10.90. 1610.

SN 304/90 REV 2

ORIG. F

CONCLUSIONS OF THE PRESIDENCY

EUROPEAN COUNCIL

ROME, 27 AND 28 OCTOBER 1990

Andreas van Agt

The United Kingdom is unable to accept the approach set out above. But it agrees that the overriding objective of monetary policy should be price stability, that the Community's development should be based on an open market system, that excessive budget deficits should be avoided, and that there should be no monetary financing of deficits nor the assumption of responsibility on the part of the Community or its Member States for one Member State's debts. The United Kingdom, while ready to move beyond stage one through the creation of a new monetary institution and a common Community currency, believes that decisions on the substance of that move should precede decisions on its timing. But it would be ready to see the approach it advocates come into effect as soon as possible after ratification of the necessary Treaty provision.

3. Organization of conferences

Both intergovernmental conferences will open on 14 December 1990. Arrangements for the organization of the Conferences will be as set out in Annex I.

II. RELATIONS WITH THE USSR

The European Council heard a preliminary report from the Commission following talks with the Soviet Government, held pursuant to its mandate from the European Council in Dublin, with a view to drawing up proposals on short-term credit and longer-term support to be given to structural reforms.

The European Council stressed the importance attaching to the success of the reforms undertaken by the Government of the Soviet Union.

The European Council expressed the will that the Community should make a substantial, concrete contribution to the success of these efforts by means of co-operation in various areas.

The Commission was instructed to submit, before the next European Council meeting, proposals for the decisions to be taken.

Should any situation requiring emergency action arise before that date, the Council will take whatever decisions are required on the basis of proposals from the Commission.

The European Council stressed the importance of close co-operation between the Community, the competent international organizations and the other countries wishing to support the endeavours of the Soviet Government. The European Council accordingly asked the Commission to put forward proposals for a major commercial, scientific and technical co-operation agreement with the USSR.

III. CENTRAL AND EAST EUROPEAN COUNTRIES

1. Co-operation

The European Council noted with satisfaction the progress made in the development of co-operation between the Community and the countries of Central and Eastern Europe in the general context of the activities of the Group of 24 and the PHARE programme. It also noted the prospects offered by the new Association Agreements which will help to further co-operation in all areas - economic, financial, cultural and political - between these countries and the Community.

The European Council is aware of the Community's special responsibility towards these countries at a time when their efforts to achieve structural adjustment, together with the transition to a market economy, are meeting with additional difficulties due to external economic disturbances, affecting in particular their financial position.

The European Council considers that, in these circumstances, the Community has a duty to help to consolidate and develop the general process of reform being undertaken in these countries, notably by playing its part in the stabilization of their financial situation.

In this context the European Council hoped that the economic reforms and democratic developments in Yugoslavia would meet with success within the framework of increased respect for human rights and the preservation of the country's unity and territorial integrity.

2. Emergency aid

Among the numerous urgent problems arising in Central and Eastern Europe, the European Council, in response to a submission from the Hungarian Government, expressed its solidarity with Hungary's efforts to solve its acute economic problems and to steer its transformation into a market-oriented economy.

It reaffirms its determination strongly to support Hungary on its path towards democracy, stability and economic development, which implies the refusal of violence and respect for legality. In this context, the European Community and its Member States will help Hungary to overcome its problems, in particular in the field of energy supplies, in the framework of the G-24. They will also endeavour to make bilateral assistance available at short notice, especially through the disbursement of the second tranche of the EC loan.

IV. GULF CRISIS AND MIDDLE EAST

The European Council discussed the Gulf Crisis and the situation in the Middle East and adopted the declarations in Annexes II and III.

V. CSCE

The European Council adopted the declaration in Annex IV.

VI. RELATIONS WITH THE UNITED STATES AND CANADA

The European Council was informed of the progress of talks with the United States and Canadian authorities on drafts of joint declarations on relations with the United States and with Canada. The question will be examined again by the General Affairs Council on 12 November 1990.

cc: John H.
Steven M
Csaba Ks
LWA

done 11/1

① cc Tsanriman
Khanna
Kavalsky
② memo to follow-up

WORLDBANK TMSS

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MOSCOW THE USSR STATE BANK 30.10.90

TO: MR. DAVID R.BOCK , DIRECTOR
OFFICE OF THE SENIOR VICE
PRESIDENT FOR OPERATIONS
WORLD BANK

FROM: STATE BANK OF THE USSR

DEAR MR. BOCK,

THANK YOU VERY MUCH FOR MATERIALS TO BE DISCUSSED DURING THE MEETINGS OF MR. CONABLE WITH SENIOR SOVIET OFFICIALS. WE BELIEVE THAT MEMORANDUM WILL BE THE MAIN SUBJECT FOR THE FORTHCOMING DISCUSSION.
OUR COMMENTS TO THESE METERIALS WE WILL BE READY TO GIVE TO YOU UPON ARRIVAL
IN MOSCOW IF IT IS CONVENIENT FOR YOU. IN ORDER TO
ACCELERATE THE FORMAL PROCEXXXXXX
ACCELERATE THE FORMAL PROCEDURE WITH VISAS OF YOUR MEMBERS DELEGATION, PLEASE ADVISE US OF THE FOLLOWING INFORMATION.

- NAME ,
- DATE OF BIRTH,
- PLACE OF BIRTH,
- PASSPORT NUMBER AND ITS DATE OF ISSUANCE,
- PERIOD OF STAYING IN MOSCOW.

GIVEN THAT MAJOR MEETINGS ARE PRELIMINARY SCHEDULED ON NOVEMBER 16, 1990 , YOU MAY CHOSE THE APPROPRIATE DATE OF ARRIVAL BY YOURSELF BEARING IN MIND THAT THE DISCUSSION WITH SENIOR GOVERNMENTAL OFFICIALS COULD HAVE TAKEN PLACE DURING THE WEEK BEGINNING ON NOVEMBER 12.

SINCERELY YOURS

VICTOR V. RAKOV
HEAD OF DIVISION

=10310608

*** END OF DOCUMENT ***

THE WORLD BANK

ROUTING SLIP	DATE 10.31.90

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

NAME	ROOM NO.
cc: Messrs. Isenman, Holsen	
Mink (for Distribution)	
Jay	

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

REMARKS

RECEIVED
90 OCT 31 PM 2:29
PRDDR

FROM: Wilfried P. Thalwitz

sads\w46935

Office Memorandum

To: Mr. Flemming/Mr. Fitoussi
Mr. Thalwitz/Mr. Holsen
Mr. Zecchini/Mr. Tuveri

October 31, 1990

From: L.A. Whittome

Subject: USSR

I attach a revised note of our lunch meeting on Monday October 15. The main addition is to note that it was agreed that EBRD should produce the first draft of Section V of the summary report.

Attachment

cc: Mrs. Ter-Minassian

International Monetary Fund
International Bank for Reconstruction and Development
Organization for Economic Cooperation and Development
European Bank for Reconstruction and Development

Meeting of Personal Representatives and Task Force Representatives, IMF Paris Office, Monday October 15, 1990

During lunch, a short meeting was held to discuss the recent letter from Mr. Ivanov; a possible letter from the four HOs to Mr. Gorbachev; the possible visit of HOs and PRs to Moscow in late November/early December; and the draft outline of the joint report. The meeting was attended by Mr. Whittome, Mrs. Ter-Minassian and Mr. Robinson (IMF); Messrs. Holsen and Levy (IBRD); Messrs. Zecchini and Tuveri (OECD); and Messrs. Fitoussi and Aghion (EBRD).

1. Mr. Ivanov's Letter

Mr. Whittome asked for comments on how to respond to Mr. Ivanov's request that the forthcoming IMF mission complete the factfinding stage of the study. During a tour de table, Mr. Holsen and Mr. Fitoussi said that their factfinding was broadly complete: Mr. Zecchini said that the OECD energy team still required some further information. It was agreed that a reply should be sent to Mr. Ivanov agreeing to his request, with the proviso that the IMF mission could be expanded to include some OECD representatives (see attached reply).

2. A letter to Mr. Gorbachev

Mr. Holsen suggested that HOs should consider sending a letter to Mr. Gorbachev setting out some general issues--not conclusions--relating to reform. A draft had been prepared, and would be circulated to PRs. It was likely that the compromise reform program due on October 15 would not be produced on time: and during the Bank's discussions, they had felt that several key issues--including price reform, hard budget constraints, and foreign trade policy--were not being given the attention they deserved. Mr. Zecchini wondered what the purpose of the letter would be: if it were to draw Mr. Gorbachev's attention to a few crucial areas, then there should be an in-depth analysis: if it were general, he wondered whether Mr. Gorbachev would not already be aware of the issues. The danger of pre-empting the joint conclusions, as well as political considerations, needed also to be borne in mind. After some further discussion, it was agreed that HOs would have to make the final decision, but in any case it should not be sent until after Mrs. Ter-Minassian's mission returned.

3. HOs/PRs mission to Moscow

There was some discussion of the possible HOs/PRs mission to Moscow. It was still not clear whether HOs wished to go, but it was generally felt that they would delegate the task to PRs. It was agreed that Mr. Whittome should coordinate with other PRs to try to arrange suitable dates to be suggested to the Soviets.

4. Draft outline

Mr. Zecchini said that the draft outline was now broadly satisfactory, although he felt (supported by Mr. Fitoussi) that a section (perhaps half a page) on incomes policy as a stabilization tool would be useful. He also felt that too large a share of the drafting had been allocated to the IMF and IBRD, and wondered whether the OECD should not undertake the whole of Chapter IV (including prospects for 1991). After some discussion, it was agreed to leave the outline as it was, but that Mr. Zecchini would send a draft to Mrs. Ter-Minassian covering developments in 1991 as an input for her work.

It was noted that since the report was a joint product of the four organizations, all were ultimately responsible for the entire draft. Mr. Fittousi said that the EBRD wanted to collaborate closely with the IBRD in drafting section III.1, and it was agreed that the IBRD would provide a preliminary draft to the EBRD for comments. Mr. Whittome said that it would be most helpful if preliminary drafts of all sections could be circulated as widely and early as possible (preferably by late October) to facilitate the drafting. Mr. Fitoussi said that the EBRD would be prepared to undertake the first draft of Section V. This was agreed; it was noted that early input from the other three organizations would be helpful.

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INFUND 610712F

OCTOBER 15, 1990

TO: MR. IVANOV
DEPUTY CHAIRMAN
STATE FOREIGN ECONOMIC COMMISSION
U.S.S.R. COUNCIL OF MINISTERS
MOSCOW

FROM: TERESA TER-MINASSIAN
INTERNATIONAL MONETARY FUND
C/O PARIS OFFICE

DEAR MR. IVANOV,

THANK YOU VERY MUCH FOR YOUR LETTERS OF OCTOBER 8TH AND 12TH, WHICH I HAVE DISCUSSED WITH MY COLLEAGUES FROM THE OTHER THREE ORGANIZATIONS.

LET ME FIRST SAY THAT WE HAVE ALL BEEN MOST GRATEFUL FOR THE COOPERATION AND HELP OUR MISSIONS HAVE RECEIVED FROM THE SOVIET AUTHORITIES, AND THAT WE RECOGNIZE THE HEAVY BURDEN THIS MUST HAVE IMPOSED AT AN ALREADY VERY BUSY TIME. WITH YOUR HELP, WE HAVE BEEN ABLE TO GATHER A GREAT DEAL OF THE INFORMATION NECESSARY FOR OUR WORK, AND AS YOU REQUEST, WE WILL TRY TO COMPLETE ALL THE REMAINING FACTFINDING DURING THE OCTOBER 16-26 MISSION. TO FACILITATE THIS--AS MENTIONED IN MY TELEX OF OCTOBER 8 AND MR. TUVERI'S RECENT FAXES--I WOULD BE GRATEFUL IF THAT MISSION COULD INCLUDE THE FOLLOWING RESPRESENTATIVES OF THE OECD:

MR. HAGEMANN	OCTOBER 16-23
MR. SHAFER	OCTOBER 21-26
MR. GRANZER	OCTOBER 16-24
MS. BJORKSTEN	OCTOBER 16-24

IF THIS IS AGREABLE TO YOU, I WOULD BE GRATEFUL IF YOU COULD (IF THIS HAS NOT ALREADY BEEN DONE) INSTRUCT YOUR PARIS EMBASSY TO ISSUE THE NECESSARY VISAS, AND ARRANGE FOR THE NECESSARY HOTEL BOOKINGS TO BE MADE (IF POSSIBLE IN THE SAME HOTEL AS THE IMF TEAM).

I LOOK FORWARD TO SEEING YOU IN MOSCOW.

YOURS SINCERELY,

TERESA TER-MINASSIAN

411699 PROFI SU
INFUND 610712F
Message: 725 -02 emis Le 15/10/90 a 16 h 38 Duree : 05 mn 16

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

NAN

DATE: 31-Oct-1990 04:23pm

TO: See Distribution Below

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

Sr.

SUBJECT: **BBC Lunch on November 12**

Two of the people I had hoped to get for lunch on the 12th are not available (Reddoway and Aron). At present, I have a tentative schedule from Aikman. It seems that only Hewett is really available. Given this, I am inclined to save the lunch briefing for another occasion. Unless I hear from you by cob tomorrow, I will assume that you agree, in which case I will inform Aikman and Hewett.

DISTRIBUTION:

TO:	Paul Isenman	(PAUL ISENMAN)
TO:	Basil Kavalsky	(BASIL KAVALSKY)
TO:	John A. Holsen	(JOHN A. HOLSEN)
TO:	Anupam Khanna	(ANUPAM KHANNA)
TO:	Sven Sandstrom	(SVEN SANDSTROM)
CC:	Chitra Perera	(CHITRA PERERA)

THE WORLD BANK

ROUTING SLIP	DATE 10-31
FROM THE SENIOR VICE PRESIDENT, POLICY, RESEARCH AND EXTERNAL AFFAIRS	

NAME	ROOM NO.
Messrs. Isenman	
Holsen	
Mink	
Jay	

	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

sads\w46935

AK
Lm

WORLD BANK OFFICE TRACKING SYSTEM
OFFICE OF THE PRESIDENT
Routing and Action Transmittal Sheet

TO:	DATE:
Mr. M. Qureshi (E-1241)	10/31/90

SUBJECT:

Document From: V. Gerashchenko
To: bbc
Dated: 10/31/90

Reference No.: EXC901031002

Topic: Bank of the USSR: would like to confirm oral inv. to visit the USSR. Have fixed major meetings for Nov. 12-16, 1990.

ACTION INSTRUCTIONS: | DUE DATE: |

__XXX__ HANDLE
_______ REVIEW AND RECOMMEND
_______ FOR YOUR INFORMATION
_______ DISCUSS WITH ____________________
_______ AS WE DISCUSSED
_______ PREPARE RESPONSE FOR ______ SIGNATURE
_______ FOR YOUR FILES
_______ RETURN TO ____________________
_______ OTHER: ____________________

Remarks: cc: Messrs. Thalwitz, Bock, Kavalsky
Linda (trip schedule)
pls. provide Mr. Conable's office a copy of resp.

RECEIVED
90 OCT 31 PM 3:10
PRDDR

URGENT

STATE BANK OF THE USSR

103016, Moscow, Neglinnaya, 12,

Victor V. GERASHCHENKO
Chairman of the Board

The World Bank/IFC/M.I.G.A.
Washington, D.C. 20433 U.S.A.
Fax. Tel. No. (202) 477-6391

To: Barber Conable,
World Bank President

Dear Mr. Conable,

I would like to confirm my oral invitation to visit the USSR made to you in September in Washington. We would be glad to discuss with you and your colleagues here in Moscow the areas of co-operation between the Soviet Union and World Bank and the respective memorandum.

It is my pleasure to remind you that we have fixed major meetings for November, 16, bearing in mind that the discussion with senior government officials could take place in the week beginning on November 12.

I would be pleased if you could express any special wishes concerning the cultural program for you and your wife.

Looking forward to see you in Moscow,

I remain,
Sincerely yours,

Victor V. Gerashchenko

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

DATE: 31-Oct-1990 09:09am

TO: Costas Michalopoulos (COSTAS MICHALOPOULOS)

FROM: Stephen Mink, DECVP (STEPHEN MINK)

EXT.: 33696

SUBJECT: **USSR brief for BBC - TA talking points**

Attached is a first draft of the talking points on technical assistance. It is basically a summary of the aide memoire.

CC: Paul Isenman (PAUL ISENMAN)
CC: John A. Holsen (JOHN A. HOLSEN)
CC: David R. Bock (DAVID BOCK)
CC: Stephen Mink (STEPHEN MINK)

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

DATE: EST

FROM: Stephen Mink, DECVP (STEPHEN MINK)

EXT.: 33696

SUBJECT: **Talking Points**

Technical Assistance Talking Points

Let me turn now to the Bank provision of technical assistance. This would be one concrete way to follow up on the Joint Study and lay the groundwork for our future relations. We sent in advance a short document describing some options for technical assistance, but let me bring to your attention some of the main considerations.

Scope. Our proposals for a possible technical assistance program are at this stage deliberately general. It is important that we learn more during this visit about your Government's priorities for technical assistance and preferences on channels through which such assistance would be provided.

We have deliberately designed the proposed program to be complementary to parallel support that might be arranged with the IMF. This will ensure broad coverage of the key issues for economy-wide reform.

Six Areas of TA Activity

Short-run actions. From our work in other economies exhibiting major distortions, we can provide advice on measures most likely to be effective in addressing immediate pressures. These may be the need for measures to improve supply of consumer goods, provide for targetted social protection of vulnerable individuals during the reform transition, and reduce waste in the use of material resources.

System reform. Technical assistance could draw on our extensive experience across countries in the detailed content and sequencing of reforms in transition to a market economy. This could cover critical reforms in exteranl trade, price structure and the financial system, and links of these reforms to fiscal and macroeconomic policy objectives.

Institutional reform. Some areas in which the Bank could assist in institutional reform are financial system restructuring, facilitation of private investment, and divestiture of state holdings. Our International Finance Corporation can contribute its valuable expertise, such as in the development of domestic capital markets.

<u>Sectoral policies and investments</u>. During the next period it will be improtant to tackle sectoral problems of distorted and non-existent markets. The Bank can assist in establishing sectoral policies and investment strategies that are consistent and supportive of your economy-wide objectives.

<u>Training</u>. Our Economic Development Institute has worked for many years doing in-country training. It can directly conduct training activities, but more importantly, will work with a country's institutions to design new training programs and train local trainers. The focus would be officials and managers with responsibilities ranging from economic management, privatization, industrial and agricultural development, to techniques of investment analysis and project appraisal.

<u>Coordination</u>. In our experience, cost-effective use of external financial resources and technical assistance is difficult to establish when there are many official providers and channels. The Bank has considerable experience in assisting countries to establish coordination and management mechanisms, to get the best use out of these scarce resources.

<u>Modalities</u>. I would suggest we think in terms of a multi-year program, perhaps three years initially. On the Bank's part, we would assure an integrated approach to the technical assistance you request us to focus upon through appointing a senior staff member as head of program. This person would coordinate teams working in the chosen areas. Such teams would spend considerable time in the Soviet Union to enable working closely with Soviet counterparts both on analytical work and on the content of evolveing work programs.

<u>Next steps</u>. The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish from the Bank. Following this, the Bank would return a technical mission to Moscow to develop and agree formally on a specific work program and financing plan.

I would like to point out that if we proceed to an agreed program for technical assistance, it will need to be submitted to the Bank's Board of Executive Directors for approval. Also, the Bank's charter limits use of its resources exclusively to member countries. The program will need to be funded in the near term by contributions from third parties or by reimbursements. The program could be initiated upon approval of our Board and implementation of the financing plan.

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

DATE: 30-Oct-1990 02:49pm EST

TO: See Distribution Below

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

TR

EXT.: 81138

SUBJECT: **Communications with the Soviet Union**

1. We have had several recent cases of official communications from the Soviet Union and its republics which have floated around in the Bank and not been responded to in a timely and correct fashion.

2. Please ensure that we follow established procedures for handling official communications with non-members. Such communications should immediately be sent to Secretary and FINSV who will consult as appropriate (e.g., with LEGVP) and respond.

3. The only exceptions would be communications which deal specifically with the ongoing study of the Soviet economy and the Soviet TA program which is now under discussion. Such communications should be directed to PRESV and OPNSV, respectively. For the time being, any outgoing communications concerning the TA program should also be cleared with this office.

DISTRIBUTION:

TO:	Ernest Stern	(ERNEST STERN)
TO:	Moeen A. Qureshi	(MOEEN QURESHI)
TO:	Wilfried Thalwitz	(WILFRIED P. THALWITZ)
TO:	Ibrahim Shihata	(IBRAHIM SHIHATA)
TO:	Timothy Thahane	(TIMOTHY THAHANE)
CC:	David R. Bock	(DAVID BOCK)
CC:	Anupam Khanna	(ANUPAM KHANNA)

DA

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

DATE: 30-Oct-1990 09:27am

TO: Paul Isenman (PAUL ISENMAN)

FROM: John A. Holsen, PADSS (JOHN A. HOLSEN)

EXT.: 33719

SUBJECT: **Mr. Orlov and TA**

Sorry, but I do not recall Mr. Orlov. He presumably is a member of Mr. Abalkin's (Union level) Economic Reform Commission. Consequently I may have met him in a large meeting. But a check of my card file indicates that he was not one of the individuals with whom we spoke at any length.

We have a contact at the Soviet Embassy here who has sometimes been helpful. His name is Sorokin. I have tried to call him this morning, but his number (628-7551) was busy. So I've sent a fax to him, asking him to call you or me if he is able to get us in touch with Mr. Orlov.

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

DATE: 30-Oct-1990 03:58pm

TO: Paul Isenman (PAUL ISENMAN)

FROM: Patricia Gallagher, PRESV (PATRICIA GALLAGHER)

EXT.: 31018

SUBJECT: <u>**Verbal Trip Briefing with BBC November 12 @ 3 pm**</u>

Mr. Conable will be briefed verbally on his Moscow trip on November 12 at 3 pm. WT will be departing for Paris November 10 or 11 (Sat/Sun).

There will also be a lunch with BBC on November 12 with some External Soviet Experts.

Please let me know if any PRE staff should attend either of these events and what our input will be (brief?).

CC: Keith Jay (KEITH JAY)

Sent cm to Johnny

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

DATE: 30-Oct-1990 02:49pm EST

TO: See Distribution Below

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

EXT.: 81138

SUBJECT: <u>Communications with the Soviet Union</u>

1. We have had several recent cases of official communications from the Soviet Union and its republics which have floated around in the Bank and not been responded to in a timely and correct fashion.

2. Please ensure that we follow established procedures for handling official communications with non-members. Such communications should immediately be sent to Secretary and FINSV who will consult as appropriate (e.g., with LEGVP) and respond.

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<u>DISTRIBUTION:</u>

TO:	Ernest Stern	(ERNEST STERN)
TO:	Moeen A. Qureshi	(MOEEN QURESHI)
TO:	Wilfried Thalwitz	(WILFRIED P. THALWITZ)
TO:	Ibrahim Shihata	(IBRAHIM SHIHATA)
TO:	Timothy Thahane	(TIMOTHY THAHANE)
CC:	David R. Bock	(DAVID BOCK)
CC:	Anupam Khanna	(ANUPAM KHANNA)

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

DATE: 30-Oct-1990 11:10am

TO: See Distribution Below

FROM: Alexander Shakow, EXTDR (ALEXANDER SHAKOW)

EXT.: 81368

SUBJECT: **BBC USSR Trip**

Tim - Attached is the plan for the BBC visit to the USSR. Sven called to say that Mr. Conable had decided that he did not want to encourage much press attention by taking initiatives with the press before and during this visit. This in part is due to the sensitivities of the Board and the uncertain nature of some of the discussions. He is also concerned about the size of the group. But Sven would like us to prepare advice for the team about what they should look out for, what we know about the press in Moscow, what materials might they take to explain the nature of the Bank, etc. There is a small window of opportunity for us to brief BBC after he returns from Africa and Europe on Nov. 12 and before the group leaves on the 14th (or is it 15th). David Bock will leave on Sunday the 11th to work with the Soviets on the technical assistance proposals and on logistics for the meetings. We should probably meet with David to discuss all this asap. We should also discuss with Wilfried what ideas we do have so that whatever arises the team will be able to handle. Let's discuss when you are back in the office later this week. Thanks, Alex

DISTRIBUTION:

TO:	Timothy Cullen	(TIMOTHY CULLEN)
CC:	Peter Riddleberger	(PETER RIDDLEBERGER)
CC:	Sarwar Lateef	(SARWAR LATEEF)
CC:	Julian Grenfell	(JULIAN GRENFELL)
CC:	Wilfried Thalwitz	(WILFRIED P. THALWITZ)
CC:	Paul Isenman	(PAUL ISENMAN)
CC:	David R. Bock	(DAVID BOCK)

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

DATE: 30-Oct-1990 10:28am EST

TO: See Distribution Below

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

EXT.: 81138

SUBJECT: **Mr Conable's trip to Soviet Union: status report..**

1. We are working on the assumption that that Mr and Mrs Conable will visit the Soviet Union on November 16 and 17 (arriving on the 15th and leaving on the 18th) . We were informed yesterday that an official invitation should arrive by the end of the week -- visa can then be arranged.

2. Two letters have been sent, to Mr Obminsky and Mr Gerashchenko, outlining the main topics which Mr Conable would be prepared to discuss during the visit: the Soviet study, the Soviet TA, and membership.

3. The following would travel with Mr and Mrs Conable: Wilfried Thalwitz, David Bock, Basil Kavalsky and Sven Sandstrom.

4. Briefing material is being prepared in a collaborative fashion within the following framework:

(a) PRE: the Soviet study (executive summary, talking points, etc), summary assessment of Gorbachev's economic plan, political scene, who is who, bio-data, etc.

PRE is also preparing a program for Mrs Conable, in consultation with Linda McLaughlin.

(b) OPS: Soviet TA (aide memoire, talking points, etc)

(c) FIN, with inputs from SEC and LEG: membership (issues note, talking points on procedures and issues, etc).

(d) IFC: talking points on potential IFC role in the transformation of the Soviet economy based on experience in Eastern Europe and elsewhere.

5. Written briefings are due to EXC by Thursday, November 8.

6. Oral briefing is scheduled for 3 pm on Monday, November 12.

7. The mission members will also be briefed by a couple of outside Soviet experts over lunch on Monday, November 12 (David Bock is arranging).

sent John S.

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

DATE: 29-Oct-1990 05:01pm

TO: Wilfried Thalwitz (WILFRIED P. THALWITZ)

FROM: John A. Holsen, PADSS (JOHN A. HOLSEN)

EXT.: 33719

SUBJECT: **JSSE**

1. Alan Whittome called me earlier to say that, before leaving Moscow, Teresa Ter-Minassian had not been able to reach any understanding regarding the dates for the discussions with Soviet officials (by PRs and team leaders) on the conclusions of the JSSE report. Alan tells me that, instead, he has now asked the Soviets what dates -- between November 26 and November 7 -- would be convenient with them. He is aware of your DAC obligations (and Mr. Zecchini's at the OECD), but apparently decided to ignore them. As the deed had already been done, I did not object when he told me the message he had sent to Moscow. Do you want to call him to remind him that you are unavailable on some dates? (Or do you want me to do so?) Dec.?

2. Alan tells me that the Fund will have its technical assistance paper finished tomorrow or Wednesday. We will exchange papers and meet to discuss them later in the week. I will keep Paul Isenman and David Bock informed and see that they are invited to any substantive discussions.

CC: Paul Isenman (PAUL ISENMAN)
CC: Patricia Gallagher (PATRICIA GALLAGHER)
CC: John A. Holsen (JOHN A. HOLSEN)

Tell him it is done.

P— SS's Malurity letter

done 10/30 to Gerashenko

Sandstrom Beck

Olson WT Fischer

Cortes Mink

Patricia said WT

signed ✓ Athena

faxed it last

night.

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

DATE: 29-Oct-1990 04:25pm

TO: See Distribution Below

FROM: John A. Holsen, PADSS (JOHN A. HOLSEN)

EXT.: 33719

SUBJECT: **FY91 Cost of JSSE**

1. This memo summarizes the current status of the budget for the Joint Study of the Soviet Economy. On the basis of the information available to date, I expect the study to be completed within the originally budgeted $650,000 except for (1) the additional costs resulting from the addition of Professor Fischer as a consultant to the project and (2) the possible addition to the project of some expenses which were originally expected to be covered by the units of the staff concerned.

2. Since the original budget was prepared on August 17 there have been a number of changes in the project, but those adding to costs (mainly additional travel to the USSR and Paris, but also some additional inputs from staff and consultants) should be offset by savings elsehere (mainly lower average travel costs because of "split charges" and less than expected expenses for local transport and interpreters).

3. The estimated costs for Prof. Fischer's consultancy is $25,000 (including two trips to the USSR). Including this raises the project cost to $675,000. The original estimates of the personnel costs for Holsen, Levy, Gelb and Schrenk that, as of the present, are being absorbed by their units amount to $102,000; in addition, travel costs of $30,000 for Gelb and Schrenk were to be covered by their division. If all of these costs were switched from the units concered to the JSSE project, the total would rise by an additional $132,000. However, because of the time involved in coordination between four international agencies, it now looks like Messrs. Holsen, Levy and Gelb will be devoting somewhat more time to this project than originally expected; consequently I would increase this figure from $132,000 to $150,000. Thus the required total budget for the project would then be $825,000 -- still well below the one million dollar danger point originally indicated.

4. Assuming no additions to the work to be done under the project, I expect that it will be completed in December and be kept within the indicated cost estimates. One possible additional expense, as part of a technical assistance effort, could be the sending of a number of the authors to the Soviet Union to discuss their background papers in some detail with interested officials; while this may prove desirable, it is assumed that such

additional work would be financed outside the present JSSE project.

DISTRIBUTION:

TO:	Wilfried Thalwitz	(WILFRIED P. THALWITZ)
CC:	Paul Isenman	(PAUL ISENMAN)
CC:	Gregory Ingram	(GREGORY INGRAM)
CC:	Richard N. Woodford	(RICHARD N. WOODFORD)
CC:	Keith Jay	(KEITH JAY)
CC:	Stephen Mink	(STEPHEN MINK)

The World Bank

1818 H Street, N.W.
Washington, D.C. 20433, U.S.A.

With the compliments of
Paul Isenman
Director
Policy & Review Department, PRE

October 30, 1990

done 10/30

to Messrs. Sandstrom
Bock
Holsen
Fischer
Michalopoulos
Mink

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

DATE October 29, 1990 **NO. OF PAGES** (Including this sheet) 12 **MESSAGE NO.**

TO STATE BANK USSR
Name ATTENTION: VICTOR V. RAKOV
Company/ Organization International Monetary Economic Department

Fax Tel. No. 9011 7095 921 6465
9011 7095 923 8196 or
9011 7095 923 8196
City & Country MOSCOW, USSR

FROM WORLD BANK
Name Wilfried P. Thalwitz, Sr. Vice President
Policy, Research & External Affairs
Dept./Div. Name

Fax Tel. No. 202 477 0952
Dept/Div No. 601/05

Room No. S13-131 Telephone No. 202 473 6860

SUBJECT/ REFERENCE Areas of Cooperation between Soviet Union and the World Bank in Preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

MESSAGE

PLEASE DELIVER URGENTLY TO MR. GERASCHENKO, CHAIRMAN, STATE BANK OF THE USSR, NEGLINNAYA 12, MOSCOW, UNION OF SOVIET SOCIALIST REPUBLICS.

Transmission authorized by Patricia M. Gallagher

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
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FACSIMILE COVER SHEET AND MESSAGE

DATE OCTOBER 29, 1990 **NO. OF PAGES** 12 (Including this sheet) **MESSAGE NO.**

TO Name MR. ERNEST OBMINSKI, DEPUTY MINISTER FOREIGN AFFAIRS & CHIEF OF FOREIGN MINISTRY DIRECTORATE FOR INTERNATIONAL EC.

Company/ Organization RELATIONS, MINISTRY OF FOREIGN AFFAIRS, USSR

Fax Tel. No. 9011 7095 2539088

City & Country MOSCOW, USSR

FROM Name WILFRIED P. THALWITZ, SR. VICE PRESIDENT
WORLD BANK
POLICY, RESEARCH & EXTERNAL AFFAIRS

Fax Tel. No. 202 477 0952

Dept./Div. Name PRESV **Dept/Div No.** 601/05

Room No. S13-131 **Telephone No.** 202 473 6860

SUBJECT/ REFERENCE

MESSAGE CC of Letter to Geraschenko, re Areas of Cooperation between Soviet Union and the World Bank in preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

..ansmission authorized by Patricia M. Gallagher

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

The World Bank
Washington, D.C. 20433
U.S.A.

WILFRIED P. THALWITZ
Senior Vice President
Policy, Research and External Affairs

October 29, 1990

Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR
Neglinnaya 12
Moscow
Union of Soviet Socialist Republics

Dear Mr. Gerashchenko:

Please find enclosed an aide memoire on possible areas of cooperation between the Soviet Union and the World Bank. In response to your request, I am sending this to you as background information to help prepare the visit by Mr. Conable to the Soviet Union.

As discussed with Mr. Obminsky, we believe that the purpose of Mr. Conable's visit should be to discuss with President Gorbachev and other senior officials the nature and scope of a future relationship between the USSR and the Bank. The first step in this emerging relationship is, of course, the Joint Study of the Soviet Economy, which is now being completed in collaboration with the IMF, the OECD and the EBRD. This study will deal with the challenges facing the Soviet Union and the Republics in the area of economic reform. More importantly, it will spell out the major actions required to implement systemic reform and revitalization of the Soviet economy.

The Joint Study will thus form a basis for follow-up cooperation between the USSR and the Bank. One important aspect of this follow-up work would be in our response in the area of technical assistance to the Union and the Republics. Because this work would be so closely linked to the overall transformation of the Soviet economy and the ongoing reform of economic policies, we believe that such a technical assistance program must be anchored in a mutual understanding at the most senior levels about the role that the Bank would be expected to play in the future development of the Soviet economy.

In this connection, I would like to point out that any such program will require the approval of the Bank's Board of Directors. Moreover, since the Bank's charter stipulates that its resources and facilities are to be used exclusively for the benefit of its members, this program will need to be funded in the near term by contributions from third parties or by reimbursements.

Mr. Conable would also be prepared to discuss the issues and next steps -- including at a political level -- associated with possible membership of the Soviet Union in the World Bank Group.

Our present plans are to send a small delegation of senior officials to Moscow a few days in advance of Mr. Conable's arrival, in order to finalize preparations for Mr. Conable's visit. We are ready to work closely with you and your colleagues to make this visit a successful milestone in this emerging Soviet-World Bank cooperation.

We look forward to hearing from you.

Sincerely yours,

Wilfried Thalwitz

cc: Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR

AIDE MEMOIRE

POSSIBLE WORLD BANK TECHNICAL ASSISTANCE PROGRAM
FOR THE SOVIET UNION

The World Bank, along with other institutions, is currently actively engaged in a joint study of the Soviet economy, which will examine some of the critical problems of economic recovery and reform. In discussions held during the IMF/IBRD Annual Meetings, the Soviet delegation requested further information on possible World Bank technical assistance beyond this initial study, in order to benefit from the experience of other countries, in Eastern Europe and around the world, and of those international institutions with substantial experience of economic reforms. The Soviet Union faces major challenges in its profound program of reform, and could benefit from this experience. As the Soviet team rightly noted, however, the Soviet economy is unique in size, diversity and sophistication, and in the depth and speed of change it wishes to bring about.

The Bank's member countries have looked to the Bank not just as a lender but as an experienced and objective advisor and provider of technical assistance. The Bank's analytical work and technical assistance span a very broad spectrum, from reform of the economic system and economy-wide policy formulation, through analysis of major sectoral problems, to specific project identification, preparation and appraisal. A key feature of the Bank's work with governments is to provide advice on policies, programs and institutions affecting a wide range of economic and social sectors, but to ensure at the same time that sectoral recommendations are broadly consistent with medium-term balance of payments and the fiscal situation, and are firmly related to investment strategy at the project level. In working on the issues of medium-term economic viability and macro-management, the Bank works closely with the International Monetary Fund, but especially focusses on possibilities of improvement in economic efficiency, restructuring of public expenditures, strengthening of incentives for the private sector, the role of the financial system and the role of the public sector in providing economic infrastructure, regulatory oversight and social protection.

This memorandum outlines areas of possible cooperation between the World Bank and the Soviet Union. The program of advice and technical assistance is comparable in many respects to that provided by the Bank to member countries, new or long established, which wish to undertake major economic reform programs. It must be noted at the outset that such an assistance program would require the formal approval of the Bank's Board of Directors and that it would need to be financed by third party contributions or reimbursements.

The scale and coverage of potential collaboration are set out in deliberately broad terms in this memorandum, to indicate what assistance might be made available. However, the actual scope of any program ultimately agreed will have to be carefully defined after further discussion between the Bank and the Soviet authorities. At this stage, for example, the Bank has limited knowledge of the government's priorities for technical assistance and has had no dialogue on this issue with the Soviet Republics, which would be expected to be beneficiaries of the Bank's support. Nor is it clear what the appropriate channels are through which such assistance might be provided to various governmental levels. Bearing these uncertainties in mind, this memorandum outlines areas of possible collaboration between the World Bank and the Soviet Union, and discusses modalities for carrying out and financing that assistance.

The content of this potential program is designed to be complementary to whatever parallel support might be provided by the IMF, in order to ensure broad coverage of the range of key issues for economy-wide reform. There would also be collaboration in the implementation of the two institutions' technical assistance programs.

<u>Program Outline</u>

The scope and content of technical assistance from the World Bank must be determined by decisions on economic reform to be taken by the Soviet authorities. Soviet economic policy debates have defined three broad challenges: to design and implement fundamental policy and institutional changes to transform the economic system; to develop the new institutions and economic practices which will allow an efficient market economy to flourish; and to increase the efficiency of investments and production in key sectors -- at Union and republic level, and in public and private sectors -- to support the transition to the new system. As Soviet decision-makers address these challenges and the difficult problems of consistency and sequencing which they entail, the Bank has experience and capacity to help at all three levels.

In summary, it is envisaged that the Bank would offer expertise to work alongside Soviet counterparts and provide advice and assistance in the following tasks:

- short-run actions to raise efficiency and production;

- detailed design and sequencing of economy-wide policy reforms, especially in the areas of trade, finance and prices;

- design and implementation of key institutional changes, especially in the financial system and in restructuring and privatization of the productive

and service sectors;

- design of sector-specific policy changes, and identification and assessment of sectoral investment priorities;

- training for Soviet cadres in a range of skills critical to a successful transition to a market economy; and

- coordination of external assistance.

These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment

through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank could also offer help in re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In industry, the broad business environment is the key -- and this will be set by the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvement in a limited number of subsectors. In agriculture, technical assistance would provide expertise on agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the Bank has a rapidly growing portfolio of experience to draw on.

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI)

can work with Soviet institutions to mount policy seminars and help to design training by Soviet institutions for officials and managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a head of program who would ensure that the Bank provided an integrated approach centred on the major problems of economic reform, rather than merely performing a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable proportion of their time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

Financing

The initial phase of the technical assistance program described in this aide memoire would be launched and implemented over at least a three-year period. A wide range of budgets is possible, depending on available funding, on Soviet decisions about how best to proceed with economic reform, on initial Soviet and Bank decisions about the desirable scope of the technical assistance, and on joint assessments of evolving experience as this enterprise gets underway. Extensions beyond the initial three years would also reflect these (and other) considerations.

To give some orders of magnitude, it is assumed that a major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be up to 60-80 staff years per year ($15-20 million) depending on mutually agreed work programs. With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million might be required.

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be limited in the near term. Accordingly, this program should be planned on the assumption that its costs would be covered by special resources contributed by third parties and/or reimbursements.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet could be on the basis of a Memorandum of Understanding (an example of such a Memorandum is attached for information only).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

. . . . . .

10/29/90

<u>Draft for Illustrative Purposes Only</u>

October 29, 1990

MEMORANDUM OF UNDERSTANDING

ON

TECHNICAL ASSISTANCE

The Government of [name of country] (the Government) wishes to avail itself of technical assistance from the International Bank for Reconstruction and Development (the Bank) in those fields of economic and human resources development which the Government considers to have the highest national priority and which fall within the specific competence and expertise of the Bank. The Government and the Bank have agreed to establish procedures to achieve this purpose and to provide for the necessary administrative and financial arrangements as set out below.

<u>Section 1</u>

(a) In ____ of each year, the Government and the Bank shall review, through their representatives, the programs, studies or other projects relating to the development of the economic and human resources of [name of country] for which the Government wishes to obtain from the Bank technical or other advisory services and for which the Bank would be able, within the scope of its competence and with grant resources available to it from donors, to provide such services to the Government during the forthcoming 12-month period (each, a program year).

(b) On the basis of this review, the Government and the Bank shall establish, by mutual agreement, an annual program of technical assistance, and related administrative budget, specifying for such program year:

- (i) the various programs, studies or other projects to be undertaken or continued during such program year for which technical or other advisory services are expected to be rendered by the Bank to the Government;
- (ii) the estimated overall staffing requirements of the Bank for such services; and
- (iii) the cost of such assistance.

(c) In establishing their annual program and administrative budget the Government and the Bank shall take into due consideration the technical and other advisory services which may be available to the Government from other international or national sources.

Section 2

The Government and the Bank shall in the course of each program year exchange views from time to time on the progress of the annual program and administrative budget for that program year and may by mutual agreement introduce such modifications in the program, and related administrative budget, as they shall deem to be desirable.

Section 3

(a) Within the scope and budgetary allocation of each annual program referred to in Section 1, the services needed for the activities specified in the annual program shall normally be provided through the appropriate departments of the Bank in accordance with the provisions of the annual program.

(b) For the purposes of this Memorandum of Understanding, the staff of the Bank shall include staff of any other Specialized Agency of the United Nations assigned to any activity hereunder pursuant to a formal cooperative program or informal administrative arrangement between the Bank and such Specialized Agency or other specialized expertise recruited by the Bank, either individually or institutionally, to supplement the Bank's permanent staff resources for the execution of the program of technical assistance. The selection and replacement of Bank staff to carry out any particular activity shall be in the sole discretion of the Bank. The Bank staff assigned to any particular activity hereunder shall, in the conduct thereof, be responsible to, and under the sole direction of the Bank.

Section 4

In special circumstances, the Bank may, within the scope and budgetary allocation of the annual programs referred to in Section 1 and under arrangements to be agreed upon in each case between the Government and the Bank:

(i) second, at the request of the Government, individual staff members of the Bank to the Government; and

(ii) direct and supervise on behalf of and for the account of the Government, a complex project or program requiring the use of outside consultants or other services.

Section 5

(a) The Government acknowledges that the Bank's cost of technical assistance activities hereunder are to be reimbursed by the Government and/or paid by grant funds provided by third parties, and that the Bank shall have no obligation to provide any technical assistance activity hereunder unless and until the Bank has received funds adequate to fully cover the cost of such activity.

(b) The rates for the services rendered by the Bank shall be calculated in accordance with the Bank's normal budgeting procedures to cover the full cost to the Bank of the services to be rendered.

Section 6

(a) The Government shall accord to the Bank and to the staff members of the Bank who shall be assigned to any activity under this Memorandum of Understanding, the status, privileges and immunities conferred on the Bank and Bank employees in the Articles of Agreement of the Bank, as if [name of country] was a member of the Bank.

(b) The Government shall, at the request of the Bank, make arrangements for the personnel of organizations engaged by the Bank to perform services hereunder to be provided with all necessary entry, stay and exit visas and permits and shall exempt such organizations and such personnel from (or pay on their behalf) any taxes and other duties on payments made to such organizations and such personnel in connection with services hereunder or on their personal effects or items brought into [name of country] by them in connection with services hereunder.

Section 7

The Government shall hold the Bank, its staff and other persons performing services hereunder harmless from any claims arising from any action, advice or omission of the Bank, its staff or such other persons in the provision of services under this Memorandum of Understanding except where the Government and the Bank have agreed that a claim arises from the wilful misconduct or gross negligence of any of the individuals mentioned above.

Section 8

The Government and the Bank shall each designate an official who shall be the official channel of communications for all matters arising under this Memorandum of Understanding and who shall be authorized in the name and on behalf of the party appointing such official to enter into agreement on the annual program and administrative budget and to take such other action as such official shall consider necessary or advisable with respect to matters arising under this Memorandum of Understanding.

Section 9

(a) The Bank in carrying out the services under this Memorandum of Understanding shall use the same care and diligence as it uses in its other operations. If, at any time, the Bank, after consultation with the Government, shall determine that for any reason it is unlikely that the services called for in any annual program can be successfully completed or carried out in accordance with the usual standards and practices which are applied by the Bank in its operations, the Bank may cease the provision of such services.

(b) If at any time the Government shall decide that it no longer wishes a specific service to be provided by the Bank under the terms of any annual program, it may so notify the Bank and the Bank shall, following receipt of such notice, cease to carry out such service. Notwithstanding any other provision of this Memorandum of Understanding, the Government shall reimburse the Bank for any costs incurred by the Bank with respect to such service.

Section 10

The understandings reached in this Memorandum of Understanding shall remain in force and effect until six months after the date on which either party shall have notified the other of its intention to terminate this arrangement. Upon receipt of such notice, the parties shall take all appropriate steps to terminate in an orderly fashion the activities then ongoing.

On behalf of:

Government of [name of country] ____________________ (date)

International Bank for
Reconstruction and Development: ____________________ (date)

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

DATE October 29, 1990 NO. OF PAGES (Including this sheet) 12 MESSAGE NO.

TO STATE BANK USSR
Name ATTENTION: VICTOR V. RAKOV
Company/Organization International Monetary Economic Department

Fax Tel. No. 9011 7095 921 6465
9011 7095 923 8196 or
9011 7095 923 8196
City & Country MOSCOW, USSR

FROM WORLD BANK
Name Wilfried P. Thalwitz, Sr. Vice President
Policy, Research & External Affairs
Dept./Div. Name

Fax Tel. No. 202 477 0952
Dept/Div No. 601/05

Room No. S13-131 Telephone No. 202 473 6860

SUBJECT/REFERENCE Areas of Cooperation between Soviet Union and the World Bank in Preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

MESSAGE

PLEASE DELIVER URGENTLY TO MR. GERASCHENKO, CHAIRMAN, STATE BANK OF THE USSR, NEGLINNAYA 12, MOSCOW, UNION OF SOVIET SOCIALIST REPUBLICS.

Transmission authorized by Patricia M. Gallagher

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1884 (2-90)

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
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FACSIMILE COVER SHEET AND MESSAGE

DATE OCTOBER 29, 1990 NO. OF PAGES 12 (Including this sheet) MESSAGE NO.

TO Name Company/ Organization: MR. ERNEST OBMINSKI, DEPUTY MINISTER FOREIGN AFFAIRS & CHIEF OF FOREIGN MINISTRY DIRECTORATE FOR INTERNATIONAL EC. RELATIONS, MINISTRY OF FOREIGN AFFAIRS, USSR

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POLICY, RESEARCH & EXTERNAL AFFAIRS

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SUBJECT/ REFERENCE

MESSAGE

CC of Letter to Geraschenko, re Areas of Cooperation between Soviet Union and the World Bank in preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

..ansmission authorized by Patricia M. Gallagher

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

The World Bank
Washington, D.C. 20433
U.S.A.

WILFRIED P. THALWITZ
Senior Vice President
Policy, Research and External Affairs

October 29, 1990

Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR
Neglinnaya 12
Moscow
Union of Soviet Socialist Republics

Dear Mr. Gerashchenko:

Please find enclosed an aide memoire on possible areas of cooperation between the Soviet Union and the World Bank. In response to your request, I am sending this to you as background information to help prepare the visit by Mr. Conable to the Soviet Union.

As discussed with Mr. Obminsky, we believe that the purpose of Mr. Conable's visit should be to discuss with President Gorbachev and other senior officials the nature and scope of a future relationship between the USSR and the Bank. The first step in this emerging relationship is, of course, the Joint Study of the Soviet Economy, which is now being completed in collaboration with the IMF, the OECD and the EBRD. This study will deal with the challenges facing the Soviet Union and the Republics in the area of economic reform. More importantly, it will spell out the major actions required to implement systemic reform and revitalization of the Soviet economy.

The Joint Study will thus form a basis for follow-up cooperation between the USSR and the Bank. One important aspect of this follow-up work would be in our response in the area of technical assistance to the Union and the Republics. Because this work would be so closely linked to the overall transformation of the Soviet economy and the ongoing reform of economic policies, we believe that such a technical assistance program must be anchored in a mutual understanding at the most senior levels about the role that the Bank would be expected to play in the future development of the Soviet economy.

In this connection, I would like to point out that any such program will require the approval of the Bank's Board of Directors. Moreover, since the Bank's charter stipulates that its resources and facilities are to be used exclusively for the benefit of its members, this program will need to be funded in the near term by contributions from third parties or by reimbursements.

Mr. Conable would also be prepared to discuss the issues and next steps -- including at a political level -- associated with possible membership of the Soviet Union in the World Bank Group.

Our present plans are to send a small delegation of senior officials to Moscow a few days in advance of Mr. Conable's arrival, in order to finalize preparations for Mr. Conable's visit. We are ready to work closely with you and your colleagues to make this visit a successful milestone in this emerging Soviet-World Bank cooperation.

We look forward to hearing from you.

Sincerely yours,

Wilfried Thalwitz

cc: Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR

AIDE MEMOIRE

POSSIBLE WORLD BANK TECHNICAL ASSISTANCE PROGRAM
FOR THE SOVIET UNION

The World Bank, along with other institutions, is currently actively engaged in a joint study of the Soviet economy, which will examine some of the critical problems of economic recovery and reform. In discussions held during the IMF/IBRD Annual Meetings, the Soviet delegation requested further information on possible World Bank technical assistance beyond this initial study, in order to benefit from the experience of other countries, in Eastern Europe and around the world, and of those international institutions with substantial experience of economic reforms. The Soviet Union faces major challenges in its profound program of reform, and could benefit from this experience. As the Soviet team rightly noted, however, the Soviet economy is unique in size, diversity and sophistication, and in the depth and speed of change it wishes to bring about.

The Bank's member countries have looked to the Bank not just as a lender but as an experienced and objective advisor and provider of technical assistance. The Bank's analytical work and technical assistance span a very broad spectrum, from reform of the economic system and economy-wide policy formulation, through analysis of major sectoral problems, to specific project identification, preparation and appraisal. A key feature of the Bank's work with governments is to provide advice on policies, programs and institutions affecting a wide range of economic and social sectors, but to ensure at the same time that sectoral recommendations are broadly consistent with medium-term balance of payments and the fiscal situation, and are firmly related to investment strategy at the project level. In working on the issues of medium-term economic viability and macro-management, the Bank works closely with the International Monetary Fund, but especially focusses on possibilities of improvement in economic efficiency, restructuring of public expenditures, strengthening of incentives for the private sector, the role of the financial system and the role of the public sector in providing economic infrastructure, regulatory oversight and social protection.

This memorandum outlines areas of possible cooperation between the World Bank and the Soviet Union. The program of advice and technical assistance is comparable in many respects to that provided by the Bank to member countries, new or long established, which wish to undertake major economic reform programs. It must be noted at the outset that such an assistance program would require the formal approval of the Bank's Board of Directors and that it would need to be financed by third party contributions or reimbursements.

The scale and coverage of potential collaboration are set out in deliberately broad terms in this memorandum, to indicate what assistance might be made available. However, the actual scope of any program ultimately agreed will have to be carefully defined after further discussion between the Bank and the Soviet authorities. At this stage, for example, the Bank has limited knowledge of the government's priorities for technical assistance and has had no dialogue on this issue with the Soviet Republics, which would be expected to be beneficiaries of the Bank's support. Nor is it clear what the appropriate channels are through which such assistance might be provided to various governmental levels. Bearing these uncertainties in mind, this memorandum outlines areas of possible collaboration between the World Bank and the Soviet Union, and discusses modalities for carrying out and financing that assistance.

The content of this potential program is designed to be complementary to whatever parallel support might be provided by the IMF, in order to ensure broad coverage of the range of key issues for economy-wide reform. There would also be collaboration in the implementation of the two institutions' technical assistance programs.

Program Outline

The scope and content of technical assistance from the World Bank must be determined by decisions on economic reform to be taken by the Soviet authorities. Soviet economic policy debates have defined three broad challenges: to design and implement fundamental policy and institutional changes to transform the economic system; to develop the new institutions and economic practices which will allow an efficient market economy to flourish; and to increase the efficiency of investments and production in key sectors -- at Union and republic level, and in public and private sectors -- to support the transition to the new system. As Soviet decision-makers address these challenges and the difficult problems of consistency and sequencing which they entail, the Bank has experience and capacity to help at all three levels.

In summary, it is envisaged that the Bank would offer expertise to work alongside Soviet counterparts and provide advice and assistance in the following tasks:

- short-run actions to raise efficiency and production;
- detailed design and sequencing of economy-wide policy reforms, especially in the areas of trade, finance and prices;
- design and implementation of key institutional changes, especially in the financial system and in restructuring and privatization of the productive

and service sectors;

- design of sector-specific policy changes, and identification and assessment of sectoral investment priorities;

- training for Soviet cadres in a range of skills critical to a successful transition to a market economy; and

- coordination of external assistance.

These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment

through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank could also offer help in re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In industry, the broad business environment is the key -- and this will be set by the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvement in a limited number of subsectors. In agriculture, technical assistance would provide expertise on agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the Bank has a rapidly growing portfolio of experience to draw on.

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI)

can work with Soviet institutions to mount policy seminars and help to design training by Soviet institutions for officials and managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a head of program who would ensure that the Bank provided an integrated approach centred on the major problems of economic reform, rather than merely performing a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable proportion of their time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

Financing

The initial phase of the technical assistance program described in this aide memoire would be launched and implemented over at least a three-year period. A wide range of budgets is possible, depending on available funding, on Soviet decisions about how best to proceed with economic reform, on initial Soviet and Bank decisions about the desirable scope of the technical assistance, and on joint assessments of evolving experience as this enterprise gets underway. Extensions beyond the initial three years would also reflect these (and other) considerations.

To give some orders of magnitude, it is assumed that a major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be up to 60-80 staff years per year ($15-20 million) depending on mutually agreed work programs. With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million might be required.

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be limited in the near term. Accordingly, this program should be planned on the assumption that its costs would be covered by special resources contributed by third parties and/or reimbursements.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet could be on the basis of a Memorandum of Understanding (an example of such a Memorandum is attached for information only).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

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10/29/90

Draft for Illustrative Purposes Only

October 29, 1990

MEMORANDUM OF UNDERSTANDING

ON

TECHNICAL ASSISTANCE

The Government of [name of country] (the Government) wishes to avail itself of technical assistance from the International Bank for Reconstruction and Development (the Bank) in those fields of economic and human resources development which the Government considers to have the highest national priority and which fall within the specific competence and expertise of the Bank. The Government and the Bank have agreed to establish procedures to achieve this purpose and to provide for the necessary administrative and financial arrangements as set out below.

Section 1

(a) In ____ of each year, the Government and the Bank shall review, through their representatives, the programs, studies or other projects relating to the development of the economic and human resources of [name of country] for which the Government wishes to obtain from the Bank technical or other advisory services and for which the Bank would be able, within the scope of its competence and with grant resources available to it from donors, to provide such services to the Government during the forthcoming 12-month period (each, a program year).

(b) On the basis of this review, the Government and the Bank shall establish, by mutual agreement, an annual program of technical assistance, and related administrative budget, specifying for such program year:

- (i) the various programs, studies or other projects to be undertaken or continued during such program year for which technical or other advisory services are expected to be rendered by the Bank to the Government;
- (ii) the estimated overall staffing requirements of the Bank for such services; and
- (iii) the cost of such assistance.

(c) In establishing their annual program and administrative budget the Government and the Bank shall take into due consideration the technical and other advisory services which may be available to the Government from other international or national sources.

Section 2

The Government and the Bank shall in the course of each program year exchange views from time to time on the progress of the annual program and administrative budget for that program year and may by mutual agreement introduce such modifications in the program, and related administrative budget, as they shall deem to be desirable.

Section 3

(a) Within the scope and budgetary allocation of each annual program referred to in Section 1, the services needed for the activities specified in the annual program shall normally be provided through the appropriate departments of the Bank in accordance with the provisions of the annual program.

(b) For the purposes of this Memorandum of Understanding, the staff of the Bank shall include staff of any other Specialized Agency of the United Nations assigned to any activity hereunder pursuant to a formal cooperative program or informal administrative arrangement between the Bank and such Specialized Agency or other specialized expertise recruited by the Bank, either individually or institutionally, to supplement the Bank's permanent staff resources for the execution of the program of technical assistance. The selection and replacement of Bank staff to carry out any particular activity shall be in the sole discretion of the Bank. The Bank staff assigned to any particular activity hereunder shall, in the conduct thereof, be responsible to, and under the sole direction of the Bank.

Section 4

In special circumstances, the Bank may, within the scope and budgetary allocation of the annual programs referred to in Section 1 and under arrangements to be agreed upon in each case between the Government and the Bank:

(i) second, at the request of the Government, individual staff members of the Bank to the Government; and

(ii) direct and supervise on behalf of and for the account of the Government, a complex project or program requiring the use of outside consultants or other services.

Section 5

(a) The Government acknowledges that the Bank's cost of technical assistance activities hereunder are to be reimbursed by the Government and/or paid by grant funds provided by third parties, and that the Bank shall have no obligation to provide any technical assistance activity hereunder unless and until the Bank has received funds adequate to fully cover the cost of such activity.

(b) The rates for the services rendered by the Bank shall be calculated in accordance with the Bank's normal budgeting procedures to cover the full cost to the Bank of the services to be rendered.

Section 6

(a) The Government shall accord to the Bank and to the staff members of the Bank who shall be assigned to any activity under this Memorandum of Understanding, the status, privileges and immunities conferred on the Bank and Bank employees in the Articles of Agreement of the Bank, as if [name of country] was a member of the Bank.

(b) The Government shall, at the request of the Bank, make arrangements for the personnel of organizations engaged by the Bank to perform services hereunder to be provided with all necessary entry, stay and exit visas and permits and shall exempt such organizations and such personnel from (or pay on their behalf) any taxes and other duties on payments made to such organizations and such personnel in connection with services hereunder or on their personal effects or items brought into [name of country] by them in connection with services hereunder.

Section 7

The Government shall hold the Bank, its staff and other persons performing services hereunder harmless from any claims arising from any action, advice or omission of the Bank, its staff or such other persons in the provision of services under this Memorandum of Understanding except where the Government and the Bank have agreed that a claim arises from the wilful misconduct or gross negligence of any of the individuals mentioned above.

Section 8

The Government and the Bank shall each designate an official who shall be the official channel of communications for all matters arising under this Memorandum of Understanding and who shall be authorized in the name and on behalf of the party appointing such official to enter into agreement on the annual program and administrative budget and to take such other action as such official shall consider necessary or advisable with respect to matters arising under this Memorandum of Understanding.

Section 9

(a) The Bank in carrying out the services under this Memorandum of Understanding shall use the same care and diligence as it uses in its other operations. If, at any time, the Bank, after consultation with the Government, shall determine that for any reason it is unlikely that the services called for in any annual program can be successfully completed or carried out in accordance with the usual standards and practices which are applied by the Bank in its operations, the Bank may cease the provision of such services.

(b) If at any time the Government shall decide that it no longer wishes a specific service to be provided by the Bank under the terms of any annual program, it may so notify the Bank and the Bank shall, following receipt of such notice, cease to carry out such service. Notwithstanding any other provision of this Memorandum of Understanding, the Government shall reimburse the Bank for any costs incurred by the Bank with respect to such service.

Section 10

The understandings reached in this Memorandum of Understanding shall remain in force and effect until six months after the date on which either party shall have notified the other of its intention to terminate this arrangement. Upon receipt of such notice, the parties shall take all appropriate steps to terminate in an orderly fashion the activities then ongoing.

On behalf of:

Government of [name of country] ____________________ (date)

International Bank for
Reconstruction and Development: ____________________ (date)

Mr. Oxenman

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
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October 29, 1990

Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign
Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR
Smolenskya Square
Moscow
Union of Soviet Socialist Republics

Dear Mr. Obminsky:

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We look forward to hearing from you.

Yours sincerely,

Willi A. Wapenhans
Acting Senior Vice President, Operations

cc: Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR

AIDE MEMOIRE

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Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a head of program who would ensure that the Bank provided an integrated approach centred on the major problems of economic reform, rather than merely performing a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable proportion of their time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

Financing

The initial phase of the technical assistance program described in this aide memoire would be launched and implemented over at least a three-year period. A wide range of budgets is possible, depending on available funding, on Soviet decisions about how best to proceed with economic reform, on initial Soviet and Bank decisions about the desirable scope of the technical assistance, and on joint assessments of evolving experience as this enterprise gets underway. Extensions beyond the initial three years would also reflect these (and other) considerations.

To give some orders of magnitude, it is assumed that a major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be up to 60-80 staff years per year ($15-20 million) depending on mutually agreed work programs. With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million might be required.

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be limited in the near term. Accordingly, this program should be planned on the assumption that its costs would be covered by special resources contributed by third parties and/or reimbursements.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet could be on the basis of a Memorandum of Understanding (an example of such a Memorandum is attached for information only).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

. . . . . .

10/29/90

Draft for Illustrative
Purposes Only

October 29, 1990

MEMORANDUM OF UNDERSTANDING

ON

TECHNICAL ASSISTANCE

The Government of [name of country] (the Government) wishes to avail itself of technical assistance from the International Bank for Reconstruction and Development (the Bank) in those fields of economic and human resources development which the Government considers to have the highest national priority and which fall within the specific competence and expertise of the Bank. The Government and the Bank have agreed to establish procedures to achieve this purpose and to provide for the necessary administrative and financial arrangements as set out below.

Section 1

(a) In ____ of each year, the Government and the Bank shall review, through their representatives, the programs, studies or other projects relating to the development of the economic and human resources of [name of country] for which the Government wishes to obtain from the Bank technical or other advisory services and for which the Bank would be able, within the scope of its competence and with grant resources available to it from donors, to provide such services to the Government during the forthcoming 12-month period (each, a program year).

(b) On the basis of this review, the Government and the Bank shall establish, by mutual agreement, an annual program of technical assistance, and related administrative budget, specifying for such program year:

(i) the various programs, studies or other projects to be undertaken or continued during such program year for which technical or other advisory services are expected to be rendered by the Bank to the Government;

(ii) the estimated overall staffing requirements of the Bank for such services; and

(iii) the cost of such assistance.

(c) In establishing their annual program and administrative budget the Government and the Bank shall take into due consideration the technical and other advisory services which may be available to the Government from other international or national sources.

Section 2

The Government and the Bank shall in the course of each program year exchange views from time to time on the progress of the annual program and administrative budget for that program year and may by mutual agreement introduce such modifications in the program, and related administrative budget, as they shall deem to be desirable.

Section 3

(a) Within the scope and budgetary allocation of each annual program referred to in Section 1, the services needed for the activities specified in the annual program shall normally be provided through the appropriate departments of the Bank in accordance with the provisions of the annual program.

(b) For the purposes of this Memorandum of Understanding, the staff of the Bank shall include staff of any other Specialized Agency of the United Nations assigned to any activity hereunder pursuant to a formal cooperative program or informal administrative arrangement between the Bank and such Specialized Agency or other specialized expertise recruited by the Bank, either individually or institutionally, to supplement the Bank's permanent staff resources for the execution of the program of technical assistance. The selection and replacement of Bank staff to carry out any particular activity shall be in the sole discretion of the Bank. The Bank staff assigned to any particular activity hereunder shall, in the conduct thereof, be responsible to, and under the sole direction of the Bank.

Section 4

In special circumstances, the Bank may, within the scope and budgetary allocation of the annual programs referred to in Section 1 and under arrangements to be agreed upon in each case between the Government and the Bank:

(i) second, at the request of the Government, individual staff members of the Bank to the Government; and

(ii) direct and supervise on behalf of and for the account of the Government, a complex project or program requiring the use of outside consultants or other services.

Section 5

(a) The Government acknowledges that the Bank's cost of technical assistance activities hereunder are to be reimbursed by the Government and/or paid by grant funds provided by third parties, and that the Bank shall have no obligation to provide any technical assistance activity hereunder unless and until the Bank has received funds adequate to fully cover the cost of such activity.

(b) The rates for the services rendered by the Bank shall be calculated in accordance with the Bank's normal budgeting procedures to cover the full cost to the Bank of the services to be rendered.

Section 6

(a) The Government shall accord to the Bank and to the staff members of the Bank who shall be assigned to any activity under this Memorandum of Understanding, the status, privileges and immunities conferred on the Bank and Bank employees in the Articles of Agreement of the Bank, as if [name of country] was a member of the Bank.

(b) The Government shall, at the request of the Bank, make arrangements for the personnel of organizations engaged by the Bank to perform services hereunder to be provided with all necessary entry, stay and exit visas and permits and shall exempt such organizations and such personnel from (or pay on their behalf) any taxes and other duties on payments made to such organizations and such personnel in connection with services hereunder or on their personal effects or items brought into [name of country] by them in connection with services hereunder.

Section 7

The Government shall hold the Bank, its staff and other persons performing services hereunder harmless from any claims arising from any action, advice or omission of the Bank, its staff or such other persons in the provision of services under this Memorandum of Understanding except where the Government and the Bank have agreed that a claim arises from the wilful misconduct or gross negligence of any of the individuals mentioned above.

Section 8

The Government and the Bank shall each designate an official who shall be the official channel of communications for all matters arising under this Memorandum of Understanding and who shall be authorized in the name and on behalf of the party appointing such official to enter into agreement on the annual program and administrative budget and to take such other action as such official shall consider necessary or advisable with respect to matters arising under this Memorandum of Understanding.

Section 9

(a) The Bank in carrying out the services under this Memorandum of Understanding shall use the same care and diligence as it uses in its other operations. If, at any time, the Bank, after consultation with the Government, shall determine that for any reason it is unlikely that the services called for in any annual program can be successfully completed or carried out in accordance with the usual standards and practices which are applied by the Bank in its operations, the Bank may cease the provision of such services.

(b) If at any time the Government shall decide that it no longer wishes a specific service to be provided by the Bank under the terms of any annual program, it may so notify the Bank and the Bank shall, following receipt of such notice, cease to carry out such service. Notwithstanding any other provision of this Memorandum of Understanding, the Government shall reimburse the Bank for any costs incurred by the Bank with respect to such service.

Section 10

The understandings reached in this Memorandum of Understanding shall remain in force and effect until six months after the date on which either party shall have notified the other of its intention to terminate this arrangement. Upon receipt of such notice, the parties shall take all appropriate steps to terminate in an orderly fashion the activities then ongoing.

On behalf of:

Government of [name of country] ____________________ (date)

International Bank for
Reconstruction and Development: ____________________ (date)

FORM NO. 89
(2–83)

THE WORLD BANK

RECEIVED

ROUTING SLIP

Date 10/29/90

OFFICE OF THE PRESIDENT

PRDDR

Name	Room No.
Mr. David Bock	
cc: Mr. Wood	
Mr. Shihata	
Mr. Isenman	

	To Handle		Note and File
	Appropriate Disposition		Prepare Reply
	Approval		Per Our Conversation
	Information		Recommendation

Remarks

Mr. Conable has approved the attached to be forwarded quickly, once the changes have been made in the Aide Memoire as suggested.

Sven Sandstrom

From

ROUTING SLIP	DATE 10/26/90

OFFICE OF THE SENIOR VICE PRESIDENT, OPERATIONS

NAME	ROOM NO.
Mr. Wood	
Mr. Shihata	
Mr. Isenman	
✓ cc: Mr. Sandstrom	

	To Handle		Note and File
	Appropriate Disposition		Note and Return
	Approval		Prepare Reply
	Comment		Per Our Conversation
	Full Report		Recommendation
	Information		Signature
	Initial		Send On

REMARKS

May I have your clearance soonest for forwarding to Wilfried and Kim for signature.

FROM
David R. Bock

Small pencilled changes on pp. 2, 3, 4, 5, 6 of aide memoire.
L.

This seems fine to me — should go quickly —
B.C.

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION
1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.
(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

The World Bank
Washington, D.C. 20433

WILFRIED P. THALWITZ
Senior Vice President
Policy, Research and External Affairs

October 26, 1990

Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR
Neglinnaya 12
Moscow
Union of Soviet Socialist Republics

Dear Mr. Gerashchenko:

Please find enclosed an aide memoire on possible areas of cooperation between the Soviet Union and the World Bank. I am sending this to you as background information in the preparation of the visit by Mr. Conable to the Soviet Union.

As discussed with Mr. Obminsky, we believe that the purpose of Mr. Conable's visit should be to discuss with President Gorbachev and other senior officials the nature and scope of a future relationship between the USSR and the Bank. The first step in this emerging relationship is, of course, the Joint Study of the Soviet Economy, which is now being completed in collaboration with the IMF, the OECD and the EBRD. This study will deal with the challenges facing the Soviet Union and the Republics in the area of economic reform. More importantly, it will spell out the major actions required to implement systemic reform and revitalization of the Soviet economy.

The Joint Study will thus form a basis for follow-up cooperation between the USSR and the Bank. One important aspect of this follow-up work would be in our response in the area of technical assistance to the Union and the Republics. Because this work would be so closely linked to the overall transformation of the Soviet economy and the ongoing reform of economic policies, we believe that such a technical assistance program must be anchored in a mutual understanding at the most senior levels about the role that the Bank would be expected to play in the future development of the Soviet economy.

In this connection, I would like to point out that any such program will require the approval of the Bank's Board of Directors and will need to be funded largely, if not exclusively, by reimbursements or contributions by third parties.

Mr. Conable would also be prepared to discuss the issues and next steps -- including at a political level -- associated with possible membership of the Soviet Union in the World Bank Group.

Our present plans are to send a small delegation of senior officials to Moscow a few days in advance of Mr. Conable's arrival, in order to finalize preparations for Mr. Conable's visit. We are ready to work closely with you and your colleagues to make this visit a successful milestone in this emerging Soviet-World Bank cooperation.

We look forward to hearing from you.

Sincerely yours,

cc: Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

October 26, 1990

Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign
Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR
Smolenskya Square
Moscow
Union of Soviet Socialist Republics

Dear Mr. Obminsky:

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We look forward to hearing from you.

Yours sincerely,

Edward V. K. Jaycox
Acting Senior Vice President, Operations

cc: Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR

POSSIBLE WORLD BANK TECHNICAL ASSISTANCE PROGRAM FOR THE SOVIET UNION

The World Bank, along with other institutions, is currently actively engaged in a joint study of the Soviet economy, which will examine some of the critical problems of economic recovery and reform. In discussions held during the IMF/IBRD Annual Meetings, the Soviet delegation requested further information on possible World Bank technical assistance beyond this initial study, in order to benefit from the experience of other countries, in Eastern Europe and around the world, and of those international institutions with substantial experience of economic reforms. The Soviet Union faces major challenges in its profound program of reform, and could benefit from this experience. As the Soviet team rightly noted, however, the Soviet economy is unique in size, diversity and sophistication, and in the depth and speed of change it wishes to bring about.

The Bank's member countries have looked to the Bank not just as a lender but as an experienced and objective advisor and provider of technical assistance. The Bank's analytical work and technical assistance span a very broad spectrum, from reform of the economic system and economy-wide policy formulation, through analysis of major sectoral problems, to specific project identification, preparation and appraisal. A key feature of the Bank's work with governments is to provide advice on policies, programs and institutions affecting a wide range of economic and social sectors, but to ensure at the same time that sectoral recommendations are broadly consistent with medium-term balance of payments and the fiscal situation, and are firmly related to investment strategy at the project level. In working on the issues of medium-term economic viability and macro-management, the Bank works closely with the International Monetary Fund, but especially focusses on possibilities of improvement in economic efficiency, restructuring of public expenditures, strengthening of incentives for the private sector, the role of the financial system and the role of the public sector in providing economic infrastructure, regulatory oversight and social protection.

This memorandum outlines areas of possible cooperation between the World Bank and the Soviet Union. The program of advice and technical assistance is comparable in many respects to that provided by the Bank to member countries, new or long established, which wish to undertake major economic reform programs. It must be noted at the outset that such an assistance program would require the formal approval of the Bank's Board of Directors and that it would need to be financed largely or exclusively by reimbursements or third party contributions.

The scale and coverage of potential collaboration are set out in deliberately broad terms in this memorandum, to indicate what assistance might be made available. However, the actual scope of any program ultimately agreed will have to be carefully defined after further discussion between the Bank and the Soviet authorities. At this stage, for example, the Bank has limited knowledge of the government's priorities for technical assistance and has had no dialogue on this issue with the Soviet Republics, who would be expected to be major direct beneficiaries of the Bank's support. Nor is it clear what the appropriate channels are through which such assistance might be provided to various governmental levels. Bearing these uncertainties in mind, this memorandum outlines areas of possible collaboration between the World Bank and the Soviet Union, and discusses modalities for carrying out and financing that assistance.

The content of this potential program is designed to be complementary to whatever parallel support might be provided by the IMF, in order to ensure broad coverage of the range of key issues for economy-wide reform. There would also be collaboration in the implementation of the two institutions' technical assistance programs.

Program Outline

The scope and content of technical assistance from the World Bank must be determined by decisions on economic reform to be taken by the Soviet authorities. Soviet economic policy debates have defined three broad challenges: to design and implement fundamental policy and institutional changes to transform the economic system; to develop the new institutions and economic practices which will allow an efficient market economy to flourish; and to increase the efficiency of investments and production in key sectors -- at Union and republic level, and in public and private sectors -- to support the transition to the new system. As Soviet decision-makers address these challenges and the difficult problems of consistency and sequencing which they entail, the Bank has experience and capacity to help at all three levels.

In summary, it is envisaged that the Bank would offer expertise to work alongside Soviet counterparts and provide advice and assistance in the following tasks:

- short-run actions to raise efficiency and production;
- detailed design and sequencing of economy-wide policy reforms, especially in the areas of trade, finance and prices;
- design and implementation of key institutional changes, especially in the financial system and in restructuring and privatization of the productive and service sectors;

- design of sector-specific policy changes, and identification and assessment of sectoral investment priorities;
- training for Soviet cadres in a range of skills critical to a successful transition to a market economy; and
- coordination of external assistance.

These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank could also offer help in re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In industry, the broad business environment is the key -- and this will be set by the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvement in a limited number of subsectors. In agriculture, technical assistance would provide expertise on agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the Bank has a rapidly growing portfolio of experience ~~to draw on.~~ on which to dra

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI) can work with Soviet institutions to ~~mount~~ policy seminars and develop help to design training by Soviet institutions for officials and managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a ~~head of~~ program leader who would ensure that the Bank provide~~d~~s an integrated approach centred on the major problems of economic reform, rather than merely perform~~ing~~s a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable ~~proportion~~ amount of ~~their~~ time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

centered

Financing

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To give some orders of magnitude, it is assumed that a major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be within the range of 60-80 staff years ($15-20 million). With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million is indicated.

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be very limited. Accordingly, this program should be planned on the assumption that its costs would be covered by reimbursements and/or special resources contributed by third parties.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet Union would be on the basis of a Memorandum of Understanding (a model of such a Memorandum is attached).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

. . . . .

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

DATE October 29, 1990 **NO. OF PAGES** 12 (Including this sheet) **MESSAGE NO.**

TO STATE BANK USSR
Name ATTENTION: VICTOR V. RAKOV
Company/Organization International Monetary Economic Department

Fax Tel. No. 9011 7095 921 6465
9011 7095 923 8196 or
9011 7095 923 8196
City & Country MOSCOW, USSR

FROM WORLD BANK
Name Wilfried P. Thalwitz, Sr. Vice President
Policy, Research & External Affairs
Dept./Div. Name

Fax Tel. No. 202 477 0952

Dept/Div No. 601/05

Room No. S13-131 Telephone No. 202 473 6860

SUBJECT/REFERENCE Areas of Cooperation between Soviet Union and the World Bank in Preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

MESSAGE

PLEASE DELIVER URGENTLY TO MR. GERASCHENKO, CHAIRMAN, STATE BANK OF THE USSR, NEGLINNAYA 12, MOSCOW, UNION OF SOVIET SOCIALIST REPUBLICS.

Transmission authorized by Patricia M. Gallagher

If you experience any problem in receiving this transmission, inform the sender at the telephone or fax number listed above.

1884 (2-90)

THE WORLD BANK/IFC/M.I.G.A.
Headquarters: Washington, D.C. 20433 U.S.A.
Tel. No. (202) 477-1234 // Fax Tel. No. (202) 477-6391 // Telex No. RCA 248423

FACSIMILE COVER SHEET AND MESSAGE

DATE OCTOBER 29, 1990 **NO. OF PAGES** 12 (Including this sheet) **MESSAGE NO.**

TO Name MR. ERNEST OBMINSKI, DEPUTY MINISTER FOREIGN AFFAIRS & CHIEF OF FOREIGN MINISTRY DIRECTORATE FOR INTERNATIONAL EC.
Company/ Organization RELATIONS, MINISTRY OF FOREIGN AFFAIRS, USSR
Fax Tel. No. 9011 7095 2539088
City & Country MOSCOW, USSR

FROM Name WILFRIED P. THALWITZ, SR. VICE PRESIDENT
WORLD BANK
POLICY, RESEARCH & EXTERNAL AFFAIRS
Fax Tel. No. 202 477 0952

Dept./Div. Name PRESV **Dept/Div No.** 601/05

Room No. S13-131 **Telephone No.** 202 473 6860

SUBJECT/ REFERENCE

MESSAGE CC of Letter to Geraschenko, re Areas of Cooperation between Soviet Union and the World Bank in preparation for visit to Soviet Union of World Bank President, Barber B. Conable.

..ansmission authorized by Patricia M. Gallagher

The World Bank
Washington, D.C. 20433
U.S.A.

WILFRIED P. THALWITZ
Senior Vice President
Policy, Research and External Affairs

October 29, 1990

Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR
Neglinnaya 12
Moscow
Union of Soviet Socialist Republics

Dear Mr. Gerashchenko:

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As discussed with Mr. Obminsky, we believe that the purpose of Mr. Conable's visit should be to discuss with President Gorbachev and other senior officials the nature and scope of a future relationship between the USSR and the Bank. The first step in this emerging relationship is, of course, the Joint Study of the Soviet Economy, which is now being completed in collaboration with the IMF, the OECD and the EBRD. This study will deal with the challenges facing the Soviet Union and the Republics in the area of economic reform. More importantly, it will spell out the major actions required to implement systemic reform and revitalization of the Soviet economy.

The Joint Study will thus form a basis for follow-up cooperation between the USSR and the Bank. One important aspect of this follow-up work would be in our response in the area of technical assistance to the Union and the Republics. Because this work would be so closely linked to the overall transformation of the Soviet economy and the ongoing reform of economic policies, we believe that such a technical assistance program must be anchored in a mutual understanding at the most senior levels about the role that the Bank would be expected to play in the future development of the Soviet economy.

In this connection, I would like to point out that any such program will require the approval of the Bank's Board of Directors. Moreover, since the Bank's charter stipulates that its resources and facilities are to be used exclusively for the benefit of its members, this program will need to be funded in the near term by contributions from third parties or by reimbursements.

Mr. Conable would also be prepared to discuss the issues and next steps -- including at a political level -- associated with possible membership of the Soviet Union in the World Bank Group.

Our present plans are to send a small delegation of senior officials to Moscow a few days in advance of Mr. Conable's arrival, in order to finalize preparations for Mr. Conable's visit. We are ready to work closely with you and your colleagues to make this visit a successful milestone in this emerging Soviet-World Bank cooperation.

We look forward to hearing from you.

Sincerely yours,

Wilfried Thalwitz

cc: Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR

AIDE MEMOIRE

POSSIBLE WORLD BANK TECHNICAL ASSISTANCE PROGRAM
FOR THE SOVIET UNION

The World Bank, along with other institutions, is currently actively engaged in a joint study of the Soviet economy, which will examine some of the critical problems of economic recovery and reform. In discussions held during the IMF/IBRD Annual Meetings, the Soviet delegation requested further information on possible World Bank technical assistance beyond this initial study, in order to benefit from the experience of other countries, in Eastern Europe and around the world, and of those international institutions with substantial experience of economic reforms. The Soviet Union faces major challenges in its profound program of reform, and could benefit from this experience. As the Soviet team rightly noted, however, the Soviet economy is unique in size, diversity and sophistication, and in the depth and speed of change it wishes to bring about.

The Bank's member countries have looked to the Bank not just as a lender but as an experienced and objective advisor and provider of technical assistance. The Bank's analytical work and technical assistance span a very broad spectrum, from reform of the economic system and economy-wide policy formulation, through analysis of major sectoral problems, to specific project identification, preparation and appraisal. A key feature of the Bank's work with governments is to provide advice on policies, programs and institutions affecting a wide range of economic and social sectors, but to ensure at the same time that sectoral recommendations are broadly consistent with medium-term balance of payments and the fiscal situation, and are firmly related to investment strategy at the project level. In working on the issues of medium-term economic viability and macro-management, the Bank works closely with the International Monetary Fund, but especially focusses on possibilities of improvement in economic efficiency, restructuring of public expenditures, strengthening of incentives for the private sector, the role of the financial system and the role of the public sector in providing economic infrastructure, regulatory oversight and social protection.

This memorandum outlines areas of possible cooperation between the World Bank and the Soviet Union. The program of advice and technical assistance is comparable in many respects to that provided by the Bank to member countries, new or long established, which wish to undertake major economic reform programs. It must be noted at the outset that such an assistance program would require the formal approval of the Bank's Board of Directors and that it would need to be financed by third party contributions or reimbursements.

The scale and coverage of potential collaboration are set out in deliberately broad terms in this memorandum, to indicate what assistance might be made available. However, the actual scope of any program ultimately agreed will have to be carefully defined after further discussion between the Bank and the Soviet authorities. At this stage, for example, the Bank has limited knowledge of the government's priorities for technical assistance and has had no dialogue on this issue with the Soviet Republics, which would be expected to be beneficiaries of the Bank's support. Nor is it clear what the appropriate channels are through which such assistance might be provided to various governmental levels. Bearing these uncertainties in mind, this memorandum outlines areas of possible collaboration between the World Bank and the Soviet Union, and discusses modalities for carrying out and financing that assistance.

The content of this potential program is designed to be complementary to whatever parallel support might be provided by the IMF, in order to ensure broad coverage of the range of key issues for economy-wide reform. There would also be collaboration in the implementation of the two institutions' technical assistance programs.

<u>Program Outline</u>

The scope and content of technical assistance from the World Bank must be determined by decisions on economic reform to be taken by the Soviet authorities. Soviet economic policy debates have defined three broad challenges: to design and implement fundamental policy and institutional changes to transform the economic system; to develop the new institutions and economic practices which will allow an efficient market economy to flourish; and to increase the efficiency of investments and production in key sectors -- at Union and republic level, and in public and private sectors -- to support the transition to the new system. As Soviet decision-makers address these challenges and the difficult problems of consistency and sequencing which they entail, the Bank has experience and capacity to help at all three levels.

In summary, it is envisaged that the Bank would offer expertise to work alongside Soviet counterparts and provide advice and assistance in the following tasks:

- short-run actions to raise efficiency and production;
- detailed design and sequencing of economy-wide policy reforms, especially in the areas of trade, finance and prices;
- design and implementation of key institutional changes, especially in the financial system and in restructuring and privatization of the productive

and service sectors;

- design of sector-specific policy changes, and identification and assessment of sectoral investment priorities;
- training for Soviet cadres in a range of skills critical to a successful transition to a market economy; and
- coordination of external assistance.

These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment

through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank could also offer help in re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In industry, the broad business environment is the key -- and this will be set by the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvement in a limited number of subsectors. In agriculture, technical assistance would provide expertise on agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the Bank has a rapidly growing portfolio of experience to draw on.

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI)

can work with Soviet institutions to mount policy seminars and help to design training by Soviet institutions for officials and managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a head of program who would ensure that the Bank provided an integrated approach centred on the major problems of economic reform, rather than merely performing a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable proportion of their time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

Financing

The initial phase of the technical assistance program described in this aide memoire would be launched and implemented over at least a three-year period. A wide range of budgets is possible, depending on available funding, on Soviet decisions about how best to proceed with economic reform, on initial Soviet and Bank decisions about the desirable scope of the technical assistance, and on joint assessments of evolving experience as this enterprise gets underway. Extensions beyond the initial three years would also reflect these (and other) considerations.

To give some orders of magnitude, it is assumed that a major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be up to 60-80 staff years per year ($15-20 million) depending on mutually agreed work programs. With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million might be required.

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be limited in the near term. Accordingly, this program should be planned on the assumption that its costs would be covered by special resources contributed by third parties and/or reimbursements.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet could be on the basis of a Memorandum of Understanding (an example of such a Memorandum is attached for information only).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

. . . . .

10/29/90

Draft for Illustrative Purposes Only

October 29, 1990

MEMORANDUM OF UNDERSTANDING

ON

TECHNICAL ASSISTANCE

The Government of [name of country] (the Government) wishes to avail itself of technical assistance from the International Bank for Reconstruction and Development (the Bank) in those fields of economic and human resources development which the Government considers to have the highest national priority and which fall within the specific competence and expertise of the Bank. The Government and the Bank have agreed to establish procedures to achieve this purpose and to provide for the necessary administrative and financial arrangements as set out below.

Section 1

(a) In ____ of each year, the Government and the Bank shall review, through their representatives, the programs, studies or other projects relating to the development of the economic and human resources of [name of country] for which the Government wishes to obtain from the Bank technical or other advisory services and for which the Bank would be able, within the scope of its competence and with grant resources available to it from donors, to provide such services to the Government during the forthcoming 12-month period (each, a program year).

(b) On the basis of this review, the Government and the Bank shall establish, by mutual agreement, an annual program of technical assistance, and related administrative budget, specifying for such program year:

(i) the various programs, studies or other projects to be undertaken or continued during such program year for which technical or other advisory services are expected to be rendered by the Bank to the Government;

(ii) the estimated overall staffing requirements of the Bank for such services; and

(iii) the cost of such assistance.

(c) In establishing their annual program and administrative budget the Government and the Bank shall take into due consideration the technical and other advisory services which may be available to the Government from other international or national sources.

Section 2

The Government and the Bank shall in the course of each program year exchange views from time to time on the progress of the annual program and administrative budget for that program year and may by mutual agreement introduce such modifications in the program, and related administrative budget, as they shall deem to be desirable.

Section 3

(a) Within the scope and budgetary allocation of each annual program referred to in Section 1, the services needed for the activities specified in the annual program shall normally be provided through the appropriate departments of the Bank in accordance with the provisions of the annual program.

(b) For the purposes of this Memorandum of Understanding, the staff of the Bank shall include staff of any other Specialized Agency of the United Nations assigned to any activity hereunder pursuant to a formal cooperative program or informal administrative arrangement between the Bank and such Specialized Agency or other specialized expertise recruited by the Bank, either individually or institutionally, to supplement the Bank's permanent staff resources for the execution of the program of technical assistance. The selection and replacement of Bank staff to carry out any particular activity shall be in the sole discretion of the Bank. The Bank staff assigned to any particular activity hereunder shall, in the conduct thereof, be responsible to, and under the sole direction of the Bank.

Section 4

In special circumstances, the Bank may, within the scope and budgetary allocation of the annual programs referred to in Section 1 and under arrangements to be agreed upon in each case between the Government and the Bank:

(i) second, at the request of the Government, individual staff members of the Bank to the Government; and

(ii) direct and supervise on behalf of and for the account of the Government, a complex project or program requiring the use of outside consultants or other services.

Section 5

(a) The Government acknowledges that the Bank's cost of technical assistance activities hereunder are to be reimbursed by the Government and/or paid by grant funds provided by third parties, and that the Bank shall have no obligation to provide any technical assistance activity hereunder unless and until the Bank has received funds adequate to fully cover the cost of such activity.

(b) The rates for the services rendered by the Bank shall be calculated in accordance with the Bank's normal budgeting procedures to cover the full cost to the Bank of the services to be rendered.

Section 6

(a) The Government shall accord to the Bank and to the staff members of the Bank who shall be assigned to any activity under this Memorandum of Understanding, the status, privileges and immunities conferred on the Bank and Bank employees in the Articles of Agreement of the Bank, as if [name of country] was a member of the Bank.

(b) The Government shall, at the request of the Bank, make arrangements for the personnel of organizations engaged by the Bank to perform services hereunder to be provided with all necessary entry, stay and exit visas and permits and shall exempt such organizations and such personnel from (or pay on their behalf) any taxes and other duties on payments made to such organizations and such personnel in connection with services hereunder or on their personal effects or items brought into [name of country] by them in connection with services hereunder.

Section 7

The Government shall hold the Bank, its staff and other persons performing services hereunder harmless from any claims arising from any action, advice or omission of the Bank, its staff or such other persons in the provision of services under this Memorandum of Understanding except where the Government and the Bank have agreed that a claim arises from the wilful misconduct or gross negligence of any of the individuals mentioned above.

Section 8

The Government and the Bank shall each designate an official who shall be the official channel of communications for all matters arising under this Memorandum of Understanding and who shall be authorized in the name and on behalf of the party appointing such official to enter into agreement on the annual program and administrative budget and to take such other action as such official shall consider necessary or advisable with respect to matters arising under this Memorandum of Understanding.

Section 9

(a) The Bank in carrying out the services under this Memorandum of Understanding shall use the same care and diligence as it uses in its other operations. If, at any time, the Bank, after consultation with the Government, shall determine that for any reason it is unlikely that the services called for in any annual program can be successfully completed or carried out in accordance with the usual standards and practices which are applied by the Bank in its operations, the Bank may cease the provision of such services.

(b) If at any time the Government shall decide that it no longer wishes a specific service to be provided by the Bank under the terms of any annual program, it may so notify the Bank and the Bank shall, following receipt of such notice, cease to carry out such service. Notwithstanding any other provision of this Memorandum of Understanding, the Government shall reimburse the Bank for any costs incurred by the Bank with respect to such service.

Section 10

The understandings reached in this Memorandum of Understanding shall remain in force and effect until six months after the date on which either party shall have notified the other of its intention to terminate this arrangement. Upon receipt of such notice, the parties shall take all appropriate steps to terminate in an orderly fashion the activities then ongoing.

On behalf of:

Government of [name of country] ____________________ (date)

International Bank for
Reconstruction and Development: ____________________ (date)

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

DATE: 29-Oct-1990 03:23pm

TO: Sven Sandstrom (SVEN SANDSTROM)

FROM: Stephen Mink, DECVP (STEPHEN MINK)

EXT.: 33696

SUBJECT: **Mrs. Conable's visit to the Soviet Union**

In response to your EM to Mr. Isenman this morning, I contacted Ms. Barbara Herz, PHRWD, and Mr. Timothy King, the Soviet study team member dealing with the social sectors. Both were frank in assessing that the Bank has not yet developed the contacts in the Soviet Union to enable making detailed suggestions on a program for Mrs. Conable. However, Ms. Herz spoke this morning with Mrs. Conable by phone, and my understanding is that Mrs. Conable has decided there are useful things to accomplish on the trip, and that she will go.

My understanding is that Mr. Gorbachev's advisor on women's affairs has not yet been contacted. How should we proceed on this? I gather from this morning's phone conversation that Ms. Conable may have her own suggestions and possible contacts for a program in Moscow.

CC: Paul Isenman (PAUL ISENMAN)
CC: John A. Holsen (JOHN A. HOLSEN)
CC: Barbara Herz (BARBARA HERZ)

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RQQWIEB GBK SU
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MOSCOW THE USSR STATE BANK 26.10.90

TO: MR. DAVID R. BOCK , DIRECTOR
OFFICE OF THE SENIOR VICE
PRESIDENT FOR OPERATIONS
WORLD BANK

FROM: STATE BANK OF THE USSR

DEAR SIR,

THANK YOU FOR YOUR TELEX OF OCTOBER 26. WE CONSIDER THE IDEA OF PROVIDING US WITH SOME MATERIALS TO THE AGENDA OF THE MEETING BETWEEN MR. CONABLE AND MR. GORBATCHEV BEING SUITABLE. THE DATE OF VISIT , AS IT WAS EARLIER DEFINED , REMAINS THE SAME - NOVEMBER 16 , 1990 . WE REMAIN

SINCERELY YOURS

O.V.MOZHAISKOV
MANAGING DIRECTOR

Mr Thalwitz 10/29
Wilfried,
David thinks this means they're working on it, not that this is an official confirmation.
Paul

=10261159

NNNN

cc: Messrs. Holsen, Mink, Costas

done 10/30

WORLDBANK TMSS

L

DISCONNECTED

*** END OF DOCUMENT ***

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION
The World Bank
Washington, D.C. 20433
U.S.A.
1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.
(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS
WILFRIED P. THALWITZ
Senior Vice President
Policy, Research and External Affairs

October 26, 1990

RECEIVED
90 OCT 26 PM 5:18
PRDDR

Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR
Neglinnaya 12
Moscow
Union of Soviet Socialist Republics

Dear Mr. Gerashchenko:

Please find enclosed an aide memoire on possible areas of cooperation between the Soviet Union and the World Bank. I am sending this to you as background information in the preparation of the visit by Mr. Conable to the Soviet Union.

As discussed with Mr. Obminsky, we believe that the purpose of Mr. Conable's visit should be to discuss with President Gorbachev and other senior officials the nature and scope of a future relationship between the USSR and the Bank. The first step in this emerging relationship is, of course, the Joint Study of the Soviet Economy, which is now being completed in collaboration with the IMF, the OECD and the EBRD. This study will deal with the challenges facing the Soviet Union and the Republics in the area of economic reform. More importantly, it will spell out the major actions required to implement systemic reform and revitalization of the Soviet economy.

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In this connection, I would like to point out that any such program will require the approval of the Bank's Board of Directors and will need to be funded largely, if not exclusively, by reimbursements or contributions by third parties.

Mr. Conable would also be prepared to discuss the issues and next steps -- including at a political level -- associated with possible membership of the Soviet Union in the World Bank Group.

Our present plans are to send a small delegation of senior officials to Moscow a few days in advance of Mr. Conable's arrival, in order to finalize preparations for Mr. Conable's visit. We are ready to work closely with you and your colleagues to make this visit a successful milestone in this emerging Soviet-World Bank cooperation.

We look forward to hearing from you.

Sincerely yours,

cc: Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR

The World Bank
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL DEVELOPMENT ASSOCIATION

1818 H Street, N.W.
Washington, D.C. 20433
U.S.A.

(202) 477-1234
Cable Address: INTBAFRAD
Cable Address: INDEVAS

October 26, 1990

Mr. Ernest E. Obminsky
Deputy Minister of Foreign Affairs and Chief of Foreign
Ministry Directorate for International Economic Relations
Ministry of Foreign Affairs of the USSR
Smolenskya Square
Moscow
Union of Soviet Socialist Republics

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Yours sincerely,

Edward V. K. Jaycox
Acting Senior Vice President, Operations

cc: Mr. Viktor Gerashchenko
Chairman
State Bank of the USSR

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FOR THE SOVIET UNION

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These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank could also offer help in re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In industry, the broad business environment is the key -- and this will be set by the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvement in a limited number of subsectors. In agriculture, technical assistance would provide expertise on agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the Bank has a rapidly growing portfolio of experience to draw on.

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI) can work with Soviet institutions to mount policy seminars and help to design training by Soviet institutions for officials and

three years would also ...

To give some orders of magnitude, it is assumed that a managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could help the Soviet Government utilize external resources cost-effectively, and may become particularly important as the range of external entities providing assistance to the Soviet Union increases.

Modalities

In designing this assistance, a multi-year program should be envisaged, most likely at least three years in the first instance. The Bank would provide highly qualified and experienced staff and consultants in each of the major areas, working under a head of program who would ensure that the Bank provided an integrated approach centred on the major problems of economic reform, rather than merely performing a series of disparate technical tasks. The team primarily responsible for systemic reform issues, for example, would be headed by a leading Bank economist, and might include experts in fiscal, trade and financial economics, supported by institutional and financial experts dealing with matters such as privatization and the design of transitional social safety nets. Comparable teams would work in the major sectors, and in the provision of training and technical assistance coordination, within a coherent framework. Team leaders drawn from senior Bank staff would assign individual experts to work alongside relevant Soviet colleagues, and liaise with the Soviet authorities on the detailed content of evolving work programs. These teams would spend a considerable proportion of their time in the Soviet Union and would be supplemented by a substantial budget for specialized short-term expertise.

Financing

The initial phase of the technical assistance program described in this aide memoire would be launched and implemented over at least a three-year period. A wide range of budgets is possible, depending on available funding, on Soviet decisions about how best to proceed with economic reform, on initial Soviet and Bank decisions about the desirable scope of the technical assistance, and on joint assessments of evolving experience as this enterprise gets underway. Extensions beyond the initial three years would also reflect these (and other) considerations.

To give some orders of magnitude, it is assumed that a

*** END OF DOCUMENT ***

18-20

 2-4

major multi-sectoral study is carried out in the first year, broadening and deepening the analysis of the current Fund/Bank/EBRD/OECD study. In parallel, other assistance equivalent to 20-40 staff years, or $5-10 million, would get underway. In the second and third years, the program might be within the range of 60-80 staff years ($15-20 million). With overheads, e.g. for secretarial and computing support and interpreting services, a total three-year funding requirement of up to $50 million is indicated. 30 40-16

Give wider range,

None of these costs could be borne by the Bank's regular administrative budget unless the USSR were to apply for membership. Even then, the scope for such financing would be very limited. Accordingly, this program should be planned on the assumption that its costs would be covered by reimbursements and/or special resources contributed by third parties.

Next Steps

The immediate next step is for the Soviet authorities to make a decision in principle on the nature and scale of technical assistance that they would wish to have from the Bank. Based on such a decision, Bank management would be prepared to send a technical mission to Moscow to discuss a more specific work program and budget and to agree on a financing plan.

Following agreement on these items, management would present the proposed program to the Bank's Board of Executive Directors. Formal agreement between the Bank and the Soviet would be on the basis of a Memorandum of Understanding (a model of such a Memorandum is attached).

In parallel with the above, Bank management would be prepared to work with Soviet authorities in seeking external funding to support the program. As the funding begins to emerge, and subject to approval of the World Bank's Directors, Bank management would proceed with initial staffing and other administrative steps to implement the program.

. . . . .

*** END OF DOCUMENT ***

FROM OPNSV (FRI)10.26'90 16:04 NO. ...207256 P. 1

FORM NO. 1599 (8-80) THE WORLD BANK

ROUTING SLIP	DATE 10/26/90

OFFICE OF THE SENIOR VICE PRESIDENT, OPERATIONS

NAME	ROOM NO.
Mr. Wood	
Mr. Shihata	
✓ Mr. Isenman	
cc: Mr. Sandstrom	

	To Handle		Note and File
	Appropriate Disposition		Note and Return
	Approval		Prepare Reply
	Comment		Per Our Conversation
	Full Report		Recommendation
	Information		Signature
	Initial		Send On

REMARKS

May I have your clearance soonest for forwarding to Wilfried and Kim for signature.

FROM

David R. Bock 72942

~~p 5 missing~~ rec'd

RECEIVED
90 OCT 26 PM 5:18
P R D D R

Szv JA

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

DATE: 26-Oct-1990 09:50am EST

TO: David R. Bock (DAVID BOCK)

FROM: D. Joseph Wood, FPRVP (JOE WOOD)

EXT.: 80602

SUBJECT: **RE: Draft Letter to Soviets**

The reference to discussions of membership "at the political level" will presumably be read as Barber's willingness to seek U.S. (or G-7) support for Soviet membership. Has Barber agreed to this?

Ernie has not told me of any discussions with G-7 officials concerning Soviet membership. If there have been some -which there may well have been- and Barber judges that he has sufficient support to expect a broadly favorable G-7 reaction, then your letter is fine. If there has been no such preliminary soundings, then It would be very risky for Barber to hint that he will lobby the G-7. The message will get back to the G-7 immediately, and they will doubtless feel aggrieved.

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

DATE: 26-Oct-1990 10:05am

TO: Paul Isenman (PAUL ISENMAN)
TO: Geoffrey B. Lamb (GEOFFREY B. LAMB)

FROM: Susan Ulbaek, PRDPD (SUSAN ULBAEK)

EXT.: 31299

SUBJECT: **EC assistance for the Soviet Union**

I do not know whether you already know about the content of the proposal for a EC assistance package for the Soviet Union. If not it might be useful for your briefing for Mr. Conable on the Paris meeting on Eastern Europe and in general.

The proposal includes:
-- technical assistance for sectors/areas such as administration, divestiture, and development of the financial sector.
-- support of concrete projects in the infrastructure sector i.e. telecommunication, transport, and distribution networks, and
-- collaboration between the institutions of the EC in areas such as analytical work, and technical advice.

Apparently there is not yet any numbers on the various components.
The Commission finds it too early in the reform process to provide larger sums e.g. for balance of payments support.

The EC Summit is going to discuss assistance for the Soviet Union at their meeting on Sunday in Rome. We will be getting the meeting communique from the EC delegation Monday.

Susan

Sv HA

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

DATE: 26-Oct-1990 08:47am

TO: David R. Bock (DAVID BOCK)
TO: Sven Sandstrom (SVEN SANDSTROM)

FROM: Paul Isenman, PRDDR (PAUL ISENMAN)

EXT.: 33957

SUBJECT: Schedule for Briefing Material for BBC (Tentative) Visit

Here's our current briefing schedule. However, Sven is to contact me on who has the lead on membership among Finance, LEG, and Secretary's; and John is going to suggest how we handle briefings for meetings with e.g. Yeltsin.

Can we, before it is too late, avoid slipping into the acronymese that is endemic in teh Bank. Soviet study and Soviet TA (admittedly partly an acronym) seem to me preferable to TAPSU and JSSE (two girl's names(?).

CC: Costas Michalopoulos (COSTAS MICHALOPOULOS)
CC: John A. Holsen (JOHN A. HOLSEN)
CC: Stephen Mink (STEPHEN MINK)

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

DATE: 25-Oct-1990 10:24am EST

TO: Paul Isenman (PAUL ISENMAN)

FROM: Costas Michalopoulos, EMNVP (COSTAS MICHALOPOULOS)

EXT.: 32596

SUBJECT: BBC visit to USSR-timetable for briefings

Following our conversation, here are my suggestions for a time timetable for the briefing material:

First Drafts

JSEE- John Holsen--November 2

TAPSU- Stephen Mink-- Oct. 30

AM/Cover Letter- David Bock--As appropriate,depending on USSR contact

Membership Material- Secretary's - You should contact; material should be ready Nov.2

Bios- John Holsen to get- November 2

Material for Other Meetings- John Holsen will call me with suggestions as to who should do

Comments to Authors: COB November 5

Final Drafts to Thalwitz/Qureshi- COB November 6

Transmittal to Conable November 8

Please modify as you see fit.

10/26/90

Soviet Study:

D
A
Z
ES

Nov 1st 0 draft
5-6 PC mtg.

> Alter wages/
> Rep. prices!
> Aid linked to accelerated reform.
Ration. (Larry)
diversion vs Russ. prices

Stabilize first.
> Too many leaks already >
> Priority to keeping ~~market~~ union market together
> Can administered prices be made more reasonable.

Go with Shatalin:
1st best
2nd best.

Accept current approach: changes on margin.
Then how fast

Huge subsidies:=
> Meat milk bread housing.
Don't need cut consumption

Too much cowboyism
Ration (?) - diversion.
> 1st best
> 2nd best

Alter – Key is shift in wages
& prices.

Stan – Plan so vague we can
deal with it.

Subsidies – aid.

J-F -- borrow another legal
code.

~~Repeat Telex to MW?~~ [illegible]

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

DATE: 26-Oct-1990 05:57pm

TO: Paul Isenman (PAUL ISENMAN)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: **RE: Draft Letter to Soviets**

Re Mozhaikov's telex: I don't know. I assume it means the bureaucracy is committed to pushing it through.

CC: Sven Sandstrom (SVEN SANDSTROM)

FROM OPNSV (FRI)10.26'90 10:07 / NO.3060[illegible] P

(NB: letter sent by fax)

The World Bank / 1818 H Street, N.W., Washington, D.C. 20433, U.S.A. • Telephone: (202) 393-6360 • Cables: INTBAFRAD

cc Mr. Fischer

done

October 25, 1990

Mr. Oleg Mozhaiskov, Managing Director
Monetary and Economic Research Department
State Bank of the USSR
Moscow
Union of Soviet Socialist Republics

Dear Mr. Mozhaiskov:

Thank you for your telex of October 24 and invitation for Mr. Fischer and myself to come to Moscow next week. Unfortunately, this timing is problematic and I would like to propose an alternative approach.

My understanding is that the purpose of such a visit would be to prepare the ground for the meeting between Mr. Conable and Mr. Gorbachev. The agenda and possible date for such a meeting were discussed by Mr. Obminsky and Mr. Qureshi on October 13, and we are still awaiting confirmation of that meeting.

We understand that you are still working towards a meeting on November 16. Our thinking had been that one or two senior people from the Bank might come to Moscow a few days before Mr. Conable's visit in order to finalize the agenda and provide necessary background information. I now understand, however, that you would like preparatory work to commence much earlier, hence the proposed date of October 30-31 for the preparatory mission. May I suggest that we instead send you some background material to the agenda early next week. Once you have reviewed this material, we could be in touch by telephone or fax to identify additional questions or items for discussion. If you still feel that an earlier preparatory mission would be required, we will do our best to accommodate you.

As to the date of Mr. Conable's visit, we see a "window of opportunity" for this visit in mid-November. Otherwise, it may need to be postponed until early in 1991. Could you please confirm this date as soon as possible.

Sincerely,

David R. Bock
Director, Operations Staff
Office of the Senior Vice President-Operations

RECEIVED
90 OCT 26 PM 12: 11
PRDDR

cc: Dr. Andrei Ye. Bugrov
Ministry of Foreign Affairs

Mr. E. Safronev
Ministry of Foreign Affairs

CC: Messrs. Holsen, Mink, Costas Michalopoulos

done 10/26

BOOK OF 3 TELEXES

1) MR. OLEG MOZHAISKOV
MANAGING DIRECTOR
MONETRY AND ECONOMIC RESEARCH DEPARTMENT
STATE BANK OF THE USSR
MOSCOW, USSR
(Telex: 411283 GBK SU)

2) DR. ANDREI YE. BUGROV
DEPUTY DIRECTOR
DEPARTMENT OF INTERNATIONAL ECONOMIC RELATIONS
MINISTRY OF FOREIGN AFFAIRS
MOSCOW, USSR
(Telex:

3) MR. E. SAFRONEV
CHIEF OF STAFF TO MR. OBMINSKY
MINISTRY OF FOREIGN AFFAIRS
MOSCOW, USSR
(Telex:

RECEIVED
90 OCT 26 PM 12:11
PRDDR

done 10/26 cc: Holsen
Mimh
Cotas

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PAGE 1 OF 2

OFFICIAL DEPT/DIV ABBREVIATION: OPNSV

MESSAGE NUMBER

TEST NUMBER (FOR CASHIER'S USE ONLY)

START HERE

MR. OLEG MOZHAISKOV, MANAGING DIRECTOR, MONETARY AND ECONOMIC RESEARCH DEPARTMENT, STATE BANK OF THE USSR, MOSCOW, USSR.

COPIED: DR. ANDREI YE. BUGROV, MINISTRY OF FOREIGN AFFAIRS; MR. E. SAFRONEV, MINISTRY OF FOREIGN AFFAIRS.

THANK YOU FOR YOUR TELEX OF OCTOBER 24 AND INVITATION FOR MR. FISCHER AND MYSELF TO COME TO MOSCOW NEXT WEEK. UNFORTUNATELY, THIS TIMING IS PROBLEMATIC AND I WOULD LIKE TO PROPOSE AN ALTERNATIVE APPROACH.

MY UNDERSTANDING IS THAT THE PURPOSE OF SUCH A VISIT WOULD BE TO PREPARE THE GROUND FOR THE MEETING BETWEEN MR. CONABLE AND MR. GORBACHEV. THE AGENDA AND POSSIBLE DATE FOR SUCH A MEETING WAS DISCUSSED BY MR. OBMINSKY AND MR. QURESHI ON OCTOBER 13, AND WE ARE STILL AWAITING CONFIRMATION OF THAT MEETING.

WE UNDERSTAND THAT YOU ARE STILL WORKING TOWARDS A MEETING ON NOVEMBER 16. OUR THINKING HAD BEEN THAT ONE OR TWO SENIOR PEOPLE FROM THE BANK MIGHT COME TO MOSCOW A FEW DAYS BEFORE MR. CONABLE'S VISIT IN ORDER TO FINALIZE THE AGENDA AND PROVIDE NECESSARY BACKGROUND INFORMATION. I NOW UNDERSTAND, HOWEVER, THAT YOU WOULD LIKE PREPARATORY WORK TO COMMENCE MUCH EARLIER, HENCE THE PROPOSED DATE OF OCTOBER 30-31 FOR THE PREPARATORY

END OF TEXT

PINK AREA TO BE LEFT BLANK AT ALL TIMES

INFORMATION BELOW NOT TO BE TRANSMITTED

CLASS OF SERVICE: TELEX	TELEX NO.: (BOOK OF 3)	DATE: 10/25/90
SUBJECT:	DRAFTED BY:	EXTENSION:
CLEARANCES AND COPY DISTRIBUTION: Cc. Messrs. Halsen, Mink, Costas	AUTHORIZED BY (Name and Signature): David R. Bock	
	DEPARTMENT: OPNSV	
	SECTION BELOW FOR USE OF CABLE SECTION	
	CHECKED FOR DISPATCH	

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PAGE 2 OF 2 OFFICIAL DEPT/DIV ABBREVIATION OPNSV MESSAGE NUMBER TEST NUMBER (FOR CASHIER'S USE ONLY)

START HERE

MISSION. MAY I SUGGEST THAT WE INSTEAD SEND YOU SOME BACKGROUND MATERIAL TO THE AGENDA EARLY NEXT WEEK. ONCE YOU HAVE REVIEWED THIS MATERIAL, WE COULD BE IN TOUCH BY TELEPHONE OR FAX TO IDENTIFY ADDITIONAL QUESTIONS OR ITEMS FOR DISCUSSION. IF YOU STILL FEEL THAT AN EARLIER PREPARATORY MISSION WOULD BE REQUIRED, WE WILL DO OUR BEST TO ACCOMMODATE YOU.

AS TO THE DATE OF MR. CONABLE'S VISIT, WE SEE A "WINDOW OF OPPORTUNITY" FOR THIS VISIT IN MID-NOVEMBER. OTHERWISE, IT MAY NEED TO BE POSTPONED UNTIL EARLY IN 1991. COULD YOU PLEASE CONFIRM THIS DATE AS SOON AS POSSIBLE. DAVID R. BOCK, DIRECTOR, OPERATIONS STAFF, OFFICE OF THE SENIOR VICE PRESIDENT FOR OPERATIONS, WORLD BANK

RECEIVED
90 OCT 26 PM 12: 11
P R D D R

END OF TEXT

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CLASS OF SERVICE: TELEX	TELEX NO.: (BOOK OF 3)	DATE: 10/25/90
SUBJECT:	DRAFTED BY: DBock/mjw	EXTENSION: 82856
CLEARANCES AND COPY DISTRIBUTION: Cleared with & cc: Messrs. Sandstrom, Wisenman cc: Mr. Qureshi (o/r)	AUTHORIZED BY (Name and Signature): David R. Bock DEPARTMENT OPNSV SECTION BELOW FOR USE OF CABLE SECTION CHECKED FOR DISPATCH	

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THE WORLD BANK

ROUTING SLIP	DATE 10.25.90
FROM THE SENIOR VICE PRESIDENT, POLICY, RESEARCH AND EXTERNAL AFFAIRS	
NAME	ROOM NO.
cc: Messrs. Isenman	
Mink (for Distribution)	

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

REMARKS

[illegible]
11/2

FROM: Wilfried P. Thalwitz

sads\w46935

2/30

Office Memorandum

October 25, 1990

To: Mr. Flemming
Mr. Thalwitz
Mr. Zecchini

From: L.A. Whittome

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

TABLE OF CONTENTS

4/30

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:

5/30

- 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 demonopolized 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 adventuristic, 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

6/30

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.

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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 system, 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 programs 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 ba

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-fixer 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, incuding 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.

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 stablization develop. Changes in taxes and interest rates will be made to promote business activity and investment.

<u>Stage IV - Completion of the Stabilization Period</u>

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 activity, 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 resolving a key problem of the transition to a market economy--the problem of internal convertibility of the ruble. The essential purpose is to enable all Soviet enterprises and foreign [illegible] 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 mutual 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 forced 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 covered 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 creation 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;
- irremediably 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 multilateral lending 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.

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 Gossnab [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 econdmy;
- 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 oil 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 banch 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 govermental 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.

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.

<u>Land reform and distinctive features of the formation of market relationships in the agro-industrial complex</u>. 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 prestige 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, groat, 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 repubics.

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 prices 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-governmentalization 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.

<u>Reform of the Banking System</u>. 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 upravlyayuschikh], 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 same 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 foeign 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, [illegible] market. is adopted. 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 auditing [illegible] 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 80 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.

C. 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 poopulation. 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 be means of their own labor and personal income.

The term real incoee 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 pooople 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 farm, 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 interruption; the consumer market is flooded with deficits, similar goods with different prices are practically unavailable, the system of paid services is poorly developed, and housing is not freely sold.

Hence, in the first stage a minimum consumer budget with a limited "consumer basket" will be adopted for 1991. The basket will subsequently be revised in accordance with the economy's possibilities.

The minimum consumer budget adopted will merely be 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.

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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 insusrance 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.

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 Conversionto 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 frame must be halted;

- construction must be de-monopolized, encouraging the splitting off of independent building organizations that focus on nonindustrial and housing construction.

At the same time, machine building enterprises whose output is not in demand or loses its markets or investment [illegible]

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released should be sold. A portion of thhe 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 values 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.

<u>Conversion of the military-industrial complex</u>. 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.

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 he 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.

29/30
1

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, comercial 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.

30/30.
1.

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 programs for support of entrepreneurial activity, the agro-industrial complex, and the nonmarket 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.

for Milit

Summer mtg.

The World Bank/IFC/MIGA
OFFICE MEMORANDUM

DATE: 25-Oct-1990 03:01pm

TO: Paul Isenman (PAUL ISENMAN)

FROM: Coralie Bryant, PRDPD (CORALIE BRYANT)

EXT.: 31264

SUBJECT: RE: Military expenditures

Actually I'm a drill sergeant.

We have settled on Dec 10-11 for the meeting. More information to follow as soon as I get it rounded up. By the way, there are a series of panels at the annual meetings of the Amer. Econ Assoc on this topic this year--some heavy weights involved like Arrow. Afsaneh is checking to see how many of those papers we can get to add to our data base.

CC: Afsaneh Farzin (AFSANEH FARZIN)
CC: Anupam Khanna (ANUPAM KHANNA)
CC: Sven Sandstrom (SVEN SANDSTROM)

Soviet.

Draft # 2.

OCTOBER 25, 1990

MR. OLEG MOZHAISKOV, MANAGING DIRECTOR, MONETARY AND ECONOMIC RESEARCH DEPARTMENT, STATE BANK OF THE USSR
MOSCOW, USSR

THANK YOU FOR YOUR TELEX OF OCTOBER 24 AND INVITATION FOR MR. FISCHER AND MYSELF TO COME TO MOSCOW NEXT WEEK. UNFORTUNATELY, THIS TIMING IS PROBLEMATIC AND I WOULD LIKE TO PROPOSE AN ALTERNATIVE APPROACH.

MY UNDERSTANDING IS THAT THE PURPOSE OF SUCH A VISIT WOULD BE TO PREPARE THE GROUND FOR THE MEETING BETWEEN MR. CONABLE AND MR. GORBACHEV. THE AGENDA AND POSSIBLE DATE FOR SUCH A MEETING WAS DISCUSSED BY MR. OBMINSKY AND MR. QURESHI ON OCTOBER 13, AND WE ARE STILL AWAITING CONFIRMATION OF THAT MEETING.

WE UNDERSTAND THAT YOU ARE STILL WORKING TOWARDS A MEETING ON NOVEMBER 16. OUR THINKING HAD BEEN THAT ONE OR TWO SENIOR PEOPLE FROM THE BANK MIGHT COME TO MOSCOW A FEW DAYS BEFORE MR. CONABLE'S VISIT IN ORDER TO FINALIZE THE AGENDA AND PROVIDE NECESSARY BACKGROUND INFORMATION. I NOW UNDERSTAND, HOWEVER, THAT YOU WOULD LIKE PREPARATORY WORK TO COMMENCE MUCH EARLIER, HENCE THE PROPOSED DATE OF OCTOBER 30-31 FOR THE PREPARATORY MISSION. MAY I SUGGEST THAT WE INSTEAD SEND YOU SOME BACKGROUND MATERIAL TO THE AGENDA EARLY NEXT WEEK. ONCE YOU HAVE REVIEWED THIS MATERIAL, WE COULD BE IN TOUCH BY TELEPHONE OR FAX TO IDENTIFY ADDITIONAL QUESTIONS OR ITEMS FOR DISCUSSION. IF YOU STILL FEEL THAT AN EARLIER PREPARATORY MISSION WOULD BE REQUIRED, WE WILL DO OUR BEST TO ACCOMMODATE YOU.

AS TO THE DATE OF MR. CONABLE'S VISIT, WE SEE A "WINDOW OF OPPORTUNITY" FOR THIS VISIT IN MID-NOVEMBER. OTHERWISE, IT MAY NEED TO BE POSTPONED UNTIL EARLY IN 1991. COULD YOU PLEASE CONFIRM THIS DATE AS SOON AS POSSIBLE.

DAVID R. BOCK, DIRECTOR, OPERATIONS STAFF, OFFICE OF THE SENIOR VICE PRESIDENT FOR OPERATIONS, WORLDBANK

*** END OF DOCUMENT ***

John Holsen
cc Costes
Steve Mink

done 10/25

FROM OPNSV (WED) 10.24'90 11:54 / NO. 3080207225 P. 1

cc by FAX: Rec'd from Bock
done To Fischer # 70549
1:15
10/24

RECEIVED

90 OCT 24 PM 1:11

PRDDR

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RYOR
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SECR6591
ATTN INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
ATTN WASHINGTON, DC 20433 (UNITED STATES)

.REFNO: SECR6591

24 OCT 1990
ZCZC
MOSCOW THE STATE BANK OF THE USSR 24.10.90.
INTERNATIONAL MONETARY FUND

FOR TECHNICAL REASONS WE CANNOT GET THROUGH TO THE IBRD MACHINES
PLEASE URGENTLY TRANSMIT TO THEM THE FOLLOWING MESSAGE:

QUOTE

TO: INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
FROM: STATE BANK OF THE USSR

ATTN: DAVID BOCK, STANLEY FISHER

I REFER TO MY CONVERSATION WITH MR. A.BOUGROV OF THE MINISTRY OF
FOREIGN AFFAIRS TO CONFIRM THAT WE WILL BE PLEASED TO MEET YOU
IN MOSCOW ON OCTOBER 30-31.

PLEASE CONFIRM IF THIS ARRANGEMENT IS CONVENIENT AND KINDLY LET
US KNOW THE TIMING OF YOUR ARRIVAL.

WE WOULD ALSO APPRECIATE IF YOU COULD FORWARD US A DRAFT MEMORANDUM
OF UNDERSTANDING FOR US TO PREPARE FOR THE DISCUSSION.

OLEG MOZHAISKOV
MANAGING DIRECTOR
MONETARY AND ECONOMIC RESEARCH DEPARTMENT
STATEBANK OF THE USSR
UNQUOTE

THANK YOU IN ADVANCE

STATE BANK OF THE USSR
=10241116
NNNN

WORLDBANK TMSS
DISCONNECTED

*** END OF DOCUMENT ***

FROM OPNSV (WED) 10.24'90 11:

cc John Holsen
Coates
Stanley Mink

WORLDBANK TMSS

ZCZC CSVP0230 WUI173 WWB1011
OPNSV
.TCP CF
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* OPNSV *
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RYOR
OPEU OPXWR PYEWUTEP SMCD8437
SECR6591
ATTN INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
ATTN WASHINGTON, DC 20433 (UNITED STATES)

REFNO: SECR6591

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WE WOULD ALSO APPRECIATE IF YOU COULD FORWARD US A DRAFT MEMORANDUM
OF UNDERSTANDING FOR US TO PREPARE FOR THE DISCUSSION.

OLEG MOZHAISKOV
MANAGING DIRECTOR
MONETARY AND ECONOMIC RESEARCH DEPARTMENT
STATE BANK OF THE USSR
UNQUOTE

THANK YOU IN ADVANCE

STATE BANK OF THE USSR
=10241116
NNNN

WORLDBANK TMSS

Ray 10/75

→ Briefings Conable sector by sector. Led to big push on education — via educ. accel. paper.

— then —

Discussed Tony quit PSD committee.
WT support.

Plans new "Dept" under Francis.
There is where he will get another position or two.

→ Beck, Holsen,
USSR -- Briefings

USSR

Canada trip file.

JSSE Talking points
Summary
Gorbachev plan:

TA Talking points = stone
Covering letter: aide memoire > Beck
~~D.R.~~

Membership Talking points
aide memoire
Susan Burmester

Polit. Who's who: Issues: Polit. issues: get at last minute
People: Gets outsider to do briefing:

~~Hewitt-Brookings.~~
~~Reddaway~~

FROM OPNSV (THU) 10.25'90 10:02 / NO. 3060207229 P. 1

FORM NO. 1599
(8-80)

THE WORLD BANK

ROUTING SLIP	DATE 10/24/90

OFFICE OF THE SENIOR VICE PRESIDENT, OPERATIONS

NAME	ROOM NO.
Messrs. Sandstrom	
Isenman	

	To Handle		Note and File
	Appropriate Disposition		Note and Return
	Approval		Prepare Reply
	Comment		Per Our Conversation
	Full Report		Recommendation
	Information		Signature
	Initial		Send On

REMARKS

For your urgent clearance please.

FROM

David R. Bock

RECEIVED
90 OCT 25 AM 11:10
PRDDR

S&V TA

OCTOBER 25, 1990

MR. OLEG MOZHAISKOV, MANAGING DIRECTOR, MONETARY AND ECONOMIC RESEARCH DEPARTMENT, STATE BANK OF THE USSR
MOSCOW, USSR

THANK YOU FOR YOUR TELEX OF OCTOBER 24 AND INVITATION FOR MR. FISCHER AND MYSELF TO COME TO MOSCOW NEXT WEEK. UNFORTUNATELY, THIS TIMING IS PROBLEMATIC AND I WOULD LIKE TO PROPOSE AN ALTERNATIVE APPROACH IN TIMING.

MY UNDERSTANDING IS THAT THE PURPOSE OF SUCH A VISIT WOULD BE TO PREPARE THE GROUND FOR THE MEETING BETWEEN MR. CONABLE AND MR. GORBACHEV. OUR THINKING HAD BEEN THAT MR. FISCHER AND I MIGHT COME BEFORE MR. CONABLE IN ORDER TO FINALIZE THE AGENDA AND PROVIDE NECESSARY BACKGROUND INFORMATION. I NOW UNDERSTAND, HOWEVER, THAT YOU WOULD LIKE PREPARATORY WORK TO COMMENCE MUCH EARLIER, HENCE THE PROPOSED DATE OF OCTOBER 30-31 FOR THE PREPARATORY MISSION. MAY I SUGGEST THAT WE INSTEAD SEND YOU A PROPOSED AGENDA NEXT WEEK, ALONG WITH SOME BACKGROUND MATERIAL. ONCE YOU HAVE REVIEWED THIS MATERIAL, WE COULD BE IN TOUCH BY TELEPHONE OR FAX TO IDENTIFY ADDITIONAL ITEMS FOR DISCUSSION AND/OR ADDITIONAL BACKGROUND MATERIAL. IF YOU STILL FEEL THAT AN EARLY PREPARATORY MISSION WOULD BE REQUIRED, WE WILL DO OUR BEST TO ACCOMMODATE YOU.

AS TO THE DATES OF MR. CONABLE'S VISIT, I UNDERSTAND THAT YOU ARE AIMING FOR NOVEMBER 16 AS THE DATE FOR THE MEETING WITH MR. GORBACHEV. COULD YOU PLEASE CONFIRM THIS DATE AS SOON AS POSSIBLE. WE SEE A "WINDOW OF OPPORTUNITY" FOR THIS VISIT IN MID-NOVEMBER. OTHERWISE, IT MAY NEED TO BE POSTPONED UNTIL EARLY IN 1991. DAVID R. BOCK, DIRECTOR, OPERATIONS STAFF, OFFICE OF THE SENIOR VICE PRESIDENT FOR OPERATIONS, WORLDBANK

*** END OF DOCUMENT ***

10-24

Fischer's home telephone: 617 964-2494

Paul,
Please speak to me. WT

MOSCOW THE STATE BANK OF THE USSR 24.10.90
INTERNATIONAL MONETARY FUND

24 OCT 1990

FOR TECHNICAL REASONS WE CANNOT GET THROUGH TO THE IBRD MACHINES. PLEASE URGENTLY TRANSIT TO THEM THE FOLLOWING MESSAGE.

QUOTE

TO: INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
FROM: STATE BANK OF THE USSR

ATTN: DAVID BOCK, STANLEY FISCHER

I REFER TO MY CONVERSATION WITH MR. A BOUGROV OF THE MINISTRY OF FOREIGN AFFAIRS TO CONFIRM THAT HE WILL BE PLEASED TO MEET YOU IN MOSCOW ON OCTOBER 30-31.

PLEASE CONFIRM IF THIS ARRANGEMENT IS CONVENIENT AND KINDLY LET US KNOW THE TIMING OF YOUR ARRIVAL.

WE WOULD ALSO APPRECIATE IF YOU COULD FORWARD US A DRAFT MEMORANDUM OF UNDERSTANDING FOR US TO PREPARE FOR DISCUSSION.

OLEG ?OZHAISKOV
MANAGING DIRECTOR
MONETARY AND ECONOMIC RESEARCH DEPARTMENT
????? BANK OF THE USSR

THANK YOU IN ADVANCE
STATE BANK OF THE USSR

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

DATE: 24-Oct-1990 12:37pm

TO: Paul Isenman (PAUL ISENMAN)
TO: John A. Holsen (JOHN A. HOLSEN)
TO: Stephen Mink (STEPHEN MINK)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: **Briefing for BBC**

The attached refers to the briefing for BBC on the USSR. His sshedule (British spelling) is very tight. Sven agreed to set up a lunch to which we would invite Reddaway and others. Apart from the Brookings chap (whose name I have misplaced), I would like to invite David Aikman, the Time correspondent that I mentioned earlier (Aikman has a PhD in Soviet Studies, has covered the USSR and China for more than 20 years, recently did an extensive one on one interview with Yeltsin, speaks Russian and Chinese, etc., so is not your average journalist).

I will call Reddaway and Aikman.

David

Sar PIz

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

DATE: 24-Oct-1990 12:39pm

TO: Sven Sandstrom (SVEN SANDSTROM)
TO: Paul Isenman (PAUL ISENMAN)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: **Telex from USSR**

I'll have to call Bougrov to find out what this is all about. I suspect that they want to follow up on the preparations for Mr. Conable's visit.

The telex is being sent to you separately.

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

DATE: 23-Oct-1990 07:58pm EST

TO: David R. Bock (DAVID BOCK)

FROM: Sven Sandstrom, EXC (SVEN SANDSTROM)

EXT.: 81138

SUBJECT: **Soviet lunch briefing**

David,

We are aiming for lunch November 12 as we discussed. We'll confirm asap.

Sven

CC: Chitra Perera (CHITRA PERERA)
CC: Linda Jean McLaughlin (LINDA JEAN MCLAUGHLIN)

mtg file

The World Bank / IFC / MIGA
OFFICE MEMORANDUM

Date: 24 October 1990

To: JSSE Coordinating Committee:
Francis Colaco, PRSVP (S 5-049)
Enzo Grilli, EAS (E 3-069)
Parvez Hasan, EMNVP (H 12-075)
Paul Isenman, PRDDR (S 13-145)
Jean-Francois Rischard, INVDR (D 4-111)

Other Distribution:
Stanley Fischer, Consultant
Gerald Alter, Consultant
Eugenio Lari, EM4DR (H 11-0678)
Ulrich Thumm, EM4DR (H 111-061)
Stephen Mink, DECVP (S-9040)

From: John A. Holsen, DECVP

Subject: Background Papers for Friday's JSSE Meeting

1. I attach several background papers for our discussion on Friday morning (11:00-12:30 in conference room S-8003).

2. The "Issues for Discussion" paper indicates several areas where the participant's views will be of particular interest to us. You should, of course, bring up any other points which you think are important. The "Background Notes on Task Force Conclusions" consists of a set of papers that were initially prepared for last week's meeting in Paris with the leaders of the task forces from the IMF, OECD, and EBRD. The papers summarize the main findings of the Bank-led task forces.

4. The third attachment provides information on the economic reform plan that was approved by the USSR Supreme Soviet last Friday. It consists of newspaper articles from last Saturday's New York Times and Washington Post plus the analysis included in the Oxford Analytica report for Monday of this week. As best we can tell from these articles, the compromise program (i) maintains the All Union market (common currency, lack of trade barriers between republics, etc.) and (ii) maintains the objective of establishing a market oriented economy, but it is certainly more cautious and less specific than the Shatalin program regarding privatization and price liberalization. (We were not able to get the text of the approved program until this morning, and have not yet had opportunity to do our own analysis.)

cc: Messrs. Wilfried Thalwitz, Fred Levy, and Alan Gelb
[S0102401.DOC]

ISSUES FOR DISCUSSION
(for JSSE Committee Meeting on October 26th)

In the absence of an agreed economic reform program, our analytical work has focussed on general issues of systemic reform (but with reference to the competing Abalkin and Shatalin plans). Now that the USSR Supreme Soviet has approved a program, we will reformulate our analysis and recommendations as a commentary on the approved program. Several policy questions have resulted in substantial discussion among the members of the JSSE task forces. Some of them, along with our tentative conclusions, are indicated below. In addition to the issues participants may wish to raise, you are asked to consider the following issues:

1. In our initial thinking we have placed a great deal of emphasis on the importance of a broad price liberalization in the early stages of the reform program. However, even the Shatalin program is relatively cautious on price liberalization. Especially in view of the political sensitivities involved, the Government is now planning to take a more moderate approach to price liberalization. This, of course, has implications for the speed with which others kinds of reforms can be implemented (e.g., the hard budget constraint). We understand that in the first stage price liberalization will be limited to "luxuries." In the case of basic materials and consumer goods, there will be many adjustment in the levels of the administered prices -- but they will continue to be administered. While we "accept the inevitable" of the Government's judgment on the politics of pricing policies, we plan to recommend that (i) the list of "essential" consumers goods which will be kept under control be as short as possible, (ii) that wholesale and producers prices for this limited list of goods be liberalized [or, as a fallback, adjusted to levels that should call forth supplies sufficient to meet the demand at the controlled consumer prices], and (iii) that the government provide subsidies (the "negative turnover tax") to cover the difference. In addition, consideration might be given to a ratio card system that would help reduce diversion of heavily subsidized consumer goods to unintended uses (e.g., bread used as animal good).

Stabilize first

Ration mkt. [illegible]

2. The reduction in subsidies, the upward adjustment of many administered prices, and price liberalization will result in increases in the COL index. A major issue is the extent to which there should be "compensation" for these price increases -- through wage increases and through either general or targeted increases in transfers (pensions, family allowances, food stamps, etc.). There is a clear trade off between the extent of compensation and the control of demand (via restraint on budget expenditures and wages). Food subsidies amount to over 10% of GDP and thus offer important opportunities for both subsidy reduction and "getting the prices right." However, substantial compensation seems politically inevitable; moreover, it should be economically feasible since there seems to be no macroeconomic need to bring about a large reduction in the real levels of private consumption. We propose to accept the view that the gains from subsidy reduction will probably

Compensate to what?

go more to compensation than to reduction in expenditures, but to argue strongly that (i) some substantial reduction in net expenditures is needed from a fiscal management point of view and (ii) that targeted and means tested income transfers should, to the maximum extent possible, take the place the place of artificially low prices and non-targeted transfer payments as means of meeting the objectives of guaranteeing a minimum real income. (We understand that indexing of wages to the COL index is being considered; insofar as compensation for subsidy reductions is given in the form of transfers to households, it will be important to avoid "double compensation" from indexing wages to the COL. The general question of wage policy is the responsibility of Task Force led by the OECD, and will not be taken up in our contribution.)

3. The approach to and pace of privatization are unresolved issues. There is, given the weakness of central authority, a great deal of "spontaneous privatization" now going on in the USSR (through, e.g., the leasing of capital assets to cooperatives). Much of this has been described as "wheeling, dealing and stealing," but it probably also means that more efficient use is being made of the capital assets involved. An attempt to discipline the process runs the risk that it will slow the pace of privatization. The absence of some discipline on the process runs the risk of a political backlash which would also slow the pace of privatization. A middle way, that regulates but doesn't stifle, is needed. We propose to recommend (i) rapid privatization of smaller enterprises, particularly those engaged in retail trade and other services and (ii) and more controlled process in the case of larger enterprises which begins with clarification of present "ownership" and "destatization" (i.e., conversion to joint stock companies and getting their operations on a commercial basis). Some other points to be made regarding enterprise management and privatization include, (iii) there is a need to give greater attention to strengthening the management of those enterprises that are likely to remain in the public sector (at least for a substantial period); (iv) in manufacturing industry there is a spectrum of conditions ranging from enterprises which could fairly easily be privatized to subsectors (e.g., steel, petrochemicals) where a subsector rather than enterprise restructuring program is needed; and, (v) while some demonopolization and restructuring may have to be undertaken prior to privatization, in many cases market processes can be used for demonopolization (e.g., growth of competition between present regional monopolies).

4. The approved plan appears to continue, at least for some time, subsidies to loss making enterprises. However, as part of strengthening both macroeconomic management and enterprise management, it is desirable to introduce the hard budget constraint as soon as possible. This can only be done if managers are given the authority to adjustment to the new situation, including the ability to change prices, product lines, employment, etc. This is an argument for accelerating the pace of price liberalization.

BACKGROUND NOTES ON TASK FORCE CONCLUSIONS

(prepared for Paris discussions with IMF, OECD and EBRD)

JSSE

Economic Organization Task Force (EOTF)

Principal Issues for Discussion at Paris Meeting, October 15-16, 1990

1. The terms of reference of the EOTF covers legal, institutional, and policy aspects of Soviet enterprise, financial sector, and price reforms in the transition to a market economy (corresponding roughly to items 2a, 2b(ii), 2b(iii), and 2b(v) of the draft outline circulated on October 1. The discussion here follows the order of that outline.

Legal Framework

2. The legal framework for economic reforms in the Soviet Union is in substantial disarray. Despite an impressive number of laws drafted and adopted over the past three years, the system is still characterized by major gaps in coverage and internal contradictions. Various pieces of the legal framework (e.g., general enterprise law, law on cooperatives, law on joint ventures, banking law, property law, anti-monopoly law) have been or are being drafted by different agencies and groups with no coordination among them and no unifying concept of the whole fabric to be woven. Differential advantages, perhaps inadvertent, are being conferred on different forms of organization and activity, undercutting the "level playing field" required for market efficiency. Contract law and bankruptcy law are not yet being addressed. Despite the political support now given to privatization, there is no law defining and protecting private property. Equally lacking or inadequate are the institutions--courts, regulator agencies--needed to enforce economic laws and to resolve the inevitable contract disputes that accompany market activity. Regulations affecting market entry are largely ad hoc and vary among different controlling ministries and levels of government. Given this legal confusion, much of the transformation of enterprises, creation of banks, emergence of new supply and trading relationships, etc. that is occurring in the USSR is of uncertain legal status at best (indeed, much of it would be illegal as speculation under the unchanged criminal code), is oriented to short-term, quick profit objectives, and may be planting the seeds of economic instability and disruption.

3. A crucial aspect of the legal picture is the continuing uncertainty of intergovernmental relationships and the related division of legal jurisdictions under the new Union treaty. At the present time, Republics are disputing the legal jurisdiction over them of Union laws and institutions; municipalities are declaring their independence from Republics; districts from cities; etc. Adding to this uncertainty are the differences already emerging in the laws being adopted in different Republics, threatening the coherence of the national market.

4. Thus, the legal foundation for orderly and efficient market activity is still virtually absent in the Soviet Union, raising issues of speed and sequencing of the other reforms. Some of these are discussed below in the specific contexts of enterprise and financial sector reform. Western technical assistance and exposure to western institutions and

experience can make a major contribution to speeding the necessary legal reforms and in pointing out the areas of highest priority. Inevitably, however, there will be much learning by doing and learning from mistakes over the next several years. Calling a halt to the changes going on until the legal framework is completed is a nonstarter--the genie is already out of the bottle.

Enterprise Reform

5. The overwhelming bulk of productive capacity in the Soviet Union is still "owned" by the State (although which level of government exercises ownership rights in specific enterprises is subject of dispute). Most industrial sectors are also characterized by extreme levels of market concentration, with the production of large numbers of products exclusive to a single enterprise. However, the last three years has seen a rapid proliferation and growth of cooperatives, leasing arrangements and other nonstate forms of organization, usually hived off from an existing state enterprise by its managers and/or employees, taking advantage of ambiguities in the law and enjoying greater freedom from government controls on production, prices, wages, and other aspects of enterprise management. These transformations and the authority and incentives they provide to managers appear to have stimulated significant improvements in enterprise physical productivity and capacity utilization. However, the continuing lack of definition of ownership and property rights still results in no one taking responsibility for the long-term health of the enterprise and the husbanding of its assets. Moreover, distorted prices, market concentration, the uneven playing field created by differences in legal treatment, and general uncertainties about the legal environment all serve to distort the decisions of these more market-sensitive modes of organization. This section of the report will emphasize four associated elements of enterprise reform: the need to define and institutionalize private property rights in the Soviet Union; the process of privatization; the demonopolization of the industrial sector; and arrangements to improve the performance of enterprises that will necessarily remain for the time being under state ownership.

6. A central issue concerns whether reform of the market--particularly, price reform, industrial restructuring, and demonopolization--should precede privatization of enterprises. The superior economic performance expected of private enterprises and proper economic valuation of enterprise assets depend, after all, on price incentives and competitive markets. As described below, the Task Force favors more rapid price decontrol and adjustment than currently set out in either of the Soviet reform programs. Attempts elsewhere, however, to rationalize industrial structures and enterprises prior to privatization have not produced encouraging results; they have rather tended to bring the process of privatization to a halt. Moreover, in an economy the size of the Soviet Union's, very few examples of market concentration can be said to rest on natural monopoly. In most cases, therefore, the Task Force would prefer that privatization proceed as quickly as possible, allowing the market itself--through freed prices, removal of restraints on competition, and the lowering of barriers to entry (including rapid privatization and decontrol of trucking and air transport and the decriminalization of wholesale marketing and storage activities currently

vulnerable to laws against speculation) to effect the needed restructuring. [The implications for the valuation of state assets and the terms of their transfer to private hands remains to be discussed.]

7. Branch ministries currently serve as cartelizing agents in the Soviet Union and should be disbanded as quickly as possible, leaving the enterprises under their control independent and unprotected from domestic competition. The rationalization and gradual liberalization of the trade regime, along with movement toward rouble convertibility, can also be used to increase competitive pressures in the system. The present trend to form industrial associations, encouraged under the present enterprise laws, presents a threat of collusion and industrial conglomeration that should be avoided. Clarification of the enterprise laws in this respect and the introduction of appropriate antimonopoly laws and enforcement mechanisms are also required.

8. Despite the increases in enterprise autonomy that have occurred in recent years, the managers of Soviet state enterprises are still severely constrained and operate more as production engineers than enterprise managers. For those enterprises that will remain for the time being under public ownership, steps can be taken to improve managerial incentives and overall firm performance. Among these steps are (i) the rapid transformation of all SOEs into joint stock companies, with the shares to be owned by state property agencies established for that purpose at the relevant levels of government and separated from the line ministries and agencies; (ii) a clear mandate to those enterprises to operate as profit-maximizing commercial firms under a hard budget constraint, with manager and worker rewards clearly tied to financial performance; (iii) a Board of Directors answerable to the owner and enjoying full power to appoint and dismiss managers and to define enterprise policies and managerial guidelines. While awaiting full privatization, the present process of allowing production units to be spun off as cooperatives or under leasing arrangements, etc. can be encouraged and accelerated.

9. Management skills and training suited to market-oriented enterprises is severely lacking in the Soviet Union. Cost control, marketing, financial management, etc. are practically unknown, and profit-oriented accounting and management information systems are rudimentary at best. Management training courses and institutes are multiplying rapidly but tend to be directed at top executives and are often oriented to dealing with foreign investors and enterprises rather than the nuts and bolts of managing a domestic enterprise. Courses for middle management, of the sort frequently given in-house in Western firms, are badly needed and offer an important area of potential assistance from the West.

Price Reform

10. The freeing of prices to determination by market forces is for most Soviets, including leading advocates of reform, the most difficult aspect of the market system to grasp. To many, the freeing of prices would invite runaway inflation, manipulation and exploitation by monopolists and speculators, massive industrial dislocations and liquidations, and drastic decline in the living standards of the weakest

members of the society. For others, the concept of market means only the decentralization of controls to lower levels of government. The fears of those who advocate going slow with price liberalization are, of course, not unfounded. In the absence of firm macroeconomic management, competition, appropriate exchange rate and trade policies, and a social safety net, all of these consequences could come to pass. On the other hand, without broad and substantial elimination of the gross price distortions currently in the system, the other proposed elements of economic reform are unlikely to succeed and could produce worse results than achieved under the old command economy.

11. In the Task Force's view, 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. We would move much faster to free prices than suggested by either the Abalkin or Shatalin programs, including the prices of basic consumer goods. In the cases of only a very few products, which are either natural monopolies and/or vital exceptionally under-priced inputs to a broad cross section of Soviet industry--e.g., energy--whose immediate adjustment to international price levels would cause major disruption of the economy. For those goods, we would recommend a time-bound, preannounced schedule of adjustment to world prices over, say three years, giving the affected industries forewarning of the need to adjust their technologies, product and input mixes accordingly. At the same time, the impact of these adjustments on the viability of Soviet industries can be cushioned by appropriate exchange rate policy, accompanied by a high, uniform, and gradually declining tariff level.

12. As regards the impact of the undoubtedly sizeable increases in the retail prices of basic food staples on the living standards of pensioners and others on fixed incomes, compensation should take the form of targeted income supplements--cash, food stamps--rather than subsidization through the price system. At the same time, the reduction of what have been, in effect, in-kind payments for labor would be compensated in the form of increased money wages, as this price too moves toward market determination. [The reform of housing rents, in conjunction with the establishment of a market for housing, is discussed separately.]

Financial System Reform

13. The Soviet banking system is currently evolving on two tracks: the division and commercialization of the state specialized banks and the rapid proliferation of the commercial and cooperative banks. Both tendencies, which can eventually be expected to merge into one unsegmented banking system, are consistent with the development of an efficient, competitive financial sector. The present ambiguousness and weakness of the constitutional, legal and regulatory framework, however, along side the substantial uncertainties and adjustments yet to be experienced in the real sectors, introduce substantial risk into the system. In contrast to its recommendations to speed up enterprise and price reforms, the Task Force is inclined to recommend caution in the present pursuit of financial sector reforms.

14. An overriding concern for the financial system is the continued lack of definition of the nature and authority of the central bank (and the uncertainty of fiscal management) to be adopted under the new Union treaty. Strong central control over the money supply is a sine qua non for the success of the other economic reforms.

15. Control over the specialized banks is now being claimed by Republican and municipal levels of government and, as in the case of state enterprises, clouds their ownership and makes uncertain their corporate boundaries. All are being converted to joint stock company form and, at least rhetorically, are to be managed in the future on a commercial basis. For some governmental authorities, however, the latter may simply mean financing local projects and deficits rather than Union projects and deficits. Meanwhile, the banks, while enjoying greater discretion than before over the allocation of credit, remain highly specialized and lacking in employee skills and managerial systems required for commercial banking. The quality of their existing portfolios, subject to only rudimentary audit and supervision by the State Bank and its branches, is a large unknown and is vulnerable to the changes occurring in the real sectors. The principal credit institutions--the Promstroibank and Agroprombank--remain heavily dependent on the Savings Bank (via the State Bank) and on largely captive enterprise deposits for the mobilization of resources. The Savings Bank, in turn, mandatorily deposits the bulk of its resources into the State Bank; it has little experience in independent lending. Commercialization of the Savings Bank is also inhibited by the lack of alternative mechanisms for financing the fiscal deficit.

16. The commercial/cooperative banks now number more than 400 and account for about 5% of total credit in the banking system. The legal status of these institutions remains cloudy, but they generally enjoy much greater freedom than do the specialized banks in their lending policies, credit and borrowing terms. Most are limited to a narrow range of operations, however, by their small size (physical as well as financial--access to premises is commonly cited as a major limitation on their growth), the uninsured nature of their deposits (in contrast to the specialized banks), and by their self-written charters which typically define their objectives as the financing of a narrow industrial subsector, usually that of their founders and shareholders. In addition to state and cooperative enterprises, shareholders commonly include local branches of the specialized banks, other commercial banks, local government agencies and city councils, and Party and civic organizations. Although these banks proclaim very conservative lending policies and rigorous collateral requirements, conflicts of interest are rife. These banks are subject to audit and prudential supervision by the State Bank, which has drafted regulations and set up special departments in the last two years to perform this function. The quality of supervision is suspect, however, and our interviews suggest that exceptions are granted by local State Bank branches to the existing prudential standards.

17. The emphasis of the Task Force's recommendations will be on the clarification of the banking system's legal status and the strengthening of regulation/supervision and the institutions responsible therefor. The modernization of accounting concepts and systems is essential for both bank managers and supervisors, and there are enormous needs for training

and technical assistance at both levels. Immediate consideration should be given to raising the capital adequacy requirements and strengthening the loan concentration limits for commercial banks. Rigorous evaluation of the qualifications of top bank executives should also be part of the approval process for new applications, with particular attention to interlocking arrangements with borrowing enterprises and conflicts of interest on the part of government officials and agencies. These measures could be expected to slow the entry of new banks (as well as the commercialization of the specialized banks) and to encourage mergers and ownership changes among existing institutions. Meanwhile, deposit protection in the specialized banks should, as they commercialize, be placed on a fully-funded insurance basis, and extended to the existing commercial banks only as the regulatory/supervisory framework is put in place and enforced.

18. In short, for the next several years, the Soviet banking sector will continue to be dominated by a few large state banks. The conversion of these to joint stock companies and to operation on a commercial, self-sustaining basis, along the lines suggested above for state enterprises, should be encouraged. The pace at which they move into full-service banking activity--the Savings Bank into independent lending and the credit banks into full responsibility for deposit mobilization--should be controlled, however, in correspondence with the pace of macroeconomic stabilization and reform in the real sectors, the establishment of the regulatory and supervisory framework for commercial banking activity, and, as necessary, the cleaning of the books of the specialized banks. The objective is to avoid excessive systemic risk that could bring the entire reform process to a halt. The existing commercial banks do not currently represent the same degree of systemic risk, but the building of public confidence in market institutions will be strengthened to the extent that their formation and growth are rationalized and regularized.

19. The poor efficiency of the payments system merits priority attention. Interbank transfers take an average of nine days to complete at present. The State Bank's efforts to modernize its equipment and clearing institutions should be supported. Technical assistance from the West could be highly valuable in introducing the commercial banking skills required by the reformed system. Joint ventures with foreign banks can be a vehicle for the transfer of technology and management skills, but will be difficult to attract until the reforms themselves are much farther advanced, and the dust has begun to clear.

20. Plans toward the creation of stock exchanges are now fashionable in the Soviet Union. Securities markets generally can offer needed mobility to capital and a vehicle for the eventual privatization of the larger state enterprises. Issues of ownership and contract law remain to be resolved, however, and a proper regulatory system put in place. Particular attention needs to be given to the creation of a government debt market, relieving the State Bank and the Savings Bank of the obligation to finance the government deficit. The authorities tend to direct their attention only to the long end of the market. Given the present uncertainties facing potential buyers, the development of the short end merits greater emphasis.

Enhancing the Supply Response of Soviet Industry

Reza Amin and Andrew Ewing
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I. The Current Situation of Soviet Manufacturing Industry

In many respects, including labor and capital productivity, product quality, energy efficiency and environmental impact, Soviet industry is performing poorly. A particular problem at present is the inadequate supply of consumer goods of acceptable quality. Shortages of industrial products are widespread; at the same time, some goods produced are not in demand.

A number of factors adversely affect the performance of manufacturing industry:

- An exceptionally high degree of autarky has insulated industries from international competition. The Central Planning system has further stifled competition through the creation of monopolies. These have prevented the entry of new businesses, which are normally the most dynamic sector of Western economies, into manufacturing industry. Recognising this, in 1987 the establishment of cooperatives, which resemble Western partnerships, was allowed, but state trading monopolies continue to act as effective barriers to their acquiring material inputs.
- Industry is vertically integrated to an excessive extent, with many major producers producing also most of their components, and high integration along Ministerial (or more recently Association) lines. This compromises the potential for scale economies, as well as losing flexibility.
- In the command economy, manufacturing enterprises did not develop a system of gathering and analysing information regarding the sources of their supplies or the needs of their clients. Such information systems are central to the successful performance of firms in a market economy. There is also a dearth of general information about business developments, financial markets, etc. Especially when combined with the inadequate communications network in the country, this puts the Soviet manager at a serious disadvantage when it comes to reacting to changes in the business environment and identifying new opportunities.
- Perhaps even more important than the constraints of physical infrastructure are those of the service infrastructure. Among the most important services lacking in the Soviet system are financial services and independent consulting services.
- Under the planned system, measures of efficiency and the tools for improving it have not developed. Cost accounting is not employed to measure efficiency, profit centers are unknown. Certain technological factors are also relevant, including a high average age of machinery, inadequate quality control and deficiencies in the process of technology transfer.
- In 1988 state orders accounted for about 89% of output and, although the intention was to bring this down sharply, this did not materialize. In 1990 state orders in manufacturing ranged from 60% to 100%. Allocated inputs often do not meet specifications.
- Relative prices are severely distorted, with prices of producer goods appearing to be low relative to those of final consumer products.
- Because of local concerns over environmental degradation, many enterprises have been shut down with consequent disruptions to the production chain.

- There are indications that input allocations for 1991 are running well below expected levels, and this is contributing to a pervasive sense of uncertainty among managers because of the lack of well-developed market alternatives

Without the authority to procure inputs, distribute outputs and set prices enterprise management cannot be held responsible for efficient operations. In sum, the Soviet "enterprise" is still largely an illusion, both because the economy is still controlled and because managers do not have the measures with which to effect efficiency gains. Reform measures, such as the Law on Enterprises and the Small Business Law of 1990 attempt to address these problems, but a far more comprehensive approach will be needed.

II. Elements of a Successful Market Economy

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 to what extent there is a common understanding of what constitutes such an economy. The key elements for the industrial sector are three:
(i) the allocation of resources on the basis of market signals which, in turn, requires prices to serve as signals, profits to help allocate resources, and enterprise autonomy,
(ii) competition, with new entry and mechanisms to facilitate exit, and
(iii) supporting infrastructure and services, including information, finance and legal framework.

There is considerable potential for improvement in Soviet industry. Most raw materials are in abundant supply, the workforce is skilled and educated workforce and technologists and engineers are highly trained. To realize this potential require: dismantling the central allocation system, removing controls which have constrained initiative and supported inefficiency, and providing the basic services which are essential for a smoothly-working market.

All of these elements will need to be addressed in a package of reforms that includes a realistic assessment of feasibility and timing.

III. Policies for Sustainable Improvement

3.1 Macroeconomic and Regulatory Framework

The enabling macroeconomic and regulatory 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 economic and regulatory reforms as far as the industrial sector is concerned. In particular:

- Input and output prices should be liberalized as quickly as possible, with imports and exports allowed subject to declining protective tariffs. Certain prices, such as those of energy, may need to be adjusted in stages. Pending full convertibility, access to foreign exchange should be widened through auction.
- State enterprises should be formed into joint stock companies and corporatised to facilitate reorganization, restructuring and privatization.
- New entry should be liberalized and direct budgetary supports ended to facilitate exit from the market of uncompetitive firms.

- 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 Republic level and wage controls on private businesses lifted.
-Taxes should be uniform for all types of industry.

3.2 Industrial Policies and the Role of Industry Ministries

A ministerial structure is needed which will support and regulate industrial activity while being totally separated from production activities. The most appropriate structure would appear to be one Ministry of Industry at Union level and single Ministries of Industry in each Republic.

In the longer term, important functions of the Ministries would be to formulate and administer industrial policy, review and monitor long-term trends and international developments and disseminate information, following the prectices of ministries in Western industrial countries. They would promote Soviet industry abroad, develop and update product standards, work with concerned agencies and industry in applying environmental and safety standards and assist regulatory agencies in developing and monitoring controls on monopolies and anti-competitive practices.

In the shorter term there will be important additional functions during the transition to a market economy. Specialized agencies will need to be established to assist with programs of industrial restructuring which will encompass several elements:

1) Reorganization of Enterprises: existing branch ministries and associations should be dissolved, and most of the amalgamates should be broken down into independent joint-stock enterprises, to increase competition and flexibility. For enterprises which are vertically integrated at a single site, a longer-term view would be required. Social activities of enterprises should similarly be separated from productive ones, and transferred to local goverenments who would then bear full responsibility for their activities.

2) Privatization and Private Sector Development: recourse to several methods rather than the exclusive use of any one would increase the flexibility and pace of the privatization effort. Ownership rights and responsibilities must be clarified, and the structure of ownership should be such as to promote efficient maximization of the returns to capital. Concurrent steps should be taken to corporatize those enterprises that will remain within the state sector for some time to come and to improve their management. Small enterprises, in particular, should be privatized as soon as posssible, and the entry of small business fostered.

3) Enterprise restructuring: with suitable management, some segments of industry appear to be able to adjust quickly to new conditions, but there will probably be a temporary drop in industrial output with significant restructuring. Some firms will adjust effectively, some will require liquidation and some will require restructuring to become competitive. Given past distortions, it is not practical at this stage to try and assign enterprises into these categories. However, certain industries may be identified as critical, especially given the drastic changes in the composition of demand envisaged in current reform plans,

away from military and heavy industrial products and towards consumer goods. For the steel, hydrocarbon-based chemicals and machine-tools subsectors there is need to consider restructuring on an industry basis. Some form of restructuruing agency is necessary to provide a focal point for delivering technical assistance to firms where required.

4) Training of Managers 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.

5) Investments Although there is little justification for major state-financed investments in industries destined for privatization, the state has a responsibility to maintain certain productive capacities. There may also be a need for investments which, though relatively small, are required to make enterprises acceptable and profitable in the new environment. One particular category of such investments may be in the area of pollution control. Funding for such investments should not come from the government budget, which should instead concentrate on funding infrastructural improvements, notably in the areas of communications and transport.

6. Social Assistance. Industrial restructuring will unavoidably result in layoffs on a large scale. Programs for retraining, unemployment insurance and social safety net systems are essential to reduce the negative impact on the population and facilitate redeployment.

3.3 Rapid Improvement in Priority Consumer Goods

While all of the above measures need to be taken as part of the comprehensive reform strategy there is a particular need to improve the supply of consumer durables, not least because of the importance of this for "unlocking" supplies of agricultural products. Rapid reorganization of this sector should be a priority. Many of the existing producers of such goods are departments of large industrial enterprises and associations whose primary products and main priorities are geared towards heavy and armaments industry. Such departments should be separated legally, financially, and to the extent possible, physically, from their parents, converted into autonomous joint-stock companies, and privatized or leased out as rapidly as possible. This rapid proposed reorganization offers the potential for abuses through the undervaluation of assets, but efforts to prevent excesses in this area should not be made to the extent that they interfere with the dynamism of the process. 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

There is a tremendous need for material and technical assistance for the upgrading of Soviet manufacturing industry, but at this stage preference must be given to measures which support reform rather than investments in new machinery and equipment. In particular:

- broad-based management training is needed, to supplement the technical and engineering skills of existing managers

- information and service centers are needed, to promote private sector development
- support for industrial restructuring is needed, including studies of some critical sectors and the channelling of technical assistance to key enterprises with major potental and needs
- institutional support for the Ministries of industry will be needed, to help them to redefine their roles
- environmental support and investments will assist industries to address critical pollution problems and at the same time to develop the capacity to design and implement an environmental protection policy.

An Agricultural Strategy for the Soviet Union

Odin Knudsen, Ferdinand Kuba, Rory O'Sullivan, Karen Brooks

Soviet agriculture and agricultural marketing systems are at a critical juncture, but the sector has the basic capability to respond strongly and quickly without much additional investment. Production costs are high as is waste (losses are estimated at between 20 and 30 percent); the sector has been taxed by compulsory state orders at below market clearing prices and independent decisionmaking has been limited. The farm sector, dominated by state and collective farms, is nearly unresponsive to price incentives, and the state-controlled food processing sector is inefficient and antiquated. Price reform and fundamental change from state to cooperative and private ownership are necessary. The agricultural strategy outlined here is radical but is in line with some of the major programs for reform currently being proposed in the Soviet Union. It is more radical than the Shatalin Plan on price reform and more cautious on land reform.

The Strategy

The proposed strategy envisages a two pronged approach with safeguards built in. First is the liberalization of both retail and farmgate prices and second is the restructuring of ownership at both the agro-industrial and farm level.

- It is proposed that the government withdraw from its strict control of retail, wholesale and farmgate prices and compulsory deliveries (state orders) of products. But it is to maintain some institutional and price structure so as to make the transition to a more market economy in agriculture as smooth and least painful as possible.
- At the farm level, it is to encourage and make orderly a process of land reform, by which state and collective farms can be either sub-divided into economic units or voluntarily reorganized into cooperative farms consisting of private or user right landholders.

- Accompanying and supportive measures in the reform process would include actions on agricultural credit and banking, investment, and agricultural trade.
- The government would also need to establish a rural and urban safety-net and to monitor and respond to possible short-term food shortages. This response would require some additional imports to cover breakdowns in marketing and distribution and to buffer the initial price shock, especially in major cities.

Price Reform and Subsidy Reduction

Sbsidies to consumers have increased dramatically with increases in procurement prices and general inflation. Currently, retail food subsidies are at about 115 billion rubles (nearly twice the projected budget deficit for 1990 and about 12 percent of GDP) and are projected to double in the next year. With the government's inability to maintain procurement through compulsory state orders, food has become increasingly scarce in the state retail stores and shortages in major urban centers have grown. About 30 percent of supplies are estimated to be from free markets where prices are twice to ten times those in state stores. Continued price controls maintain the state's responsibility for prices, require administrative controls especially at the wholesale level and subject the state to political pressures to again let subsidies rise. Full retail price liberalization, although a severe and politically difficult measure, would permit overall price reform in the sector and the privatization of retail trade. Retail price liberalization would be followed by reforms at processing and at the farm. State orders would be eliminated and be replaced by selective state purchases forfixed quantities off the market; this would offer some transitional price guidance. Input markets would also need to be liberalized.

It would not be economically prudent to fully compensate for these price rises through general wage hikes. But a safety-net consisting of targeted income supplements to protect vulnerable groups would be needed immediately (pensions, supplemental school feeding programs, food stamps).

Land Reform and Privatization of Agro-industry

Incentives are inadequate and responsibility (eg for maintenance) are now diffused. Equipment is deteriorated and, while only having 3 percent of the land, private farming is able to produce 20 to 30 percent of the output. Slowly it is being realized that there is no substitute for private property or a close surrogate (for example, transferable long-term user rights), but this needs to be formally recognised.

Both proposals are predicated on the elimination of state control of farming, the separation of services from the ownership of the farms so as to ensure access to inputs for all farmers, and the privatization of agro-industry.

Proposal A. Under the more radical proposal, the state or collective farm would be divided into economic landholdings and the services --equipment, tractors and combines, fuel stations, and associated buildings-- into share packages of roughly equal value to the landholdings (with the absence of market prices these divisions by necessity would tend to be crude and based upon rough judgments). Individuals would be permitted to sell their shares or landholdings to others, and could regroup as cooperatives.

Proposal B. Under this proposal state or collective farms are converted to cooperatives, services are separated into either cooperatives or share companies, and private plots are slightly extended.

Collective and private farms and service cooperatives and stockholding companies that became bankrupt after conversion would be liquidated by auction to repay their debts.

Credit and Banking In the past, the banking system has been primarily a conduit for subsidies with debt forgiveness having been implemented 23 times since 1965. Interest rates and spreads have been low. Agrobank has no experience with financial and economic evaluation. This situation should be addressed, but banking will require time and attention, and possibly debt forgiveness to place the sector on a sound footing.

Investment Despite relatively high levels of investment the capital structure of agriculture is inadequate. Much investment has been wasted. After initial reform gains, investment will be needed for continuing growth. Storage and processing are the most critical areas, also machinery of a scale more appropriate for medium size private plots. The poor state of the farm machinery industry means that much of this equipment will need to be imported. Investment should be channeled through the banking system to response to private farming and agro-industry. Rural infrastructure should be the primary focus of the public sector but this will require establishing capability to do independent economic and technical analysis of projects. Refocusing current levels could permit a more than doubling of public investments and help to maintain employment and economic vitality in rural areas during the transition.

Agricultural Trade The state monopoly has been challenged by the declarations of economic sovereignty by the Republics. In a country as vast and diverse as the Soviet Union, it makes no sense to maintain central control over trade. An immediate priority is to begin the process of de-monopolization of trade and the establishment of uniform tariffs for agricultural products and inputs. An immediate benefit of this liberalization would be the imports of protein feed to supplement deficiencies in animal feed and save grain. Trade liberalization will take pressure off the internal transport system because exports from one Republic and imports of the same commodity by another makes more economic sense than trans-shipment across the Soviet Union.

Safety-Nets and Food Emergency Stocks The transition to a market economy will impose costs on some groups and government will have to institute measures to reduce the impact of rising food prices on the poor and pensioners and to smooth adjustment for farmers living in low productivity regions. In addition emergency supplies of food may become necessary in some regions where transport and distribution break down or farms withold supply because of accelerating inflation. An inter-Republic council should be established to monitor food shortages and take corrective actions.

This council could have as non-official members international aid agencies. Some extraordinary imports of flour, meat and milk products may be needed for major urban centers to assist in buffering the initial shock of price liberalization. But these imports should be moderate so as not to cause an excess supply and thereby reduce the incentives to deliver domestic produced products.

Measures to Improve the Situation Immediately:
- Price and distribution liberalization, with possible import buffers
- Supplemental, targeted programs
- Announcement of land reform program
- and the liberalization of the imports of protein animal feed and farm inputs and machinery.

Technical assistance needs will be substantial. Broad areas include: banking and credit, project and economic analysis, trade systems and policy, nutrition monitoring, and management and marketing of agro-industry. Standard information systems such as statistical collection of private market activity, crop reporting and trade flows are necessary. Controls and regulation of crop commodities and livestock products standards for hygienic and disease will need to be instituted; chemical standards and practices will also have to be reviewed. Steps should also be taken to assist in establishing more sophisticated markets such as options and futures. The research and extension network will also have to be revamped to take into account the changing structure of farming and the more independence of some of the Republics. A longer-term program of training and fellowships should also be instituted. Legal assistance will be necessary.

Investments in rural infrastructure and agro-industry will also need to be substantial, in particular, rural roads and communications are required. Irrigation and drainage systems need to be upgraded; public investment prioritization requires a comprehensive review. Large investments are needed in agro-industry but this should be channeled to cooperative and private enterprises. The emerging private farm sector will require suitable farm machinery. However, money alone will not solve agriculture's problems - a fundamental change in approach and policy is required.

The USSR Housing System and its Reform

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I CURRENT HOUSING CONDITIONS

Due to the neglect of housing during the Stalin era and war destruction, the USSR emerged with an extremely low per capita housing availability of 4m2 of usable space in the 1950s. Thanks to massive housing production efforts, especially in the 1960s, the current level is 15.8 m2 of usable space per capita, still less than half of that in Western Europe and with major quality shortfalls. Prices per m2 derived from exchanges exceed construction costs by a factor of four.

- The service quality of the housing stock is deteriorating steadily. Rent control, unchanged since 1928, produces rents that cover less than 40% of even low maintenance costs. Rents would have to be raised 6 to 8-fold to achieve genuine full economic cost recovery.
- Individual housing has been marginalized, although the share of private investment has risen recently, to 13.1% in 1989.
- Production and rent subsidies are linked to apartment units and not to the socio-economic characteristics of households; housing, rather than wages, is a major source of inequality in the USSR.
- Housing allocation mechanisms are unfair and increasingly corrupt. Typically 15-25 percent of a city's population is on waiting lists even though registration is limited (by measures including residence permit or "propiska"). The liabilities accumulated by the government through the waiting lists and the very important principle of a "socially guaranteed housing minimum" are important issues in considering housing reform and privatization plans.
- Production is dominated by large, inflexible and highly integrated monopolies, which are sustained by the supply and regulatory systems
- Housing availability differs between republics and, within republic, between cities. The Western and Baltic republics enjoy better housing and large (especially capital) cities are better off than small ones and rural areas.
- The housing situation is a major obstacle to labor force mobility, stability (in Siberia) and economic development.

II HOUSING REFORMS AS PART OF STRUCTURAL REFORM

Housing reforms are needed for macroeconomic stabilization, economic efficiency, and equity and social stability.

- Macroeconomic stabilization requires reduction of public deficits. Evidence from other socialist economies suggests that housing subsidies in the USSR could easily range between 3% and 6% of GNP. (This compares with food subsidies of 95.7 Billion rubles or 10.3% of GNP).
- Savings for housing should be promoted and excess household financial balances converted into real assets. In 1989, the average financial assets per household were R5,750, of which R4,250 were held in savings accounts; this compares with the official construction cost of a standard 55 m2 urban housing unit of R15,000 rubles. For comparison, using an unspecified methodology, the Shatalin report estimates the effective demand for housing at R70-75 billion rubles, so that somewhere less than half of involuntary

household savings would be neutralised through the housing sector in the immediate future.
- Considering efficiency and equity, reform is needed to facilitate labor mobility and to restructure incentives towards productivity-related cash wages rather than access to housing; it therefore requires wage policy to be reformed in parallel.
- Reforms need to promote an efficient housing industry (there is potential to cut construction costs by 30-40% with given materials prices from more flexible, and competitive construction and revised urban planning) as well as to free firms from providing housing, an activity in which they have no comparative advantage. Infrastructure use and energy efficiency could also be raised.

III REFORM STRATEGIES

From an economic perspective, major increases in rents should precede changes in property rights, to create an incentive to purchase. 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 housing market systems and that the clarification of property rights induces better pricing and cost recovery. In the housing area, property rights reforms imply at least three simultaneous changes: (i) strengthening ownership rights; (ii) in the opposite direction, the conversion of "permanent and guaranteed" administrative tenancy rights to fixed-term renewable rights; (iii) free and unrestricted exchange of existing units. These reforms should proceed rapidly as part of more general defininition of property rights.

Subsidies and allowances should be re-channeled away from the construction industry directly to households as far as possible. This should be accompanied by rent reforms, progressively moving towards charging economic rent, in close coordination with the privatization of various segments of the state-owned stock. This could follow the lines of proposed reforms, with some basic minimum given free and a charge levied for housing in excess of that level.

Introducing competition among producers will be easier as households gain greater freedom of choice, subsidies are redirected and markets widen for materials. All preferential treatment for large firms should be eliminated. Land use codes should be reviewed, and building codes will need to be revised to accommodate greater diversification of housing types and smaller-scale construction units.

Wheras many aspects of reform should be implemented on a decentralized basis, housing finance must be developed from the national level as an integral component of financial sector reform, and with particular attention to the viability of mortgage instruments. Special mechanisms may be needed to increase affordability while minimizing subsidy.

Reforms concerning the existing housing stock and new construction need to proceed in parallel because of their close interaction. A fairly detailed framework for reform has been developed for other socialist countries, and it is generally applicable to the Soviet Union.

Constraints on the Speed of Reform

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 development of market mechanisms in housing, which is managed as a social service subordinated to other priorities and with fragmented and uncoordinated administration. Nowhere are economic, financial, legal and technical issues brought together.

- Understanding of the implications of developing a housing market is uneven, even among reformers.
- 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 responsibilities and of assets between different levels of government is unclear.
- The analytical tools for policy analysis have to be developed and the information needed to evaluate winners and losers from reform is not available to support decisionmaking.
- Basic monitoring systems are needed to track the progress and implications of reforms.

10/20/90

Gorbachev's Economic Plan Approved

By BILL KELLER

Special to The New York Times

MOSCOW, Oct. 19 — President Mikhail S. Gorbachev won an overwhelming parliamentary mandate today for his plan to transform the destitute Soviet state from a Communist to a market economy.

The vote came after the Soviet leader challenged his radical critics with an urgent appeal for national discipline and a scorching attack on his chief political rival, Boris N. Yeltsin, President of the powerful Russian Republic, whom Mr. Gorbachev portrayed as a destructive opportunist.

If Mr. Gorbachev can overcome his two biggest obstacles — the threat of inflation rising out of control and the political resistance of the nation's restive republics — and achieve his broadly stated goals, it would mean the most sweeping reformation of the Soviet economy in six decades.

Mr. Gorbachev and his aides said the transition would begin with a period of draconian budget discipline, and would reverse the decline in supplies of consumer goods within two years. But they warned that it would be years — one top adviser said perhaps a generation — before a "full blooded" market economy is in place.

Role of Powers of Decree

The final vote, 333 for and 12 against, with 34 abstentions, reflected resignation more than enthusiasm.

The vote ended months of wavering between competing economic blueprints. One contender was a 500-day crash program to demolish central controls, which has already been adopted by the Russian Republic. The other is a variant for more gradual change drafted by the Government of Prime Minister Nikolai I. Ryzhkov.

Mr. Gorbachev's compromise is radical in its general direction, but vague about the mechanics of getting there.

Aides said he would rely heavily on the extraordinary powers of decree given to him this summer to bring the economy under control and create conditions for a marketplace. That means tightening the budget and money supply, creating stock markets and a more independent banking system, clearing the way for more foreign investment, and protecting private entrepreneurs from state meddling.

Republics' Broad Latitude

The plan also retains the central authorities's control over export of natural riches like oil and gold, although some kind of profit-sharing is to be negotiated with the republics that also claim those resources.

The plan envisions phasing out price controls, so that within two years only essential consumer goods will be priced by the state.

Broad latitude is offered to the republics and local governments, although far short of what some of them demand. The republics are to set the pace for deregulating prices, transferring state enterprises and farms into private hands, governing wages and social security, among other powers.

Even many radicals who said the program did not move decisively enough to break up the central economy's autocracy ended up supporting it, eager to take at least the first steps toward a free market.

'Now We Have to Calm Down'

Stanislav S. Shatalin, a co-author of the 500-day crash program favored by Mr. Yeltsin, showed up to urge a consolidation of forces.

While saying he still preferred his own, more drastic and detailed economic plan, Mr. Shatalin said he would remain on Mr. Gorbachev's Presidential Council to push for rapid expansion of private enterprise.

"Now we have to calm down and look at what can be done, what should be added to the program to speed up privatization," he said.

To succeed, his aides said, Mr. Gorbachev must assert control over inflation, which has undermined public confidence and diminished the incentive to produce, and win the political cooperation of the 15 republics, most of which have asserted their sovereignty.

Gorbachev Assails Yeltsin

The combative Mr. Yeltsin denounced the plan within hours of its publication Tuesday as a catastrophe doomed to failure. He insisted that economic reform should be in the hands of the republics' leaders, like himself, who have the popular trust to lead the country through hard times.

Today, Mr. Gorbachev tried to portray Mr. Yeltsin as a spoiler whose political tantrums are holding up a united attack on the economic crisis.

"I have the impression that the leadership of Russia is retreating from difficulties, and that it wants to lay the full responsibility for possible difficulties and consequences on the central authorities," Mr. Gorbachev said. "They are keeping their path clear for retreat."

"We must all realize that in the current explosive situation, the program of stabilizing the economy touches upon vital interests of the country, and it is immoral to turn it into a subject of political games."

Car Accident and Back Injury

Mr. Yeltsin was absent from the session today. Aides said he was scheduled to leave Moscow for a sanitarium, where he will spend 10 days recuperating from an automobile accident that aggravated a back injury.

Nikolai Y. Petrakov, Mr. Gorbachev's personal economic adviser and a free-market advocate, asserted that Mr. Yeltsin had repeatedly rebuffed Mr. Gorbachev's overtures, including refusing invitations to meet in recent days.

"His popularity is a great force, but it needs to be used properly," Mr. Petrakov said. "It's time to get to work, not to lead people out to demonstrations."

While Mr. Gorbachev concentrated his ire today on Mr. Yeltsin, his program was also intended to head off opposition from those fearful of encroaching capitalism and from those nervous about higher prices and unemployment. Summaries and full texts of the plan have been published this week in central newspapers.

Getting Control of Prices

To hold the support of squeamish Marxists in the Communist Party, he deftly skirted the ideologically charged issue of whether people will be allowed to buy and sell land. Land-ownership rights are viewed by many Communists as a sellout to the privileged and to speculators.

Mr. Gorbachev's plan supports private ownership of small businesses, stock-ownership plans for large enterprises, and lifetime leases of farmland with the right of inheritance. But full land ownership, he said, must be decided by the public, possibly by a referendum.

Mr. Gorbachev's immediate economic problem is to get control of prices, which have begun careering out of control, as goods gravitate from price-controlled state stores to the black market.

He admitted that "the worst mistake in the years of perestroika" was losing control of spending and the money supply.

"The crisis of the consumer market can't be eliminated until the machines that produce shoes, fabrics and other goods begin working faster than the mint," he said.

This year's deficit, swollen most recently by a new round of payments to meat farmers, is estimated to be at least 85 billion rubles — about 10 percent of the value of everything the Soviet Union produces. By that measure, percentage of the gross national product, the Soviet deficit is about 10 times as severe as the United States deficit.

Mr. Shatalin's 500-day plan specified deep cuts in the K.G.B. But the chairman of the police, Vladimir A. Kryuchkov, did not seem worried today that his agency would suffer much cutting.

Asked if the K.G.B. would take sharp cuts, Mr. Kryuchkov told reporters, "We'll see."

Excerpts From Gorbachev's Speech

10/20/90

Special to The New York Times

MOSCOW, Oct. 19 — Following are excerpts from President Mikhail S. Gorbachev's speech to the Supreme Soviet today, as translated by The New York Times.

You have received the 'Main Directions in Stabilization of the National Economy and the Transition to a Market Economy.'...

I would like to spell out why we declined a detailed elaboration of the program, and presented only guidelines.... It is better to formulate the general principles and create conditions for broad initiative in the republics and localities in considering their specifics. Where federal leadership is required — monetary, fiscal, credit, currency policy, basic social guarantees for citizens, structural policy, reorganization of administration at the union level — the line must be simple, exact and clear.

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A few words on fears about the market.... Popular fears of the unknown are understandable and natural. We have never lived in a normal market environment and have an extremely distorted understanding of the market. We know well what the black market is, speculators, collective farm and cooperative markets. We know the empty market of the state-run trade, the monopolized market without competition for the consumer's ruble, without competition to satisfy the consumers' needs. Competition is upside down here. People compete with each other by lining up for hours to buy goods, which have become scarce....

Now, against the backdrop of serious economic difficulties, we hear voices. Didn't we rush too fast to abandon the administer-by-command system? Of course, by selling off the richest natural resources we could have attempted to prolong the agony of the old system and tolerate the growing backwardness compared to economically developed countries, to drag out for a number of years the decrease in living standards, and slightly postpone the current crisis. But it would be impossible to prevent it this way. I must say this with full certainty: Sooner or later we would have had to pay for ignoring reason, for our refusal to make use of this instrument of common value — the market....

Land Ownership

I think we can certainly forecast that we are moving toward a mixed economy. Based on a sober evaluation of the existing situation, we can forecast that the conditions of modern production, historical traditions, and social environment will mean the dominance of public forms of property: joint stock, cooperative, collective. Judging by our own and world experience, we can say for sure there will be a significant role for state property. In cases when the private property is competitive and produces results, it has a right to exist.

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Especially sensitive is the eternal question of land ownership. Here we have to consider not the adapted stereotypes but deep national traditions and our inborn vision of fairness. Working on the program of restructuring the land relationships, we will have to find ways of making the peasant feel himself master on the land.... I think it makes sense to emphasize the development of lifelong leasing of land with the right to inherit it, which will create broad possibilities for economic initiative and exclude a chance of abusing and speculating of plots of land. We are speaking only about the general direction. The last word will be pronounced by the people themselves.

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It is important not to cross the line dividing real decentralization and sovereignty of the republics from the collapse of all state structure, chaos in the economy and society. This is our common responsibility. I think that the document presented to you succeeded in achieving such a balance. For the first time, the republics are being given such broad rights, including in the area of property, prices and incomes, social protections of citizens, formation and use of the budget, development of the credit system, and many other things...

Control of Finances

To establish a full-blooded market mechanism, we will need a number of years. The document solves the most difficult task of stabilizing the economy and creating the main instruments of the market.... The most important thing is in one and one half to two years, maximum, to radically improve the state of finances, stabilize the monetary system and to strengthen the ruble, and on this basis to provide control over inflation, control over the liberation of prices, over the creation of conditions for economic incentives, activating the mechanisms of market self-regulation.

• • •

We lost control over the financial situation in the country. This was our most serious mistake in the years of perestroika. The crisis of the consumer market cannot be eliminated until the machines that produce shoes, fabrics and other goods begin working faster than the mint. Achieving a balanced budget today is the No. 1 task, and the most important one. ... Enterprises in all industries will be put under strict financial conditions. They will have to abandon the thought that the budget or the bank will always come to help them in the end, and that they can count on free credit.... But we have to be realistic. This problem cannot be solved in a few months. So in the nearest future, in order to not allow a drastic drop in production, we will have to maintain economic ties by administrative methods.

• • •

In the transition period, the state will do everything possible to restrain the growth of retail prices on essential goods. There will be fixed state prices on a number of essential goods. When prices change, pensions, stipends, scholarships, fixed incomes, including doctors, teachers, military servicemen, workers at state offices will be indexed. That is, they will grow along with the growth of prices on goods in the consumer basket.

• • •

On Yeltsin's Comments

In its manner, and in the timing, and by its content and tone, it claims to be a political statement and therefore it can't be ignored. What do I think about this question? Yeltsin's concerns and worries about the aggravated situation in the country, and about the serious difficulties we are experiencing, are understandable.

One can only share his judgment of the need for urgent and extraordinary measures to change the situation. ... Unfortunately, other, confrontational motives prevailed in the speech. Sharp words, instead of weighty arguments and proposals. I was told that some kind of speech was being prepared, and that it was prepared in contradictory conditions. Some were in favor of such a speech, some were against it. ... I'm afraid that in this case, Boris Nikolaevich was let down by his consultants and advisers. ... I have an impression that the leadership of Russia is retreating from difficulties, and that it wants to lay the full responsibility for possible difficulties and consequences ... on the central authorities. They are keeping a path clear for retreat.... His speech is so full of confrontational fervor and diktat that it casts doubt on the sincerity of his intentions. In proposing to create a coalition, Comrade Yeltsin got so wrapped up in this side of the business, and so wanted to demonstrate his wrestling ability, that he seemed to forget that there are 14 other republics in the union.

We must all realize that in the current explosive situation, the program of stabilizing the economy touches upon vital interests of the country, and it's immoral to turn it into a subject of political games. Its failure would not bring dividends to anybody. It would only bring hardship and sufferings to all people.

10/20/90

Soviets Adopt Gorbachev's Reform Plan

Compromise Voted In Rout of Radicals

By Michael Dobbs
Washington Post Foreign Service

MOSCOW, Oct. 19—The Soviet legislature today endorsed President Mikhail Gorbachev's cautious economic reform plan to begin a gradual transition toward a free-market economy in place of the discredited system of central planning.

"The time has come to make a responsible choice. We cannot postpone the decision any longer," Gorbachev told the legislators, winding up a debate that has raged inside and outside the Supreme Soviet for the past three months on how to dismantle the economic system constructed by Joseph Stalin.

The document approved in principle by the Supreme Soviet today by a lopsided margin of 356 to 12 is designed to set the world's first socialist country on a long and tortuous road to a Western-style mixed economy. But, rejecting more radical suggestions, Gorbachev and his senior advisers warned that it could take many decades before the Soviet Union achieves its final goal.

"To create a real market, deep changes will be needed in the structure of our economy, the military-industrial complex and psychological stereotypes. All this will require at least 10 years, perhaps an entire generation," Deputy Prime Minister Leonid Abalkin told a news conference. "But if the Soviet Union wants to be a great power, respected in the world, it has no alternative but to go down this road."

Although practically all Soviet leaders now agree on the strategic shift toward a market economy, there is sharp disagreement over tactics. Earlier this week, the president of the giant Russian republic, Boris Yeltsin, denounced the Gorbachev plan as a recipe for "catastrophe," saying it preserves too many elements of the old command-administrative system.

In his 50-minute address, Gorbachev accused Yeltsin of "playing political games" and trying to escape responsibility for the economic hardships that would inevitably accompany the transition to a market economy. He rejected his rival's call for a coalition government in which the Communist Party would share power equally with representatives of the radical opposition, saying he would not bow to "ultimatums."

The plan approved today combines features of a government program for gradual reform with a radical plan favored by Yeltsin that promised to create the foundations of a market economy within 500 days. It relaxes the forced-march approach of the 500-day plan, maintaining a wide range of price controls and prolonging subsidies to loss-making companies through most of next year.

On several key points, such as the right of the federal government to raise taxes and retain control over export revenues, the final document represents a victory for Prime Minister Nikolai Ryzhkov. Denounced by the radicals as a spokesman for the vast state bureaucracy, Ryzhkov has conducted a tenacious and ultimately successful rear-guard action over the past two months to preserve some powers of the central government.

Back in early September, after Gorbachev said he favored the 500-day plan, the prime minister seemed a lonely, abandoned figure on the verge of resignation or dismissal. Today, however, he had regained a jaunty self-confidence, boasting to journalists that his "principled position" had paved the way for a sensible compromise.

"If the government had thrown in the towel and said, 'Whatever you want,' we wouldn't have had today's document, but rather the document I still think is unrealistic," Ryzhkov said.

The principal author of the 500-day plan, Stanislav Shatalin, put the best face possible on the political turnabout. After earlier insisting that the two rival plans could not be merged, and that he would not participate in "a farce," he claimed today that the final document contains many of his original ideas.

"For me the most important thing is the emphasis on free enterprise and private ownership. This has remained," Shatalin told journalists. Private ownership was long denounced by Marxist ideologues as tantamount to exploitation of fellow humans and therefore unacceptable under socialism.

Paradoxically, the initial phase of Gorbachev's plan is likely to witness several steps away from a free market rather than toward one. In

> *"If the government had thrown in the towel and said, 'Whatever you want,' we wouldn't have had today's document."*
>
> —Prime Minister Nikolai Ryzhkov

his address to the Supreme Soviet, the president warned that the Soviet economy is now in such a chaotic state that "administrative methods"—a euphemism for central direction of the economy—will be required to avoid a drastic slump in production and complete economic breakdown this winter.

"The situation on the consumer market has worsened catastrophically. The reason is clear . . . . We have begun to print money at several times the rate of previous years. We have lost control over the financial situation in the country," said Gorbachev, in a stunning acknowledgement of the economic mistakes made during his first five years in power.

The Soviet leader cited the growing budget deficit—officially estimated at more than 10 percent of the gross national product—as one reason why it was impossible to implement the 500-day plan in its original form. He accused the Russian republic's legislature of compounding the country's financial problems, and giving a further twist to the inflationary spiral, by raising procurement prices for meat by 50 percent last month.

(cont'd)

(Wash. Post 10/20/90 cont'd)

Like the 500-day plan, the Gorbachev proposals promise to slash the budget deficit by more than 50 percent as a prerequisite for serious economic reform. How this goal will be achieved is, however, unclear. While the latest plan promises to consider such measures as cutting expenditures on foreign aid, defense and the KGB security police, it fails to set precise targets.

The president's chief economic adviser, Nikolai Petrakov, said in an interview that Gorbachev has "several measures up his sleeve" to cut the budget deficit. "Journalists should not know about them, as they could create an explosion in society," he said.

According to Deputy Prime Minister Abalkin, the government will soon announce plans to centralize control of foreign exchange revenues under a new committee representing the republics. In a related move, Gorbachev raised the possibility of requiring that any future foreign assistance to the Soviet Union be channeled through the central government to ensure that aid is properly used.

Designed to be implemented over the next 18 to 24 months, the Gorbachev plan envisages a four-stage timetable for the recovery of the Soviet economy. Unlike the 500-day plan, it does not set precise time limits for each stage.

■ First Stage: The budget deficit will be slashed through cuts in public spending. An independent central bank will be established to control the money supply. Prices on luxury goods will be freed. Some state property will be privatized and land distributed to peasants on long leases. Existing economic ties between enterprises will be maintained.

■ Second Stage: Tight monetary control will be maintained to allow prices to be freed on nonessential goods without risk of hyperinflation. Fixed prices will be maintained on at least one-third of all goods, including oil and raw materials. Social security measures, including income indexing, will be introduced to protect living standards.

■ Third Stage: A housing market will be developed to help soak up the vast supply of excess rubles. A labor market will be established. The government hopes to fill shops with consumer goods, but will maintain centralized controls over exports of raw materials until the end of 1992.

■ Fourth Stage: Further privatization will provide the groundwork for a self-regulating market in light industry, food production, agriculture and services. Foreign companies will be allowed to reinvest their ruble profits in the Soviet Union. Full external convertibility of the ruble will take several more years.

#

October 22, 1990

EVENT: On October 19, the Soviet parliament approved Gorbachev's compromise economic reform plan.

SIGNIFICANCE: The confusion and delays in Soviet economic reforms have reduced the credibility of the reform process.

ANALYSIS: Although parliament has approved the new plan, there is no guarantee that it will be implemented or that it will be successful in establishing a market economy. The key issue is whether the plan is economically viable and politically acceptable to the union-republics, particularly the Russian Republic under the presidency of Boris Yeltsin.

The new plan is a compromise between the Soviet government plan drawn up by Soviet Prime Minister Nikolai Ryzhkov ('the Ryzhkov Plan') and the so-called Shatalin Plan (the 500 Days programme). e Shatalin group was assigned the task of drawing up a reform programme by a joint decision of Gorbachev and Yeltsin (see OADB, August 8, 1990, III).

The Shatalin Plan is more radical than Ryzhkov's (see OADB, September 20, 1990, IV). It envisages an early de-control of most prices and a faster privatisation of state enterprises. However, the most sensitive issue is the question of the powers of the central Soviet authorities versus the powers of the union-republics.

Much of the thinking of the Shatalin Plan is based on a acceptance of the fact that 14 out of the 15 union-republics in the Soviet Union have issued declarations of sovereignty. Representatives of all the republics (except Estonia) attended sessions of the Shatalin team and approved the section of the programme that dealt with "economic union of sovereign republics". The key principle embodied in that section is that the union-republics will decide what powers to delegate to the central government. The aim is to keep a customs union and a military union, plus whatever other powers republics will agree to delegate to the central Soviet government.

Yeltsin sought to persuade the union-republics to accept the Shatalin programme (the Russian parliament approved the Shatalin an in September) and so make it impossible for Gorbachev to reject or substantially modify it. Ryzhkov denounced the Shatalin Plan as liable to encourage centrifugalist tendencies, resulting in the disintegration of the Soviet Union. As a result, Yeltsin has called for Ryzhkov's dismissal. In order to avoid destabilising political conflict, and the consequent further loss of his own authority, Gorbachev sought to achieve a compromise between the two plans.

Whilst the compromise was being drafted, Gorbachev used his presidential powers to issue two decrees (on October 4 and 12) that run counter to the Shatalin Plan's directives. One directive called for higher domestic wholesale prices to be adopted next year. The other called for internal security forces to be used to protect enterprises from being unlawfully taken over. This latter decree could be used to prevent union-republics taking control over all-union enterprises.

Russian Prime Minister Ivan Silaev, and his deputy Grigorii Yavlinskii (who played a key role in drafting the Shatalin Plan), have said that the centrally ordained price rises make the Shatalin programme unworkable, as they undermine its call for prompt and tough budget cuts. As a result, Yavlinskii has offered his resignation to the Russian parliament, which will meet tomorrow to determine whether to accept it or not.

e published text of the new compromise plan, like both the ...yzhkov and Shatalin plans, aims to accomplish financial stabilisation and price de-control, and to make a substantial start on privatising state assets. It aims to accomplish these objectives within 18-24 months -- less than the Ryzhkov Plan and only slightly longer than the time period envisaged by the Shatalin Plan. It is, however, extremely vague on details and much less specific on time-tabling than the Shatalin Plan.

The published text of the new plan also says nothing about whether the powers of the central Soviet government will be delegated to it by the union-republics (as envisaged by the Shatalin Plan), or whether the central government itself will determine which powers it will exercise. The full text probably indicates the latter. Gorbachev probably wishes to retain a higher degree of central control, as he fears that the Shatalin Plan will excessively weaken the power of both the central government, and his own presidency.

This is endorsed by reports that the Gorbachev programme seeks to maintain central control of key exports -- most of which come from Russian natural resources (80% of the Soviet Union's exports of natural resources come from the Russian Republic). It is also suggested by Yeltsin's reaction to the compromise plan -- he called it a "catastrophe".

A month ago it looked as Yeltsin's position was dominant, and that Gorbachev would have to accommodate himself to Yeltsin's wishes. In economic terms, Yeltsin's position remains quite strong, as a result of Russia's natural resources base and the leadership's young and capable economic reform team -- in contrast to that of the Soviet government.

Politically, however, Gorbachev is still quite strong. He probably still has effective control over the armed forces and the KGB. His finance minister, Valentin Pavlov, has said that the Russian Republic lacks the legislative backing to pursue its own economic policies. However, the attempt to preserve greater central control is only likely to lead to further disaffection with the all-union government, and so will hinder, rather than facilitate, economic reform. In turn, this will increase, rather than diminish, centrifugalist tendencies, and so reduce further the country's political stability.

CONCLUSION: Gorbachev's determination to maintain the power of central government has probably set back the already slim chances of successful reform by several years. Politically, the Soviet Union is likely to become less stable.

Keywords: EE/SU, Soviet Union, economy, politics, policy, prices, fiscal, government, opposition, regional

THE WORLD BANK

ROUTING SLIP	DATE 10.23.90
FROM THE SENIOR VICE PRESIDENT, POLICY, RESEARCH AND EXTERNAL AFFAIRS	
NAME	ROOM NO.
~~cc: Messrs. Isenman & Mink~~	
Mr Holsen,	
John,	

[illegible]

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

REMARKS

Paul

10/23

FROM:

Wilfried P. Thalwitz

sads\w46935

Office Memorandum

To: Mr. Flemming
Mr. Thalwitz
Mr. Zecchini

October 23, 1990

From: L.A. Whittome

Subject: USSR--Production of Study Documents

At the Task Force leaders' meeting in Paris last week, several participants suggested that it would be easier to assemble the report if the documents were either produced in, or converted into, a common word processing package; it was also noted that ideally presentation should be standardized as far as possible, both for aesthetic reasons and to underline the joint nature of this report. The attached note elaborates these suggestions, based on informal discussions with Task Force leaders: comments would be welcome.

Two further issues. First, it was I think agreed at the meeting that the document would be most easily assembled in one place. On our part, we would be prepared to undertake the task, but would happily defer to any other who positively wished to do it. Second, as you will see from the attached note, it would be useful to come to a preliminary agreement on the ordering of the Task Force documents to facilitate table and chart numbering. One simple solution would be to follow as far as possible the ordering in the outline of the summary report, but without breaking up individual Task Force drafts, for instance:

I. Economic organization (IBRD)

II. Social issues (OECD)

III. External trade (OECD)

IV. Macroeconomics (IMF)

V. Sectoral Policies (IBRD)

VI. Energy and Environment (OECD)

VII. Primary industries, etc. (EBRD)

VIII. Medium term (OECD)

One could imagine other variants involving breaking up individual drafts, although this could prove considerably more complex. But please let me know what you think.

Attachments

USSR--Notes on Coordinating Word Processing Packages
and Presentation of Task Force Studies

1. Word processing

Following informal discussions with Task Force leaders, we understand that, with the exception of the EBRD who use Mackintosh Word 4, all either use WordPerfect 5.1 or can easily convert the package they use into it. We are exploring with the EBRD whether our computer department can assist with the conversion into WordPerfect; in the meantime, it seems sensible to use WordPerfect 5.1 as the standard.

2. Presentation

It would be desirable to eliminate the most obvious likely differences in the textual presentation, such as indentation of paragraphs, and number of headings. The attached note suggests some possible conventions: comments would be most welcome. Several Task Force leaders added that it would be advisable to adopt the simplest possible presentations in the Task Force studies, especially if they were not produced originally in WordPerfect and would have to be converted. In particular, footnotes should come at the end of chapters or sections, and bold print should be avoided.

Given that tables are very difficult to convert from other word processing packages, and that some teams may wish to use LOTUS tables, or tables in some other format, we may need to accept some diversity in presentation in this area. The same is clearly true for charts. For these reasons, it would be best if tables or charts were not incorporated directly in the text, but put either at the end of a chapter or printed on a separate page and inserted only if absolutely essential to the understanding of the text.

It would be useful to coordinate table and chart numbering conventions. Assuming that the chapter numbers suggested in the covering note were agreeable, one simple convention would be Table I.1, Table I.2 ... in Chapter I; Chart II.1, Chart II.2 in Chapter II and so on.

DRAFT

International Monetary Fund
International Bank for Reconstruction and Development
Organization for Economic Cooperation and Development
European Bank for Reconstruction and Development

Title of Paper

I. Main Section Headings

Indent first line of text five spaces. The main section headings are centered, underlined and identified with Roman numerals. The first word and principal words are capitalized. No period is placed after the heading.

II. A Main Section Heading Typed on Two Lines Should be
Centered and Underlined Only Under the Last Line

The following shows how the headings for subsections and divisions of subsections are presented.

1. Heading for subsection [1]

Headings for subsections are underlined and identified with Arabic numerals, placed flush with the left margin. Only the first word and proper names are capitalized. No period is placed after the heading.

Paragraphs within subsections are not numbered.

a. Headings for divisions of subsections [2]

These headings are indented five spaces. No period after the heading.

b. Headings that are on two lines should be typed
and underlined in this way

Text for this subdivision would begin five spaces in unless one wanted to create another subdivision in which case please see below.

(1) Headings for subdivisions

The first line of text would be indented ten spaces. The identifying number of the subdivision is enclosed in parentheses.

Begin all subsequent paragraphs here, regardless of indentation of first paragraph. This is true for all subsections and subdivisions.

Endnotes

1. Endnotes should be used to provide references etc. throughout the text.

2. Please note that only the first word of this heading is capitalized.

THE WORLD BANK

ROUTING SLIP	DATE 10-26

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

NAME	ROOM NO.
Messrs. Isenman	
Lamb	
Holsen	
Gelb	
Mink	

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REMARKS

RECEIVED
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PRDDR

FROM: Wilfried P. Thalwitz

sads\w46935

MULTILATERAL INVESTMENT GUARANTEE AGENCY
O F F I C E   M E M O R A N D U M

DATE: October 23, 1990

TO: Mr. Wilfried Thalwitz, Sr. Vice President, PRESV

FROM: Ghassan El-Rifai, Vice President, MIGPA

EXT.: 3-6162

SUBJECT: Issues Paper on Reform in Socialist Economies

Mr. Conable's office sent the above Issues Paper to Members of the President's Council and asked that we send comments directly to you. Mr. Terasawa asked me to review it and the following are some suggestions on the paper.

The outline is a good, well reasoned piece of work, that touches upon most of the key issues. As a general point, the outline could benefit from a more systematic distinction between stabilization and adjustment issues. Both are important as most of the former communist countries in Eastern and Central Europe not only need to adjust and transform their economies from a centrally controlled system to a free market system, but also have to rectify macroeconomic distortions and imbalances. Although, both issues are dealt with in the paper, a clearer conceptual distinction between them could sharpen the discussions.

In the paragraph presenting the main elements of reform, trade and fiscal reforms are not listed among the six key elements of adjustment, but are only mentioned as appendices to other reform elements, even though in latter parts of the paper both are mentioned -- rightly -- as essential reform measures. They merit to be considered key reform measures in their own right and to receive the corresponding emphasis.

More important, however, is the lack of emphasis given to private investment and, more generally, to the role of private initiative as an engine of economic growth and adjustment. This is all the more important because in the chapter on the preliminary lessons of experience, the importance of private small-scale business is mentioned prominently. There is no doubt in my mind that one of the first policy changes to be made in a communist economy ought to be the phasing out of laws and regulations hampering the free development of private initiative. Such policy changes can bring rapid -- albeit limited -- results with no cost to the Government budget, no additional burden on the Government administration and no danger of creating unemployment. As a next, already more demanding step, governments should improve the environment for private initiative and investment through changes in taxation laws, investment incentives, etc.... Considering that the paper is certainly right in assuming that public enterprise reform and privatization are "likely to be slower than anticipated" it is essential that measures be taken promptly to encourage spontaneous private initiative and investment, domestic and foreign. This ought to be recognized as one of the key elements of reform.

Finally, the paper gives too much emphasis on how to turn existing public enterprises into private ones, and too little on how to stimulate the creation of new private investments. The two issues would seem to me to be equally important. While the infamous Polish traders rummaging through the Balkans might not be the example of useful private initiative, they do prove that private initiative is live and kicking even after 40 years of communist rule. What is needed is the creation of the right environment to channel the forces of private initiative into the desired directions.

cc: Members of the President's Council

cc: Messrs. Sandstrom, Khanna

THE WORLD BANK

ROUTING SLIP	DATE 10.23.90
FROM THE SENIOR VICE PRESIDENT, POLICY, RESEARCH AND EXTERNAL AFFAIRS	
NAME	ROOM NO.
cc: Messrs. Isenman & Mink	

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REMARKS

FROM:
Wilfried P. Thalwitz

sads\w46935

Office Memorandum

To: Mr. Flemming/Mr. Fitoussi
Mr. Thalwitz/Mr. Holsen
Mr. Zecchini/Mr. Tuveri

October 23, 1990

From: L.A. Whittome

Subject: USSR

I attach a note setting down my understanding of the main points covered during the discussion over lunch at the Task Force leaders' meeting on October 15 in Paris. Any comments or corrections would be welcome.

It was agreed that the next meeting which would need to discuss the first draft of the summary report, would be held in Washington on November 19-21: I had generally felt that this meeting should be attended by the PRs and the task force leaders. I would assume that the first item of the agenda should be consideration of whether the flow of the argument was satisfactory. Next I think the meeting should discuss the draft report section by section resolving outstanding issues and eliminating inconsistencies. This may make for a long discussion but hopefully an earlier exchange of drafts followed by the circulation of second drafts which sought to take account of the major comments of the others could ease the task. Ideally by November 21 we should have an agreed draft, which could form the basis for a subsequent discussion with the Soviets.

Attachements

International Monetary Fund
International Bank for Reconstruction and Development
Organization for Economic Cooperation and Development
European Bank for Reconstruction and Development

Meeting of Personal Representatives and Task Force Representatives, IMF Paris Office, Monday October 15, 1990

During lunch, a short meeting was held to discuss the recent letter from Mr. Ivanov; a possible letter from the four HOs to Mr. Gorbachev; the possible visit of HOs and PRs to Moscow in late November/early December; and the draft outline of the joint report. The meeting was attended by Mr. Whittome, Mrs. Ter-Minassian and Mr. Robinson (IMF); Messrs. Holsen and Levy (IBRD); Messrs. Zecchini and Tuveri (OECD); and Messrs. Fitoussi and Aghion (EBRD).

1. Mr. Ivanov's Letter

Mr. Whittome asked for comments on how to respond to Mr. Ivanov's request that the forthcoming IMF mission complete the factfinding stage of the study. During a tour de table, Mr. Holsen and Mr. Fitoussi said that their factfinding was broadly complete: Mr. Zecchini said that the OECD energy team still required some further information. It was agreed that a reply should be sent to Mr. Ivanov agreeing to his request, with the proviso that the IMF mission could be expanded to include some OECD representatives (see attached reply).

2. A letter to Mr. Gorbachev

Mr. Holsen suggested that HOs should consider sending a letter to Mr. Gorbachev setting out some general issues--not conclusions--relating to reform. A draft had been prepared, and would be circulated to PRs. It was likely that the compromise reform program due on October 15 would not be produced on time: and during the Bank's discussions, they had felt that several key issues--including price reform, hard budget constraints, and foreign trade policy--were not being given the attention they deserved. Mr. Zecchini wondered what the purpose of the letter would be: if it were to draw Mr. Gorbachev's attention to a few crucial areas, then there should be an in-depth analysis: if it were general, he wondered whether Mr. Gorbachev would not already be aware of the issues. The danger of pre-empting the joint conclusions, as well as political considerations, needed also to be borne in mind. After some further discussion, it was agreed that HOs would have to make the final decision, but in any case it should not be sent until after Mrs. Ter-Minassian's mission returned.

3. HOs/PRs mission to Moscow

There was some discussion of the possible HOs/PRs mission to Moscow. It was still not clear whether HOs wished to go, but it was generally felt that they would delegate the task to PRs. In view of an OECD conference on November 28-30 (and in order to avoid Thanksgiving) the dates were tentatively changed to December 3-4.

4. Draft outline

Mr. Zecchini said that the draft outline was now broadly satisfactory, although he felt (supported by Mr. Fitoussi) that a section (perhaps half a page) on incomes policy as a stabilization tool would be useful. He also felt that too large a share of the drafting had been allocated to the IMF and IBRD, and wondered whether the OECD should not undertake the whole of Chapter IV (including prospects for 1991). After some discussion, it was agreed to leave the outline as it was, but that Mr. Zecchini would send a draft to Mrs. Ter-Minassian covering developments in 1991 as an input for her work. Mr. Whittome said that it would be most helpful if preliminary drafts of all sections could be circulated as widely and early as possible (preferably by late October) to facilitate the drafting.

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INFUND 610712F

OCTOBER 15, 1990

TO: MR. IVANOV
DEPUTY CHAIRMAN
STATE FOREIGN ECONOMIC COMMISSION
U.S.S.R. COUNCIL OF MINISTERS
MOSCOW

FROM: TERESA TER-MINASSIAN
INTERNATIONAL MONETARY FUND
C/O PARIS OFFICE

DEAR MR. IVANOV,

THANK YOU VERY MUCH FOR YOUR LETTERS OF OCTOBER 8TH AND 12TH, WHICH I HAVE DISCUSSED WITH MY COLLEAGUES FROM THE OTHER THREE ORGANIZATIONS.

LET ME FIRST SAY THAT WE HAVE ALL BEEN MOST GRATEFUL FOR THE COOPERATION AND HELP OUR MISSIONS HAVE RECEIVED FROM THE SOVIET AUTHORITIES, AND THAT WE RECOGNIZE THE HEAVY BURDEN THIS MUST HAVE IMPOSED AT AN ALREADY VERY BUSY TIME. WITH YOUR HELP, WE HAVE BEEN ABLE TO GATHER A GREAT DEAL OF THE INFORMATION NECESSARY FOR OUR WORK, AND AS YOU REQUEST, WE WILL TRY TO COMPLETE ALL THE REMAINING FACTFINDING DURING THE OCTOBER 16-26 MISSION. TO FACILITATE THIS--AS MENTIONED IN MY TELEX OF OCTOBER 8 AND MR. TUVERI'S RECENT FAXES--I WOULD BE GRATEFUL IF THAT MISSION COULD INCLUDE THE FOLLOWING RESPRESENTATIVES OF THE OECD:

MR. HAGEMANN	OCTOBER 16-23
MR. SHAFER	OCTOBER 21-26
MR. GRANZER	OCTOBER 16-24
MS. BJORKSTEN	OCTOBER 16-24

IF THIS IS AGREABLE TO YOU, I WOULD BE GRATEFUL IF YOU COULD (IF THIS HAS NOT ALREADY BEEN DONE) INSTRUCT YOUR PARIS EMBASSY TO ISSUE THE NECESSARY VISAS, AND ARRANGE FOR THE NECESSARY HOTEL BOOKINGS TO BE MADE (IF POSSIBLE IN THE SAME HOTEL AS THE IMF TEAM).

I LOOK FORWARD TO SEEING YOU IN MOSCOW.

YOURS SINCERELY,

TERESA TER-MINASSIAN

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INFUND 610712F
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THE WORLD BANK

ROUTING SLIP

DATE 10-23

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

NAME	ROOM NO.
Messrs. ~~Isenman~~	
Mink (For Distribution)	
For Study	

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REMARKS

FROM: Wilfried P. Thalwitz

sads\w46935

Office Memorandum

To: Mr. Flemming
Mr. Thalwtiz
Mr. Zecchini

October 23, 1990

From: L.A. Whittome

Subject: USSR

At the Paris meeting there was a brief discussion of the timing of a possible visit to Moscow, on the assumption that the HOs do not wish to be present (on this the Managing Director has told me that for his part he would not wish to go unless his colleagues all considered that the visit should be at their level).

The date tentatively suggested was December 3 and 4. It now seems that this would not be possible for all of us. As far as I can ascertain November 26 and 27 might be possible although I know Salvatore would be squeezed if the meeting continued until late on the 27th. Would you please let me know if these dates are possible.

I assume that at this meeting we shall be each accompanied by one or two colleagues. It has also been suggested that the meeting might be a lot more effective if a short summary of our views were sent to Moscow a few days in advance. I can see virtue in this and we could discuss the suggestion and if it were agreed that text at our meeting on November 19-21.

THE WORLD BANK

ROUTING SLIP	DATE 10.23.90
FROM THE SENIOR VICE PRESIDENT, POLICY, RESEARCH AND EXTERNAL AFFAIRS	

NAME	ROOM NO.
cc: Messrs. Isenman, Gelb, Holsen,	
Mink, Lamb	

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REMARKS

FROM: Wilfried P. Thalwitz

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

DATE: 22-Oct-1990 07:06pm

TO: See Distribution Below

FROM: Linda Jean McLaughlin, EXC (LINDA JEAN MCLAUGHLIN)

EXT.: 81137

SUBJECT: Visit to USSR

While we still do not have confirmation of dates for Mr. Conable's visit to the Soviet Union, preparation of briefing books has begun. Mr. Conable returns from his visit to Africa and the meetings in Paris on Friday, November 9. He may have to leave as early as Wednesday, November 14, for the Soviet Union. Meetings are being sought with the Ministry of Foreign Affairs, the central bank and President Gorbachev.

The deadline for written briefings to EXC is COB Thursday, November 8; verbal briefings will be scheduled during the 12th through the 14th.

Thank you for your adherence to these deadlines, as time in the office between trips is very limited.

Linda

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

My file

DATE: 22-Oct-1990 09:37am

TO: See Distribution Below

FROM: John A. Holsen, PADSS (JOHN A. HOLSEN)

EXT.: 33719

SUBJECT: **Discussion of Conclusions of Bank-Led JSSE Task Forces**

1. The Bank-led task forces for the Joint Study on the Soviet Economy returned to headquarters on October 9. On October 15 the Task Force Leaders from the four organizations met in Paris to discuss their broad conclusions, and to agree on drafting responsibilities and on the next steps in preparing the report. We are now working on the draft of our sections of the Main Report (which has grown for the originally planned 30 pages to more like 75-100 pages) plus a series of background papers.

2. We would like to meet with you on Friday morning, October 26. Fred Levy, Alan Gelb and I will want to report on the current status of our work and also hear your comments on the approach we are taking. To assist in the latter we will send you (not later than Wednesday, October 24) a preliminary summary of our analysis and conclusions under each of the topics assigned to the Bank-led teams. The meeting will take place in DECVP's conference room, S-9021, beginning at 11:00 am.

3. So far our analysis has concerned the general issues involved in the proposed reform program, with references to both the Abalkin and Shatalin programs. Now that the Supreme Soviet of the USSR has formally approved a compromise between these two, however, we will need to shift our focus to a commentary on the approved program. However, because we have not yet obtained a copy of this program, the papers we will distribute on Wednesday will necessarily still take the more general approach.

4. The first draft of the Main Report is scheduled to be completed on November 9. However, we intend to have a "zero draft" of our contributions ready by November 1; this will let us get a further round of comments before the contributions of the four agencies are combined in the official "first draft."

[S0102201.DOC]

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

DATE: 22-Oct-1990 08:23am EST

TO: Paul Isenman (PAUL ISENMAN)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: **Soviet Note**

Paul,

I am still sitting on the aide memoire. I hope to hear from Bugrov or Obminsky today re the BBC visit and Soviet requirements for preparatory work. I would like to then take a fresh look at the AM and draft a cover letter. I realize that I missed Geoff's excellent assistance, but am prepared to do the redrafting myself.

I'll keep you posted.

David

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION/MULTILATERAL INVESTMENT GUARANTEE AGENCY

OFFICE MEMORANDUM

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W Rene

DATE: October 19, 1990

TO: Distribution

FROM: John Nellis, CECPS JN

EXTN: 37482

SUBJECT: Draft of component for the Soviet Economic Study

I attach a draft of my component of this study. Comments welcome.

Distribution:

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I. Newport (LEGPS), A. Ewing(EMTIE), M. Hinds (EMTTF)
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Stanley Fischer, MIT;
Paul Hare
R. Amin

P-1867

DRAFT

JOINT STUDY OF THE SOVIET ECONOMY

BACKGROUND REPORT ON ENTERPRISES: OWNERSHIP RIGHTS, PRIVATIZATION, PERFORMANCE AND MANAGEMENT IMPROVEMENT

by

John Nellis
World Bank

October, 1990

TABLE OF CONTENTS

Draft

Joint Study of the Soviet Economy

Background Report on Enterprises: Ownership Rights, Privatization, Performance and Management Improvement

I. The Problem

1. The overwhelming bulk of productive capacity in the USSR is, at present, the property of the state. Over the years, the Soviet state has not acted as a prudent "owner" of this property. It has not taken the appropriate steps to assure and enhance the long-run productive capacity of its assets. This failure to represent adequately the interests of capital is a deficiency that lies at the heart of socialist economies in general, and the Soviet system in particular. Property belonging to "the state" -- i.e., to society in general -- is often treated as though it belongs to no one. It tends to suffer from neglect, mis-use and waste. Substantial financial and economic gains can be expected from market-oriented efforts to address this problem. This background paper examines those aspects of the problem that relate to state enterprises. It looks in turn at ownership rights in state enterprises, privatization of state enterprises, performance improvement in enterprises that, temporarily or indefinitely, remain in the hands of the state, and ministry and enterprise management.

II. Ownership Rights in Soviet State Enterprises

A. Enterprises

2. In the USSR, non-agricultural production is centered in the thousands of enterprises that make up the real sector of the economy. There are a reported 46,000 of these enterprises in the industrial arena alone. Adding energy, infrastructure and large service-oriented firms, the number of state enterprises of all sorts is said to exceed 55,000. Moreover, many of these enterprises are large "amalgamation," "associations" or "concerns;" i.e., multi-divisional entities, containing sub-units of

substantial size that in the West would often be regarded as self-standing companies. This suggests that the actual number of state owned productive units is much larger than the official aggregate indicates.

3. Until the mid-1980s, the Soviet enterprise system functioned roughly as follows: At the central or "All Union" level, sectors of industrial and manufacturing endeavor were identified and isolated as administrative "branches." All Union Ministries were formed not simply to supervise but to direct and control the affairs of the enterprises in their branch. By 1985 there were over one hundred branch ministries in industry; e.g., the Ministry of Light Industry, the Ministry of Electronics, the Ministry of Metallurgy, the Ministry of Automobiles, the Ministry of Machine Building and Machine Tools, etc.

4. These ministries acted in close conjunction with the four central organizational pillars of the command/planned economy: GOSPLAN, GOSSNAB, GOSKOMTSEN and GOSBANK; respectively, the State Planning Commission, the State Supply Authority, the State Price Commission and the State Bank. Until the onset of the <u>perestroika</u> reforms, these four central agencies and the branch ministries determined exactly what (and how much of what) an enterprise would produce; how much of which inputs it would receive to effect planned production; what investments were needed to maintain, expand or alter production; where all current and capital inputs would come from and what prices the enterprise would pay for them; and to where and at what price all production would be sold.

5. To complicate somewhat the picture, the All Union coordinating agencies and the branch ministries were partially duplicated at the republic level, so that the Ukranian Republic Ministry of Light Industry (for example) was responsible for a set of firms, the dealings of which took place within the Ukraine's borders, while strategic enterprises or those with trans-republic activities were dealt with from the center. Local government or city councils too had a set of firms under their jurisdiction; the relatively smaller entities producing services and items for purely local consumption. For a perhaps unusual example, 20% of all enterprises located in the region of the Moscow City Soviet are "subordinated" to this local authority. But irrespective of the level of government to which an enterprise was officially attached, its objectives, inputs, outputs and prices were dictated to it by government authorities.

6. Under these circumstances the very term "enterprise" was a misnomer. The firms were simply not independent companies, but rather were production units that responded to the directives of superior government offices and decision makers. Firm directors were much more production engineers than managers; i.e., they were concerned first with meeting the physical targets of the plan and second -- often a distant second -- with the quality of the item

produced. Questions of design, cost minimization and the division of retained earnings between rewards for the workers/managers and reserves for the expansion of the firm were not in the control of enterprise management (and the notion of a "dividend" -- a return to the owner on the capital invested -- was not even considered). By the beginning of the 1980s it was widely conceded, within the Soviet Union itself, that enterprises generally produced poor quality goods, operated at low levels of efficiency, mostly failed to maintain high technological standards, and were increasingly producing negative externalities such as pollution.

B. Current Reforms

7. Changes in the system of enterprise control began in earnest in 1985, were codified in a 1987 "Law on State Enterprises," spread and deepened in 1988, and were re-considered and expanded in a recently passed (June 1990) "Law on Enterprises," which will go into effect in January of 1991. The overall intent of the various changes instituted and contemplated to date is twofold:

- a- to increase the independence of industrial enterprises by augmenting the autonomy of enterprise managers and assigning some policy and managerial authority to enterprise councils of one sort or another; and
- b- to permit the existence of non-state enterprise (quasi-private) forms of production, and to place all production forms on an equal legal and regulatory footing.

The goal of these changes was to decentralize some decision-making to the level of the firm, to widen the scope for personal/ private initiative, and to substitute (partially) indirect financial signals for direct planning as a means to guide enterprises.

8. Thus, enterprise managers have been given an increased capacity to negotiate the amount of planned annual production, to design products in response to consumer demand, to seek foreign markets for their products and foreign partners in joint venture and co-production agreements, to retain in the firm increased portions of foreign exchange earned and to seek financing and credit arrangements from outside the traditional "official" funding sources. Starting in 1991, most enterprises will be allowed to sell non-state order, or above quota, production to non-traditional customers, in many cases, it seems, at above state prices. (Some enterprises have been doing this for the last two years.) All enterprises will enjoy a lighter and uniform rate of corporate tax. In 1987, enterprise councils were accorded the power to name managers and given a say in determining the use of retained earnings. From 1991, a new form of enterprise board -- composed half of workers' representatives and half of persons appointed by the "owner" -- will have a potentially powerful role in determining the direction of the firm, though it will not appoint the managers.

9. On the question of production forms, since 1988 the state has tolerated the formation of non-enterprise entities. These include cooperatives, leasing arrangements, "collectively owned" enterprises -- these are worker/manager buyouts -- "small" enterprises employing low numbers (which thus escape certain regulations), and "limited" companies. These non-state enterprise forms are quasi- or semi-private in nature. They are growing in number and in economic, financial and social importance. There are reported to be 215,000 cooperatives in operation as of October of 1990, employing 5.2 million people. One source asserted that cooperative production accounted in 1989 for 5 percent of GNP, and estimated that they would account in 1990 for from 8-10 percent. It is reported that for the period 6/89 to 6/90 employment in cooperatives increased by 70 percent, while output went up by 130 percent. Another source said there were 12,500 leasing arrangements officially registered.

10. It is reasonable to think that similar or even higher relative employment and output figures apply to leasing operations and the growing number of "collectively owned" firms, though these latter types are far less numerous than the "older" cooperatives. (Because of their lengthier history and the availability of information, the discussion below relies heavily on the example of cooperatives; the surmise is that their behavior reflects that of the non-enterprise sector as a whole.)

C. **Effects of the Reforms**

11. For the Soviet ministerial official, enterprise manager or person in the street, the changes of the last five years appear major, indeed near revolutionary, when contrasted to the rigid centralism of the past. The changes have not yet been fully effected, and data on the results are fragmentary and inconclusive. Some ministries and firms report production increases; some do not. Overall production has declined in the past two years; whether because of or despite the changes is unknown. Nonetheless, this report asserts that the changes are not sufficient to bring about large and sustained improvements in enterprise performance. What is the reasoning behind this assertion? First, with regard to enterprise autonomy, the announced reforms have not gone far enough; that is, they do not empower enterprise boards and managers to deal with the crucial set of parameters that determine enterprise performance. Managers cannot now set output prices, and the debate over when they will be allowed to do so -- or even if -- is unsettled. They cannot hire or fire their management team and workforce. They cannot chose inputs, locate plants or vary product lines and runs in accord with cost and demand structures.

12. Second, while the tolerance of new and different types of production forms is a more positive aspect of the reform process -- because in these entities assets <u>are</u> being put to more productive use and incentive wages and salaries <u>are</u> being paid to

involved staff -- the promised "level playing field" is far from being established. Cooperatives, for example, pay higher prices -- sometimes by a factor of 10 -- than state enterprises for many inputs, much higher taxes on corporate profits, and far higher duty levels on imports, reportedly to the point where few cooperatives now import inputs of any sort. This systematic discrimination against the cooperatives adds greatly to their costs. Nonetheless, there is considerable evidence that they generally outproduce state enterprises. Cooperative authorities stated that their average costs as a percentage of revenues are one half that of enterprises, even though they pay (on average) double the state wage prevailing in comparable industries.[1] The reason offered is that people in cooperatives work "better, harder and longer."

13. Soviet cooperatives (and the other non-enterprise forms) are attractive to entrepreneurial officials and managers in state enterprises, who see a chance to evade bureaucratic controls and amass wealth; to workers attracted by the higher pay scales; to state enterprise directors who increasingly rely on cooperatives and lease holders to produce inputs or finished goods that their regular workforce or suppliers cannot or will not make; and to liberalizing intellectuals who see the non-enterprise forms as eroding the monolithic command system and launching the market mechanism.

14. However, the cooperatives (at least) have a generally negative image among the populace as a whole. The public appears to view those in the service coops -- which make up 63 percent of the total -- as speculators, gougers, exploiters; i.e., people taking unfair advantage of the present unsettled circumstances to charge usurious prices and perhaps even manufacture shortages for high demand goods. In the production sphere the attitude is a bit less negative, though even here one often encounters an attitude that the coops consist of former nomenklatura who have found a way to enrich themselves by obtaining and using state assets at low prices.[2]

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[1]. As is discussed below, despite the claimed (and in many cases real) discrimination against them, some cooperatives are doubtlessly obtaining inputs at low or zero cost, through fraud or outright theft. Thus, this claim of generally lower costs to sales ratios would need examination in detail before it could be used as unequivocal support of the cooperatives' superior efficiency.

[2]. Not surprisingly, in all the non-enterprise examples reviewed by the mission, the driving force behind the creation of a cooperative, a lease, or a buyout was a well-placed manager or official who perceived an opportunity, and persuaded the workers that a change in status was in their self collective self-interest.

15. Detailed data on cooperative formation, location and operation are sketchy. One industrial branch ministry visited comprised a total of 401 enterprises, of which:
370 were state enterprises;
28 lease arrangements;
2 independent cooperatives; and
1 joint stock company.
But in addition, the ministry's enterprises contained 55 "small enterprises," and some 361 cooperatives "within the framework of enterprises." Some managers (in other ministries) were somewhat reluctant to speak openly of the cooperatives in their organizations. When asked about coops in his firm, one General Director noted: "I don't tell anyone but we have quite a lot. Practically every employee is in this coop or that." It is clear that these quasi-private forms are numerous within state enterprises, and that they are spreading rapidly.

16. In the past the emphasis on equality, combined with a need to limit growth in ministerial wage bills in order to minimize budget deficits, created a system of very small wage differentials between firms or professions. Still today, enterprises whose wage bills exceed a stipulated percentage of revenues are subject to a confiscatory tax on the excess. But the tolerance of quasi-private production forms creates a large incentive for workers and managers to organize themselves in this manner, since they escape the wage restraints. Enterprise managers either allow their production units and work teams to form coops or leases, or face the prospect of having their skilled, experienced workers resign from the firm and seek coop membership elsewhere. Many enterprise managers mentioned this new and, for them, disquieting phenomena. Thus, in order to retain the best portion of the workforce and to maintain production, managers either actively assist, or at least turn a blind eye to, the formation of the quasi-private forms. (It should be noted that the predictable macroeconomic impacts of this policy change -- large increases in average wages and an increased budget deficit -- are now in evidence.)

17. One possible microeconomic disadvantage of the quasi-private arrangements has already been mentioned; the likelihood, despite the coops' complaints of discrimination, that they are obtaining some or much of their inputs from the state at excessively low or zero cost. An even more fundamental potential problem is that, as yet, none of the quasi-private forms create real owners of all the capital they work with. A lease group may, over time, come to own the tools, trucks, etc., that it uses in its

work, but by definition it does not own the full range of assets it deals with.[3] The production coops often work in the same way.

18. The "collectively owned" enterprises come closer to a capitalist conception of private ownership, but in none of the cases encountered could one find any capital involvement or risk on the part of the new owners. Rather, they "purchased" the assets by turning over to the parent ministry the reserve fund of the enterprise in question (with the price of the enterprise being the depreciated book value of the firm -- a method which may be systematically undervaluing the long run value of the assets). Further, it seems that there is no "leverage" in these buyouts, which would at least impose a debt discipline on the new owners. In the vast majority of transactions so far concluded there has been a cash transfer from enterprise reserves and no debt incurred. While most of these quasi-private firms will in all likelihood perform better than state enterprises, and some of these new owners will undoubtedly perform well by the most rigorous of economic standards, the fact remains that generally those in the quasi-private sector are not at risk. They will not suffer personal loss (other than having to find a new job) if the firm is decapitalized or goes bankrupt; they are still mainly using other peoples' money.

19. This is the prime reason why the ownership reform process must be deepened. In order to achieve large-scale, enduring efficiency and production enhancing effects, the Soviet government(s) must move beyond the quasi- or semi-private forms of production and embrace full private ownership. This will entail changes in legislation (spelled out in the background paper on the legal aspects of Soviet economic reform).

20. This shift will not be easy. Unlike other reforming socialist economies, there is in the USSR no portion of the population that retains memories of a functioning capitalist system. The level of exposure to the principles of the neo-classical approach to economics is lower, even among reformers, than elsewhere in East and Central Europe. For example, a fair number of officials encountered claimed to support fully the free market approach, but when asked what should be done to solve a particular problem tended to respond with an interventionist, state-dictated solution. An egalitarian ethic appears to have

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[3]. The USSR Union of Lessees is aware of this problem. Officials of this organization made the point that 75 percent of existing leases contain an option to purchase for the lessee. The Union has asked the government to grant this option to the remaining 25 percent, and to include an option to buy in all future lease contracts. No data are available on how many lessees have already exercised their option, but the Leningrad branch of the Union said that "many" of their members had done so.

taken firm root in the Soviet political culture; citizens seem more concerned with relative differences in wealth than with improving the general level of opportunity. Overriding these factors is the question of to whom, to what level of government, do the assets actually belong? The resolution of these issues is urgently required, so that the process of privatization can move forward.

III. Privatization of Enterprises

A. Why Privatize?

21. The optimal and ultimate solution to the problem of poorly performing public enterprises -- particularly those producing tradeables and operating in competitive or potentially competitive markets -- is to privatize them. By privatization is meant the sale or transfer of a majority portion of the shares in an enterprise from a public entity to a private -- individual or group -- owner.[4] Private owners of capital have the most appropriate and powerful set of incentives to provide or employ competent management in the firms, and at the same time to watch over the long run health of the assets. The performance of enterprises <u>can</u> often be improved under public ownership, but privatization appears to be the most effective way to "lock in the gains." That is, privatization does not in and of itself cure the disease of poor performance, but it does help in preventing a recurrence of the problem. Finally, under purely private ownership, in those cases where wrong decisions on the part of the owners and managers lead to insolvency and bankruptcy, (a) the losses are private, not social; and (b) poor performance acts as a signal for competing entrepreneurs to step in, acquire the assets, and try to put them back to productive use.

B. Proposals Under Consideration

22. In the Soviet Union, in comparison to every other country (save perhaps Albania) in East and Central Europe, the level of debate on these issues is not well advanced. Why is this? First, the quasi-private production forms in operation in the USSR appear quite novel, advanced and perhaps even adequate to many actors in the enterprises. Second, the lack of a legal foundation for full private ownership (land ownership, for example, remains expressly prohibited) is a serious obstacle to further practical reform in this area. Third, there is little understanding among Soviet officials or citizens concerning just what private ownership is or

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[4]. Some analysts use the word privatization more broadly to refer as well to lease arrangements, management contracts, the private purchase of a minority block of shares, etc. Here the word is taken literally; it means majority private ownership of the enterprise.

entails; thus, even the most radical reform plans produced seem sometimes to confuse steps on the road to privatization with privatization itself. For example, there is a tendency to equate turning an enterprise into a joint stock company with privatization.

23. Some thinking is taking place on privatization mechanics, but the major and prior question of how enterprise ownership will be distributed among the levels of government -- Union, republic and local soviets -- has first to be resolved. Most of what concrete thinking exists is taking place at the republic and local soviet levels. Officials interviewed in one republic stated that privatization would begin in its territory on November 1, 1990; that the process would apply to all enterprises apart from some defense and strategic industries such as machine tools; and that "everybody" -- presumably meaning all citizens in the republic -- would be given 3000-4000 Rbls worth of shares.

24. No other meeting yielded such specific statements. Most respondents were quite uncertain as to when privatization would begin, the number or type of enterprises to which it would apply, whether the firms would be sold or given away, and how either one of these approaches would be carried out. Many officials vaguely thought that a cautious plan would be adopted, whereby enterprises would first be turned into joint stock companies; their shares would then be sold to banks, enterprises and other institutions, and that if the sales experience proved beneficial, then the sale (or giveaway) of shares first to the workforce, and then to the general public, would be considered. This complex process would obviously take some time to unfold. In general, there appears to be insufficient thinking about the specific mechanics of privatization, and in particular, on whether or how the population at large should be involved in the ownership change process.

25. Some local officials interviewed, in both Moscow and Leningrad for example, assumed and asserted that a substantial percentage of enterprises located on their territories would be theirs, to dispose of as they wished.[5] One local soviet offered the following program for privatization:

a- enterprises would be transformed into joint stock companies and their assets valued by a Special Commission

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[5]. One reason for this is that local councils are in most areas facing large financing gaps in their budgets due to massive reductions in grants from the central government. Since they have almost no taxing powers, local councils are keen to find ways to generate revenues from the assets they theoretically control: local enterprises and real estate. Local governments are in serious financial straits; for example, Moscow City Soviet officials anticipate a budget shortfall of 12 billion rbls in 1991, a sum equal to half of total projected expenditure.

of the All Union Ministry of Finance (asset valuation on the basis of depreciated, not-adjusted-for-inflation book value);

b- enterprises selected for sale (there was no mention of a giveaway) would first be offered to the existing "collective" -- the workers, technicians and managers in the firm; they -- or any purchaser -- would buy the enterprise but only long-term lease the land on which it stood;

c- the members of the collective would use their own savings for the purchase, but if more funds were needed banks would be involved; and these banks would receive shares in the enterprises for their funding of the collectives' buyouts;

d- if a collective did not exercise the option to purchase within 6 months (the Shatalin Plan suggests consideration time be limited to 1 month) the enterprise would be auctioned to Soviet legal entities, meaning private individuals or groups, or other enterprises;

e- priority in the auction would be given to certified residents of the local soviet area, regardless of their area of origin within the USSR;

f- if no suitable offer were made by a local resident, then the firm would be offered to any citizen of the USSR, regardless of area of residence; and finally,

g- if no suitable offer were made by a Soviet citizen, then the enterprise would be offered to foreign buyers.

26. These proposals of the republican and local officials are revealing. They indicate a lack of an agreed-upon approach to privatization, a very optimistic view on the availability of paying purchasers, both domestic and foreign, and an equally rosy assessment of how easily the process can be organized. In the main, they seem aimed more at minimizing political opposition than maximizing financial and economic returns. The notion of offering the enterprise first to its collective, and only broadening the market successively as preferred buyer groups decline the purchase option, is an illustration of this: the approach may make sense politically but it sacrifices possibilities of raising revenues from the sale, and relegates to the background the bringing in of managers with needed experience and fresh capital.

27. In Yugoslavia, Poland and Hungary, enterprise-controlling workers' councils have established claims or rights that severely complicate the privatization process. The difficulties of resolving these claims, combined with widespread fears that uncontrolled or "spontaneous privatization" was resulting in illegal and unjust transactions, has complicated and sometimes halted divestiture efforts in those countries. In the USSR, workers councils have not had as much legal power, nor have they exercised what powers they possess for a lengthy period (since 1987 only). Soviet workers do not seem to have developed as strong

a sense of ownership rights as workers in the three countries mentioned. However, as noted, a number of radical voices are now advocating giving free of charge the enterprises to their existing collectives; and this position is, not surprisingly, finding a receptive audience among workers.

28. A competing claim, expressed by some managers and ministries, is that the Soviet experience with "free" property has been disastrous, and that any and all transfers of ownership must involve payments. To add to the concern, there is considerable and growing public unease over the supposed illegalities and perceived inequities of the quasi-private sector. But all of these discussions are preliminary and unsettled; they have not yet reached the stage of deliberation found in the three countries named above (or Czechoslovakia). Except for the single case mentioned, the mission encountered no talk of distribution mechanisms; i.e., of "voucher schemes," "ownership coupons," or widely-held holding companies. The reason for this is that discussion of the extremely unsettled union/republic situation has taken precedence over consideration of technical details.

29. However, the issue of privatization techniques/ mechanics will probably soon come to the fore, at the local soviet and republican, and perhaps the all-Union level as well. If the notion of giving or selling enterprises to their collectives takes root, complaints will start to surface from the large number of people whose work positions would not automatically confer ownership rights under such a transfer system. These people include professionals, administrators, intellectuals; i.e., articulate groups. To assist in the process of formulating an appropriate and workable privatization policy, and to minimize the possibility of disruptive disputes, Soviet authorities at all levels could profitably examine the experience in ownership change carried out or envisaged in neighboring reforming socialist countries, with a view to applying the lessons so far learned to the Soviet scene.

30. Even if the legal and policy frameworks were immediately settled and made conducive to sales, it would not be possible to sell 46,000 enterprises overnight; indeed, it would be hard enough to give them away all that fast, even assuming that one could find competent people to take them. Nonetheless, many parts or bits of these enterprises could and should be divested with extreme rapidity. In Poland, more than 6,000 state owned small retail shops and service units were transferred to private owners -- usually those who had been working in the units -- in the course of a few months in 1990. Such activities are envisaged in the Shatalin reform plan; they could in many cases be implemented by local and republican authorities without waiting for the resolution of Union/sub-Union relations. This process should begin as soon as possible.

C. Problems with the Quasi-Private Sector

31. An absolutely critical question is whether and how to regulate the quasi-private sector. The dilemma is as follows:
<u>On the one hand</u> --

* the existing quasi-private sector appears to be more efficient and productive than the state enterprises.
* The larger it grows the more productive it will become; and
* the more numerous the units within the quasi-private sector the greater the likelihood that competition, and all its attendant benefits, will emerge.

Therefore, the quasi-private sector should be unleashed, meaning the bureaucratic barriers to entry in this sector should be eliminated, the discriminatory tax, credit, pricing and customs policies should be abolished, and the process of "hiving off" parts of enterprises, or entire firms, and turning them into quasi-private operations should be not grudgingly tolerated but actively encouraged.
<u>On the other hand</u> --

* not being complete owners the quasi-private operators may tend to reward themselves and their workers at the expense of the long range health of the capital they employ;
* the quasi-private sector has in many instances obtained the assets it controls or "owns" for an excessively low price (sometimes zero cost), and this, as noted, may be a major reason for its higher productivity;
* it often consists of enterprise employees doing at night, for a higher salary, that which they are supposed to -- but do not -- do during the day for their normal salary;
* through "under the counter" barter deals and outright corruption some quasi-private operators are diverting a substantial flow of inputs to their own production needs, at the expense of the planned production schedules of many state enterprises; and finally, (a problem of a quite different sort),
* the widespread negative attitudes of the public toward quasi-private operators in general, and service cooperatives in particular, could be used as a rallying point for conservatives who wish to return to the administered security of the command system.

Therefore, the quasi-private sector needs to be regulated, so as to ensure that a reasonable price is obtained for state assets transferred, to see to it that the state is not paying twice for inputs, to minimize monopolistic practices of the quasi-private operators, to prevent other abuses so easy to perpetrate in an economy of scarcity and distortions, and to preclude the possibility of a backlash against what is perceived as theft and gouging. (The critical first issue; i.e., shifting the sector from quasi- to full private ownership is a matter not of regulation, but of a fundamental change in legislation.) Faced with this dilemma, what should the Soviet authorities do?

32. Ideally, to deal with these issues the authorities should at the same time deepen and regulate the quasi-private sector. That is, they need to establish in law a full set of property rights that allows individuals and legal entities to purchase assets, including land, and to receive a legal, tradeable title to the assets bought. This by itself would open the floodgates to further and beneficial privatization transactions.[6]

33. However, Soviet authorities also need a review mechanism to assure that assets and enterprises are being privatized in a transparent and fair manner. Other reforming socialist governments, facing similar problems, have established a State Property Agency[7], a Ministry for Ownership Changes or republican level Development Funds (in Hungary, Poland and Yugoslavia respectively). The purposes of these bodies are to see that the assets up for sale receive a valuation by someone outside the enterprise (other than the bidder, of course); that the valuation method used is reasonable, consistent and transparent; and that there is a process to examine the bidder's background, sources of funds and/or credit, and potential competence in running the enterprise.[8] Finally, these government bodies either retain or share with legislatures the responsibility for the final acceptance or rejection of an offer. The divestiture issue is normally so sensitive that it must be decided by the higher political levels; it is not a decision to be left to administrators.

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[6]. It would not eliminate all remaining problems. For example, in a number of Soviet cities, it has become possible in the last two years to purchase the apartment in which one dwells. To date, very few have exercised the option. Why? Because the cost of housing is highly subsidized; the average citizen pays about 5 percent of total income for rent, heat, lights and local phone charges. Since there has been no move or threat to remove the large degree of subsidy, there is little incentive to purchase an apartment. Indeed, there is a disincentive, in that obtaining the materials to effect repairs is both time consuming and expensive. Until the subsidy is removed and rents move upward sharply few Soviets will see any point in buying their apartments.

[7]. In the USSR legislation has already established a State Property Agency, but it is not functioning, and cannot until the question of what level of government owns what is settled.

[8]. In capitalist countries the best general method for determining these factors is a bidder's willingness and capacity to pay a higher price than other bidders. This means that the larger the number of bidders in a sale, the greater the chances that the seller will maximize his objectives. This is another reason to be concerned over the suggestion in the USSR that privatization will proceed from narrow to broader markets.

34. All this sounds quite reasonable and straightforward; it seems to impose a tolerable minimum of review and control on an unavoidably contentious topic. The problem is that in Hungary and Poland (and elsewhere in non-socialist countries) attempts to rationalize and regulate the privatization process have resulted in delaying it. That is, rather than make sales transparent and fair, regulation of this nature has brought divestiture to a halt. This is everywhere regrettable. But it would be particularly unfortunate in the Soviet Union, which is in desperate need of enhancing levels of efficiency and production, and where, to date, the quasi-private sector is performing comparatively well.[9]

35. Thus, finding a way to promote the productive aspects of the quasi-private sector while preventing the chaotic grabbing of assets is a top priority. While recognizing the risks involved, this report recommends that Soviet authorities tilt the scale in favor of deregulation, unleashing and indeed actively encouraging the quasi-private sector. The reasoning behind this recommendation is as follows: First, despite the explosive growth of the quasi-private sector in the last few years, the state enterprise position remains absolutely dominant. Second, the chances for diminishing this dominance through the channels of legal reform followed by the sale of individual enterprises, are slight. At the very least, this type of reform would take years to effect. Given these circumstances, the costs of the quasi-private sector's operations are outweighed by its production and efficiency benefits. Moreover, the larger the size of the quasi-private sector, the greater the possibility that internal competition will begin to mitigate its deficiencies.

36. The only alternative would be to wait for the resolution of the present political crisis, to wait for the promulgation of more appropriate laws, and then to wait for the definition and the implementation of a rationalist privatization policy. It seems evident that the wait would be interminable. It is preferable to support the growth of the quasi-private sector.

37. Still, some measures could be contemplated to guard against serious abuse. One possible mechanism would be to require existing branch ministries to review all quasi-private operations proposed in the framework of their enterprises, and to have the capacity to refer to republican and All Union ministries of finance cases of dubious utility or legality. The branch ministries would not have any power to stop a proposed operation; rather they could

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[9]. This illustrates yet again the urgency of addressing the underlying legal issues, as some of these problems are muted or disappear as soon as the qualifier is removed, and the quasi-private becomes simply the private sector, able to operate as an owner.

only refer questionable cases to higher decision-making authorities. The idea is to avoid the creation of a licensing or administrative vetting agency with power to approve or disallow any proposal. Making every transaction or transformation reviewable by such authorities would create administrative delays and overwhelm the reviewers; better that they should review only questionable cases referred to them.

38. Another possible guarding mechanism would be to require all quasi-private operations coming into being to publish in the press a statement listing the names and addresses of the members of the cooperative, those involved in a lease-holding, or those participating in a "collectively owned" enterprise; to list the capital they have contributed, the assets they have obtained, the price paid for those assets, the cash/debt ratio of the payment, where the credit was obtained and under what conditions. This is a transparency requirement.

39. Some will argue that these proposals are too strict and constraining for quasi-private operators; others will see them as too lenient and permissive. It is admitted that it is difficult to find ways to both encourage and control the quasi-private sector. Whatever position the Soviet's adopt, what they must not do is let the situation drift in its present unsettled manner.

IV. Performance Improvement in State Enterprises

40. The private and quasi-private sectors may expand very rapidly, but given the present lack of clarity concerning basic policy, and the sheer number and weight of state enterprises, it is simply inevitable that the various levels of the Soviet state will -- temporarily or indefinitely -- remain responsible for a large number of firms. What can be done short of ownership change to improve performance in this mass of companies?

41. Two prefatory points: the first is that in both socialist and non-socialist countries improvement efforts short of privatization have generally yielded only modest results. Nonetheless, it is possible to recommend a reform package that has a chance both of being implemented and of improving performance. The second is that, as noted, the Soviet authorities have already initiated a set of reforms; but these are reminiscent of efforts tried earlier in other socialist economies, particularly Hungary and Poland, both in terms of the type of changes instituted and meagerness of achievements. To reiterate: the problem with past Soviet reforms is that they did not create an "owner" protective of the capital employed; they did not formulate a limited set of achievable, commercial goals for enterprises; they did not provide sufficient autonomy to managers at the level of the firm, nor did they create mechanisms by which the representatives of the owner

could monitor performance, reward success and punish failure. This, in essence, is what further reforms must do.

42. The achievement of these further reforms requires a number of inter-related steps. These are:

a- All state enterprises should immediately be transformed into joint stock companies. Their shares should be held by portfolio management agencies brought into being at each level of government (that is determined by the political and legislative process to be an owner of firms). These agencies[10] represent the owner of the enterprises.

b- The owner's representatives should issue clear policy statements stipulating that enterprises will henceforth be run as profit maximizing, commercial operations.

c- In conjunction with the introduction of price liberalization, a hard budget constraint should be imposed on all enterprises; i.e., as prices start to represent scarcity values the transfer of government funds to the enterprises -- in the form of unjustified capital injections or credit at concessionary or negative interest rates -- will end.

d- The notion of "non-commercial objectives" should be introduced. Most Soviet enterprises have long been burdened with non-economic goals, including educating their workers and surrounding residents, providing health care for workers and surrounding residents, selling "socially desirable" products at less than cost, producing consumer items for which their technology and workforce is unsuited, locating plants for regional equity rather than commercial concerns, etc. In the future the assignment of such objectives to firms must be minimized. Where the owner determines that there is both an acute need for such an objective to be filled, and that there is no superior, lower cost alternative to the work being carried out by an enterprise, then such objectives may be assigned to an enterprise. However, their special nature must be noted in writing, the cost of carrying out these activities should be calculated, and the firm directly compensated for their fulfillment.

e- The general point is that the performance of managers and workers should be evaluated on the basis of transparent commercial factors within their control. They should neither

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[10]. These portfolio management bodies might be called State or Republican Property Agencies, or that name might be reserved for the agencies in charge of the privatization process. Experience elsewhere indicates that it is difficult to combine in a single agency the portfolio management and privatization responsibilities, regardless of how related the activities appear on the surface. The plural, agencies, is used because it is likely that both the political process and the overwhelming workload will necessitate a number of these bodies, probably at the republican level.

be rewarded for improvements in performance caused by shifts in exogenous variables, nor should they be punished for losses brought about by efforts to achieve the socio-political goals of the government/owner.

f- The owners' agents should guide and assess enterprises by naming the members and supervising the performance of the enterprise Board of Directors.[11] Ideally, a majority of the Board of Directors should be drawn from the private sector; but this is patently impossible in the present Soviet circumstances. Still, the boards could be composed of technical experts in the field of the enterprise's activity, of legal and banking experts, and of persons representing the firm's clientele, creditors or suppliers.

g- The board should have full power and capacity to appoint, evaluate, reward and dismiss enterprise management. The owner has the same rights over the board, and in particular the chair of the board. The board deals with the enterprise; the owner deals with the board. The owner has <u>no</u> direct dealings with enterprise management. Enterprise management has the power to set output prices, hire and fire, determine product line and run, and plant location. Salaries and rewards for managers and board members should be commensurate with their talents and responsibilities (i.e., not dictated by government pay scales).

h- It is the board's responsibility, working with and through management, to establish and then monitor a formal system of annual statements of corporate intent, specifying the commercial objectives, clear targets against which performance shall be judged, a dividend policy, the non-commercial objectives imposed and their compensation, and details of the rewards or sanctions handed out if the objectives are -- or are not -- achieved.

i- In cases where managers fail to perform well -- in areas under their control -- they should be dismissed by the board. In cases where boards prove incapable of eliciting good performance from managers, the boards should be dismissed by the owner. Conversely, good performance deserves rewards.

j- In this schema, the role and powers of the branch ministries would be greatly reduced. Many of their responsibilities would be taken over by the portfolio management agencies, the emerging commercial banks, and the revamped boards of directors. A possible organizational variation would be for the branch ministries to assume the portfolio management role; this is not the preferred solution.

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[11]. The type of Board of Directors suggested here may conflict with the composition of enterprise boards in the Law on Enterprises that comes into force in January of 1991 (see para. 8).

43. This reform package has proven its capacity to effect substantial performance improvements in enterprise sectors to which it has been applied. However, it has to be acknowledged that there is much in the above list of steps that the mass of Soviet bureaucrats and enterprise managers would find difficult to understand, much less enact. The very notion of an enterprise as a unit isolated from the larger "branch" in which it is situated, having a commercial life of its own separate from the interests of the workers in the firm, succeeding or failing as its sales and prices fluctuate -- these are alien conceptions to many in the Soviet system. Even if one assumes that the lack of widespread understanding of these issues delays or complicates, but does not preclude a transition to market mechanisms, there are many specific legal and policy preconditions that must be fulfilled, or issues that must be addressed, before the proposed enterprise reforms could take place.

44. To list the most salient:

* Transformation of all enterprises to joint stock form assumes that the "state" is defined as the sole or controlling owner; this has not been easily accepted elsewhere in reforming socialist economies, and the issue is by no means resolved in Soviet law or thinking.
* Price liberalization has to precede the imposition of a hard budget constraint; otherwise some good firms with output prices set below costs would disappear. The extent and pace of price liberalization has not yet been determined.[12]
* Minimizing non-commercial objectives requires that legitimate social functions be undertaken by other bodies, either public or private. This issue is just beginning to be addressed.
* Turning management and supervision activities over to firm level bodies -- the board and the enterprise managers -- means finding a mass of people with the competence to take on these new and different roles. People with the requisite skills do not exist in the needed numbers.

45. The point in listing these issues is not to dwell on how difficult reform will be; rather it is to show the inter-related nature of the reform process, and to shed light on the manner in which it might usefully be phased. For the issues under review then, step one is specification in law of ownership rights, step two is movement on price liberalization, step three is attention to the social safety net to deal with those negatively affected by reform, and step four is providing the firms with capable directors and managers. The first three steps are dealt with by other

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[12]. This discussion ignores the issue of monopoly pricing; the topic is covered in other background reports.

background papers in the joint study; the fourth issue is addressed below.

V. Ministry and Enterprise Management

A. Perceptions and Reactions

46. The bulk of higher level enterprise personnel encountered by the mission were production engineers and technicians, not managers. That is, they were more at home describing the design and quality of the items they produced than they were in discussing firm finances. Financial directors, both in the firms visited and in branch ministries, not surprisingly had a better grasp of levels of profits, debt structure and types and amounts of government support. But even here there were several surprises: one financial director of a very large plant stated that annual average revenues of the enterprise were "a mystery" to him; while the financial director of another firm of 3500 employees did not know the rate of interest the firm was paying on a 10 million ruble loan.

47. Every one of the managers met saw that the rules of the game had been altered. But rather than take steps to position themselves and their enterprises to deal with, or take advantage of the changed set of rules, many were waiting to be told -- by the ministry, by other central authorities, by anybody -- what to do next. Management trainers interviewed said that a "wait to be told" attitude typified Soviet managers, who were previously not expected and are now generally not prepared to take decisions, to seize opportunities and to act in a self-reliant manner. This assertion was backed by several ministerial officials, who said that the new system was fine for the bold and the brave, but made more difficult the life of the average manager.

48. Nonetheless, the mission encountered a number of managers, and ministerial officials, who perceived possibilities in the unsettled, flexible scene, and were taking positive steps to position themselves in order to survive, and perhaps even thrive, in the newly emerging environment. One manager, for example, was using a new found latitude on paying workers to form "flexible production teams" in his assembly plant. This method allows core teams of workers to determine the pace of production and the number of supplementary workers to be brought into the team; the teams choose how many people to involve and how many hours to work, and are rewarded financially for quantity and quality of production and cost minimization measures. This, and several other incentive systems linking significantly higher pay with higher individual or small group output, is very new in Soviet firms. The initiating manager noted that workers in the teams earned 2.5 times the average wage, that there was keen competition to join the teams (the foremen are told to take only the best), and

that by allowing him to start such teams he now had a way to compete with the cooperatives.

49. A number of other managers encountered are going farther (without crossing the line and joining the quasi-private sector). There is a generalized and almost feverish effort on the part of innovative managers to involve a foreign partner/investor in their operations. There is considerable wishful thinking in this on the part of managers who hope to find market access and hard currency capital through foreign -- read western -- participation in their enterprises. But they generally have unrealistic estimates as to the interest and willingness of western firms to invest in domestic operations, and most (not all) of the goods produced are not competitive in foreign hard currency markets. In a few cases -- machine tools, for example, where firms attach western-made controls to a Soviet chassis -- jointly produced items are selling well in the west.

50. The point is that the reaction to the unsettled but clearly altered rules of the game varies greatly from ministry to ministry, sector to sector, company to company. Several ministries visited announced intentions to turn themselves from allocative central planners and policemen of production quotas to sector policy analysts, facilitators of contacts with foreign firms, investors and buyers, and R&D centers. A few ministries have already changed their names, from the All Union Ministry to the All Union Committee on Light Industry (for example). The innovative Minister of Machine Tools announced his intention to turn his ministry into a joint stock company, owned by its constituent firms, obtaining its revenues purely by selling services to the enterprises, and competing with other providers of the same service, public and private -- no firm would be required to use the services.

51. Still on the positive side, the mission interviewed some managers who were eagerly awaiting joint stock company status so as to sell shares (in the first instance to banks and other enterprises) and raise capital. One firm visited held shares in a Finnish industrial firm, had sent several hundred of its workers to Finland for training, and it was paying for the training by having the trainees work part time in the very plant in which they held shares. Contacts with western financial and business organizations are booming and intensely sought after. Many enterprises are tapping their flush social development funds and enrolling, at firm expense, their middle level managers in one of the many new management training centers.[13] In short, there is a

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[13]. There reportedly exist over 120 private management training institutes/schools/centers, ranging from very inexpensive and unstructured weekend courses to 20,000 ruble -- or more -- a year MBA programs, complete with foreign teachers

great deal of positive activity taking place, as the more spirited managers and officials respond to the limited degree of autonomy they have been awarded, and try to envisage what the next openings will be so that they will be in a position to profit from them.

52. Some are not responding. The mission met officials who deplored the instability and chaotic nature of the present situation; they hesitated to convert enterprises to joint stock form until there was complete clarification on the legal front; they defended the need for certain "important" sectors to continue to receive allocations from the planning system; they insisted that private owners have only a short term view which must be balanced by the long and general view of the planners; a few were hostile to any notion of privatization; and a number of respondents said that "limits" on enterprise freedom and behavior were desireable and necessary. One official went so far as to characterize the changes of the last few years as the result of a "temporary euphoria" which would soon dissolve. These attitudes constitute a considerable obstacle to a smooth transition to the market.

B. Specific Improvement Measures

53. In these circumstances, what needs to be done to improve the quantity and quality of managers and board members? First with regard to managers: The highest management levels are already relatively well-served. They have increasing access to a number of courses that expose them to the practices and approach of western private business firms. This is all well and good; marketing, advertising, cost-effective production techniques, and issues of quality control are basic themes in western business, and they have been largely ignored in Soviet industry. The efforts underway aimed at CEOs and their closest deputies thus deserve support and expansion.

54. However, the key areas requiring improvement are at less than general director level. The installation of a "business orientation" in firms cannot be the task of one CEO or a few leaders. Large numbers of middle and lower level managers must understand what is at stake in the changed environment. They will need training, not so much in an academic, MBA-type approach, but more in the manner of the training provided "in-house" in western firms. It can be seen at once that this is an enormous task; no matter how few people an enterprise picks for training, the total number will be very large, given that the multiplier is between 46 and 55 thousand.

55. To facilitate the management improvement process, the Soviet authorities, at all levels, might take advantage of the experience accumulated by other reforming socialist economies, and

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and internships in western firms.

the technical assistance/training agencies that have been working in these countries. The Soviet authorities should inquire of the Polish, Hungarian and Yugoslav governments as to the methods they have devised or applied to turn civil servants who were receivers of orders into managers who seize opportunities. Particularly useful from the enterprise perspective is the well regarded Polish "company doctor" program. Working with a private management consultant firm, the Poles are training teams that make a rapid triage of enterprises, dividing them into the comparatively healthy, the hopeless -- and thus candidates for liquidation -- and those in which restructuring would prepare them for sale or healthy performance. While the thought of launching a similar process in the massive number of Soviet firms is daunting in the extreme, first steps have to be taken.

56. The Soviets should also expand and deepen their contacts with the multi-lateral and bi-lateral funding and assistance agencies; i.e., the OECD, the IMF, the IBRD, the EBRD, and the British Know-How Fund, all of which can offer information, advice and -- either now or in the future -- grant or loan financing to undertake studies, and hire or obtain consultants, technical assistants and advisors.

57. The Soviets might consider the use, perhaps at first in a few pilot or experimental enterprises, of management contracts. These would hire managers, or entire management systems, from abroad and turn over the selected firms to their direction. If the authorities were able to grant the hired managers near complete latitude, and if the contract contained incentives for good performance, then the Soviets might gain expanded production and internal efficiency gains in the contracted firms, plus a substantial amount of practical information on what they had to do, and how to go about it, in other enterprises. One could even go farther along these lines: in the innovative New Zealand enterprise reform program, it was decided to abolish citizenship requirements for enterprise CEOs, and to recruit internationally for these key posts. At present, several New Zealand public corporations are headed by non-citizens, frequently coming from the private sector (they are paid accordingly).

58. The Soviets should seek assistance for, and set about the creation of a training program for members of boards of directors. This would be necessary if the approach suggested above in section III is adopted (see para. 42); but it would also be needed to render effective the "enterprise boards" supposedly coming into being as of January, 1991 (see para. 8). Indeed, all members of all supervisory boards, of whatever type, require instruction on the objectives of the owners, the functioning of the firm, the rights and duties of the board, and the information that has to be submitted to the board and how to interpret it.

18/19 USSR Holson Cortas Mink GL

Bank Fund OECD
EBRD

~~Subs.~~
Price lib Fast
Subs →
targetted
compensation lots Little
(to get
budget
funds)

Oil EXP - OECD #s
1989 1990 1991
171 - - 7 135 100

End Oct - 1st draft exchange.
→ 19 Nov. -- meet here to
finalize draft.
26 Nov -- pers reps go to Moscow.
→ Gorbachev letter & ff.
Try have 4-5 pp. ~~exo~~ summary for 26th
ZT paper slipped.

~~JSS~~ Objectives:
→ Role Bank
→ JSSE
→ TA
→ Membership.

Sven -- talk to Abalkin x Petrakov.
What to say on enterprise
+ [illegible].

→ agenda -- on briefing
with Region.

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

DATE: 18-Oct-1990 10:07am

TO: Sven Sandstrom (SVEN SANDSTROM)

FROM: David R. Bock, OPNSV (DAVID BOCK)

EXT.: 82856

SUBJECT: **Mr. Conable's Visit to the Soviet Union**

Sven,

I spoke to Obminsky's office. Apparently, the 12th is not workable for Gorbachev and they are still waiting for confirmation for the 16th. Both the Ministry of Foreign Affairs and the central bank are already on board for the 16th. They could not give me an estimate as to when they would be able to firm up a visit with Gorbachev. I told them it was urgent due to his other travel arrangements and commitments.

David

CC: Wilfried Thalwitz (WILFRIED P. THALWITZ)
CC: Paul Isenman (PAUL ISENMAN)
CC: Gillian Butler (GILLIAN BUTLER)

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: October 18, 1990
NAME	**ROOM NO.**
Messrs. J. Linn	N-11-051
P. Isenman	S-13-145
G. Lamb	S-13-119

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

REMARKS:

FROM:	ROOM NO.:	EXTENSION:
Alexander Shakow	E-8065	81368

RECEIVED
90 OCT 19 AM 7:44
PRDDR

cc:
J Holsen done 10/23
S Mink
C Michalopoulos

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1990

TO: Mr. Alexander Shakow, EXTDR

FROM: David Loos, NYO

EXTENSION: 7-2265

SUBJECT: Address by Professor Stanislav S. Shatalin to the Second Committee

1. Professor Shatalin, member of the Presidential Council of the USSR, one of Mr. Gorbachev's economic gurus, addressed the Second Committee of the UN on the subject of "The transition to a market economy in the Soviet Union."

2. In his remarks, Professor Shatalin made the following points:

Profound changes had taken place in the past year in the Soviet Union, but primarily in political terms. While it was clear that a new economic system had to be built in the Soviet Union, it was also evident that economic restructuring could not be effected overnight. The radical economic reforms called for in the earlier proposals were not comprehensive. Moreover, no one anticipated how far-reaching and complex the process would be. Republics were currently erecting barriers between themselves which could lead to the economic collapse of the country if this were not checked. He said that he was working on an economic program which would serve as a compromise among three programs (Gorbachev's, Yeltsin's, Shatalin's). The Supreme Soviet will discuss this "harmonized" program next Monday, October 15. The main principles and underlying factors of the program are as follows:

a. A free enterprise system should be implemented.

b. A convertible rouble, at least internally. The Government deficit had to be brought under control. Government expenditures had to be cut back with spending on defense and national security being reduced.

c. Acceptance that the Soviet Union was a union of sovereign states. The political reality was that the USSR as a unitary state with control from the top no longer existed. The heads of the various states had to play significant roles in the planning and implementation of any economic program. However, it was also recognized that some form of central control must be applied on issues like defense, outer-space activities, national strategic matters, some infrastructure projects, health and communications. There would have to be special funds for development and for social development and assistance to the less developed republics.

d. Agrarian reform was essential. Farming techniques were outdated. A third of this year's harvest would be lost due to incompetence. Private ownership of farmland would be permitted, but the extent of land purchased, which would be available even to city dwellers, would be strictly limited. Neo-capitalism would not be permitted.

e. A shift to a market system demanded sacrifice. It was necessary, therefore, to protect the poorest groups in society. The current program had been criticized for not going far enough in the protection of vulnerable groups. The problems were of varying degrees among the regions.

f. There was a lot of "hot money" floating around, which if harnessed could provide a boost in the shift to a market economy.

g. They were convinced that they would not succeed without cooperation from the world community, both in the east and west. While the USSR had paid bills on time in the past, this was no longer the case. Current and upcoming payments would be postponed. Thus, the country was in dire need of credit and looked to the international community to provide economic assistance.

h. Very few people in the USSR knew what a market economy was, let alone how to manage one. Not having lived, worked or studied in a market economy, Soviet economists found it difficult to develop comprehensive plans for moving towards one. They were generally poorly trained. The USSR, therefore, needed financial and economic experts to train its people, and wanted to commence sending its graduate students to the west.

i. In the past, assistance to Third World countries had been given on an ideological basis. Billions of roubles had been provided to countries strictly because of their ideological slant. This had to change. The USSR would join the rest of the world and provide assistance on the basis of need.

3. In summing up, Mr. Shatalin asserted that the USSR had moved very far and very expeditiously in putting a new political system in place. The country was moving towards democracy. While a new economic order will be given genuine political support from the highest levels, economic reform would take time. It would not be accomplished in "500"

days. Indeed, it was difficult to place a time-frame on it.

4. Mr. Shatalin's address was followed by a short question and answer period:

Q. What criteria would be used in guiding pricing policy?

A. The USSR needs to use every instrument to eliminate the budget deficit and stabilize the consumer market. If the stabilization program was successful, it would be possible to let prices float.

Q. What will be the role of the exchange rate?

A. Until the economy is stable, the rouble cannot be made completely convertible. As expected, the rouble will soon be devalued. A free market will be created gradually, and when this is done, the rouble could be traded on the open market, and its true value assessed.

Q. How close are you to the target budget deficit of 60 billion roubles?

A. The budget deficit is much larger than 60 billion roubles. It is likely to be of the order of 150 billion roubles, or 85 billion according to western calculations. The USSR had to take strict measures in eliminating the deficit. They wished to copy the Federal Reserve Bank system of the United States, incorporating the 15 Central Banks of the USSR into a single federal system, - the Union Reserve Bank, which would be a single juridical body.

Q. What about Soviet membership in GATT, IMF, World Bank and G7?

A. He maintained that he was not an expert in this area. Nevertheless, he foresaw the USSR becoming a full member of GATT and adhering to its decisions at the Uruguay Round. He said, tongue in cheek, that they would like to join the G7 if they were considered a developed country. He did not comment on the issue of joining the Bank and the Fund.

ACC/1990/CRP.1
5 October 1990
Original: English

ADMINISTRATIVE COMMITTEE ON CO-ORDINATION
Second regular session of 1990
New York, 22-23 October 1990

THE ECE ECONOMIES IN THE MID-1990S

Paper prepared by the Economic Commission for Europe

ECE.ACC (WP51)

90-25068

THE ECE ECONOMIES IN THE MID-1990S

CONTENTS

OVERVIEW

1. The contrast in Europe between economic performance in the west and in the erstwhile centrally planned economies of the east has become even more marked in the first half of 1990. Economic growth continues strongly in the market economies while in the east there is general and deepening recession.

2. The economic performance of western Europe and North America remained quite favourable in 1989, although on average the pace of expansion tended to moderate. This reflects largely the impact of tighter monetary policies designed to prevent inflation from accelerating. Output growth slowed down in North America but remained broadly unchanged in much of western Europe. There was also a deceleration in the pace of economic activity in Japan, although GDP growth was still higher there than in the other two regions. Growth differentials between these three regions tended to narrow in the course of 1989. Total output in the market economies grew on average by some 3.5 per cent, compared with over 4 per cent in 1988.

3. Expectations for 1990 are for a continuation of relatively strong performance in the ECE market economies. There will be some further slow-down in output growth, and this will tend to ease the strains which high activity levels have put recently on the utilization of available resources. Fixed investment will again be the major support for growth. In western Europe the forecast deceleration in output growth is small, except for the United Kingdom. The outlook for the United States is surrounded with some uncertainty, but growth in 1990 is now expected to be around 2 per cent. Inflation rates have generally tended to stabilize since last October and in many countries there have been tentative signs of deceleration in recent months. Nevertheless, official concerns are focused on the high rates of capacity utilization in western Europe and on the possible inflationary consequences of the German monetary union. Although fears of the latter may well be exaggerated, monetary policies are likely to remain cautious and avoid any general reduction in interest rates until there is a decisive downturn in average inflation rates. Nevertheless, despite high interest rates, private consumption growth and fixed investment in western Europe generally remain strong: forecasts for growth in the Federal Republic have been raised since the beginning of the year and the secretariat now expects average west European growth to be about 3 per cent this year. For the ECE market economies as a whole, GDP growth in 1990 is expected to average 2.5 per cent, compared with 3 per cent in 1989.

4. Economic activity in eastern Europe and the Soviet Union slowed progressively throughout 1989 and went into a recession in the final months of the year, which has continued and generally deepened in the first quarter of 1990. In the Soviet Union,

output rose by less than 2.5 per cent in 1989, down from 4.5 in 1988. Output fell in absolute terms in three of the six east European countries in 1989 and declined by 1.5 per cent for the group as a whole. Worsening output trends were accompanied by rising inflationary pressures or open inflation, which turned into a classical hyper-inflation in Poland. Together with the domestic balance, external balances generally deteriorated.

5. Many of these processes accelerated in 1990, but for reasons which varied much more widely among the countries of the region than was the case last year. In the first quarter of 1990, output was below the level of the same period of 1989 in **all** the eastern countries, with very sizeable falls in some. In aggregate, the region's industrial production declined by almost 5 per cent. Inflation, open or repressed, accelerated in most countries. Exports generally fell steeply, largely because of supply problems; imports also declined in most countries, but much less than exports, or increased -- notably in Romania and the Soviet Union -- and balance-of-payments constraints tightened considerably in the region.

6. Social or political upheavals played an important role in the 1989 downturn, but deteriorating macro-economic control -- central planning systems are being dismantled, but have not yet been replaced by viable market institutions -- and the inflationary impact of growing fiscal deficits appear to have been the main causes. The resulting internal market imbalances were transmitted among the eastern countries through the intra-CMEA trading system, which has shown signs of disintegration as member countries strove to avoid incurring surpluses in transferable roubles that might never be convertible into goods.

7. Economic policies set for 1990 were very diverse: they range from those assigning priority to radical and very rapid systemic change in conjunction with fiscal and monetary austerity to eliminate inflation (the Polish "shock therapy") to those giving short-term priority to stabilization as a prerequisite for more far-reaching measures of systemic reform in the future (the Soviet case). Many of the new interim governments in eastern Europe merely struggled to keep their economies running, pending mandates for systemic change from the elections in the first half of 1990. If the austerity policies, where attempted, have largely achieved their initial goals -- although, particularly in Poland, at the cost of a far deeper recession than expected -- policies aimed at stabilizing economic activity in the old economic framework have generally failed. This became clear by mid-1990, but governments have encountered considerable difficulties in obtaining a consensus for new solutions. The policy landscape at mid-year is thus dominated by uncertainty.

The only certain element appears to be that the recession in eastern Europe and the Soviet Union is far from having run its course.

1. Eastern Europe and the Soviet Union

(i) Developments in 1989 and early 1990

8. The objectives that the countries of eastern Europe and the Soviet Union had laid down in their respective national economic plans for 1989 envisaged an acceleration of **NMP growth**, from an average 3 per cent reported for eastern Europe in 1988 and the 4.5 per cent registered in the Soviet Union to some 4.5 per cent and 6 per cent, respectively. These targets were predicated on the expectation of substantial efficiency gains and fairly strong output growth in industry as well as in agriculture throughout the area.

9. Policy targets on the **utilization** of national output (domestic absorption) tended towards austerity in eastern Europe, while in the case of the Soviet Union the policy stance appears to have been still fairly permissive. By late 1988, when these plans were being formulated, inflationary pressure -- and the state budget deficit which was feeding it -- had become a serious policy concern in the Soviet Union, yet policy makers still found it very difficult to face up to the full dimensions of the problem. In most of the east European countries (apart from Hungary and Poland), the inflationary problem and its monetary policy and public deficit origins were still kept under wraps in the policy statements for 1988-1989, but the evident worsening of balance-of-payments constraints (in part also revealed in the public statistics only in early 1990 after the changes in the power structure) forced the hand of policy makers.

10. Within the constraints on total domestic absorption, **consumption** appears to have been favoured relative to **accumulation** in the plans for 1989. Targets for average wages and retail sales volume indicate that fairly high growth was aimed at in Bulgaria, the German Democratic Republic, Poland and the Soviet Union, whereas a more restrictive stance prevailed in Czechoslovakia, Hungary and Romania. **Investment** targets, by contrast, were restrictive (negative or below planned NMP growth) in Czechoslovakia and the Soviet Union, but appear to indicate that some rise in the investment rate may have been intended in a number of other countries (Hungary, Poland, Romania). However, given the tense situation in consumer markets combined with the priority assigned by policy makers to consumption to ease social tensions, as well as balance-of-payments pressures, the leeway for investment outlays was evidently quite narrow everywhere.

11. Regarding the overall pace of output growth, the policy stance for 1989 varied substantially among countries. In eastern Europe, the countries most actively engaged in economic reform -- Hungary and Poland, and also Czechoslovakia, anticipated some slowing of NMP growth, whereas in Bulgaria, the German Democratic Republic and Romania the targets implied a pronounced upswing from the 1988 performance. In all countries, efficiency gains were to feed this expansion, as indicated by sectoral targets, formulated in **gross** output terms, which generally were lower than those for NMP.

12. At the same time, most countries hoped to gain some flexibility in the **foreign trade** sector by placing a lid on total domestic absorption and by boosting exports. This was to enable countries to continue with their external adjustment efforts, first introduced in the early 1980s, as well as with structural change and economic reform.

13. The growth objectives for 1989 over a wide range of output and consumption targets proved, in retrospect, to have been overly optimistic. In early 1989, the ECE secretariat had suggested that a target of 3.5 per cent aggregate growth for the group as a whole would be more realistic. Official growth rates were deemed to be too ambitious, in part because of prevailing internal market imbalances and difficulties with the reform programmes in countries that had already put them in train. It was already evident that the constraints on intra-CMEA trade were tightening, largely because of adverse changes in the Soviet Union's terms of trade at a time of slowing or declining Soviet export supplies. This in turn would restrict the ability of eastern Europe to export and, in some cases, to operate near full capacity.

14. Even that judgement in the end proved to have been optimistic. In eastern Europe, aggregate NMP actually fell in 1989 (see table 3), reflecting performances ranging from 1-2 per cent growth in Czechoslovakia and the German Democratic Republic to a 10 per cent fall in Romania. Three countries (Bulgaria, Hungary and Romania) reported a decline in NMP produced. In Poland it stagnated. In the event, only Czechoslovakia almost succeeded in reaching its 1989 aggregate output target. In the Soviet Union, growth in 1989 slowed to just under 2.5 per cent, and perhaps less if the widespread doubts of Soviet economists about the official deflators are warranted.

15. On the whole, the 1989 output results were the worst since the post-war stabilization. In addition to three countries actually in recession (defined as a fall in net real output), several others were clearly close to it, as indicated by the

downward trend of output in successive quarters of 1989 and the results for the first three to four months of the current year.[1]

16. The socio-political events of 1989 were only in part responsible for the economic deterioration. Labour disputes, demonstrations and chaotic emigration obviously contributed to the slow-down. But the current weakness had deeper roots in the continuing inability of policy makers in eastern Europe and the Soviet Union to regain a growth path with sustained significant increases in output per head. The paltry gains in average labour productivity reflected largely low capital- and resource-use efficiency. This is a phenomenon of long standing in all the economies that used to rely mainly on detailed central planning for resource allocation.

17. Most large production sectors contributed to the downturn. Aggregate **gross industrial output** stagnated in eastern Europe in 1989. In the Soviet Union it grew by less than 2 per cent, the lowest growth rate registered in the post-war period; however, the output of consumer manufactures ("sector B") advanced faster than industry as a whole, by 4.5 per cent -- a reflection of the high priority that the Soviet leadership has recently been placing on improving consumer market supplies. The weakness of aggregate east European industrial production reflected a significant contraction of output in Hungary, Poland and Romania (-2 per cent) and near stagnation in Czechoslovakia. Only Bulgaria and the German Democratic Republic reported real growth in 1989 (above 2 per cent), in both countries in spite of a substantial outflow of skilled workers since mid-1989 and the disorganization caused by political disturbances later in the year. The cumulative effect of these factors, however, was increasingly felt in both countries in the last quarter.

18. Generally, industrial production deteriorated throughout 1989. In the last quarter, output fell in absolute terms in all eastern countries but Czechoslovakia. It declined further, generally at increasing rates, in **all** countries in the first three to four months of 1990. In the first quarter of 1990, output was below the level of a year earlier by 8-9 per cent in Bulgaria, 3 per cent in Czechoslovakia, 5 per cent in the German Democratic Republic, 8 per cent in Hungary and by almost

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1 In the context it should be noted, however, that conclusions about recent trends are somewhat hazardous owing to the large changes in statistical reporting practices now occurring in the region. The downturn in a number of countries may in fact have occurred earlier but have been hidden by deceptive statistics.

one-third in Poland and one fifth in Romania. An absolute downturn occurred also in the Soviet Union (see table 1).

19. **Agricultural** performance also remained well below expectations in 1989. The **construction** sector probably registered a sharp contraction, judging from the information on investment activity in 1989, as did the **transport** sector in a number of countries.

20. Information on developments in the **allocation** of national income in 1989 is still sketchy. There is little doubt, however, that intentions regarding **absorption levels** could not be implemented in most countries. In Hungary and Poland, austerity was maintained -- as originally planned -- but at levels of aggregate absorption sharply lower than intended. Elsewhere in eastern Europe and in the Soviet Union, however, widening consumer market imbalances and measures to improve supplies to ease social tensions resulted in worsening external balances -- in some cases by sizeable margins -- in spite of cut-backs in investment outlays.

21. Aggregate **consumption** grew very little in real terms in most countries in 1989, or contracted -- as in Hungary, Poland and Romania. Although rising fast in nominal value, retail sales in real terms increased only marginally in several of these economies. Money incomes generally grew more rapidly than nominal retail sales, which further aggravated domestic market imbalance. This occurred in spite of efforts to boost production for the domestic market, to increase consumer imports and encourage savings through more differentiated interest rates. An especially large increase in retail sales was reported by the Soviet Union. A substantial share of the overall rise stemmed, however, from the rapid increase in the sale of alcoholic beverages, an item that had deliberately been placed under official supply constraints for social reasons in the mid-1980s, with deleterious consequences for macro-economic balance. Though part of the increase was made possible by the earmarking of defence industry capacities and inventories for civilian uses, emergency imports -- which contributed to a sharp deterioration of the external accounts -- also had to be called upon. None the less the consumer markets remained severely disturbed throughout the year, as is suggested by the rapid spread of local rationing schemes and other non-market arrangements to "distribute the shortages".

22. The volume of **gross investment** (and in some cases nominal investment outlays) clearly contracted in eastern Europe in 1989; in the Soviet Union it grew only marginally. This marked a sharp break with the trends of the preceding three years, when investment volume growth had outpaced the expansion of total

output. Policy makers in several countries, including the Soviet Union, have been looking for ways of curtailing investment outlays. In that sense, the results of 1989 must have been encouraging. However, the micro-economic aims associated with the easing of the investment ratio -- improved efficiency in the investment process and in the use of capital -- were not achieved. Moreover, in the reforming countries the hoped-for replacement of budget financing by enterprise financing does not appear to have improved investment discipline. This has been mainly due to chronic rigidities in the distribution system for investment goods and unabated administrative controls over investment activity.

23. The foreign trade sector remained a constraining factor in all countries of the group in 1989 and early 1990. Although import volume in most countries increased faster (or fell less) than export volume, which eased domestic market imbalances, balance-of-payments concerns generally held this in fairly narrow boundaries. None the less, the external balances deteriorated in both eastern Europe and -- substantially -- the Soviet Union.

24. In CMEA relations, the trade-constraining tendencies inherent in a structure of predominantly bilateral arrangements appear now to be moving the system onto a downward spiral. At its origin is the deterioration of the Soviet terms of trade vis-à-vis eastern Europe which stemmed from the lagged introduction of world market prices into the CMEA trade price structure and caused the Soviet trade balance with eastern Europe to swing into deficit in the second half of the 1980s. In 1989 and early 1990 several east European countries (notably Hungary and Poland) took special measures to curb rouble exports in an attempt to stave off sizeable surpluses in transferable roubles. The Soviet Union, on the other hand, introduced export constraints of its own on manufactured consumer goods to protect the supply to domestic markets. In addition, Soviet deliveries of fuels and raw materials fell short of commitments owing to production and, probably, transport difficulties.

25. In the event, the volume of Soviet exports to eastern Europe appears to have contracted slightly in 1989 -- by perhaps 1-2 per cent -- while Soviet imports from eastern Europe fell somewhat more steeply -- by 2-3 per cent; nonetheless, the Soviet trade deficit rose from 2.5 billion roubles in 1988 to over 4 billion roubles in 1989. The downturn became much steeper, and the imbalance widened, in the first quarter of 1990, when intra-CMEA trade declined by some 10 per cent in volume (table 2).

26. External payments constraints were largely responsible for the weak trade performance with non-CMEA partners in 1989. Imports from these partners increased in both eastern Europe and

the Soviet Union, in some cases as a consequence of the deliberate choice of policy makers around mid-year to improve domestic supplies through consumer goods imports. As a result, the trade balance of the Soviet Union with the convertible currency area registered a $6 billion turnround, swinging from surplus to a deficit of about $1.5 billion. A substantial proportion of this change -- roughly $2 billion -- was on account of a declining Soviet surplus with the developing countries. Matters were less dramatic in eastern Europe's relations with third partners. None the less the trade surplus of $2.5 billion with the market economies in 1988 contracted to some $2 billion in 1989. The early months of 1990 produced a sharp deterioration in these balances (table 2.)

(ii) Prospects for 1990

27. Policy objectives for 1990 for most countries of the area are in a state of flux in mid-1990. Only the Soviet Union had adopted an explicit annual plan of the old variety that is still -- at least formally -- in force. It attempted to stabilize the economy, but this effort clearly has not worked. Remedial measures are under consideration, but they impose serious costs for which social acceptance has to be found. Similar issues arise with the transformation plans of some east European countries.

28. Current economic policy in the eastern countries is dominated by preoccupation with regaining economic, social and political stability, in conjunction with preparations for systemic change. In some countries, notably Hungary and Poland, with Czechoslovakia lagging only as regards the scheduling, a social consensus already prevails, and formal economic stabilization programmes are at the heart of short-run economic policy or are being formulated. In these cases, regaining order in monetary and fiscal affairs is considered a prerequisite for moving towards a more market-oriented environment. In other countries, particularly Bulgaria and Romania, official intentions have been more conservative in the early months of 1990, but more radical changes appear to be in the making after the recent elections. In Romania, the new government has announced the intention of turning decisively towards market-oriented reforms, presumably without central planning.

29. Economic **reforms** under way in the eastern countries accelerated dramatically in 1989, together with political change. In the economic sphere, these aim, to one degree or another, at improving performance through increased use of markets and through closer integration into the world economy.

30. In the Soviet Union, and probably also in Bulgaria and Romania (where the formulation of objectives is still at an early stage), reforms basically envisage a transformation of the existing centrally planned system through the use of monetary and financial instruments and market channels to replace the "command" system of physical resource allocation and output determination. Much increased enterprise autonomy, demonopolization of the enterprise structure, room for non-state economic activity alongside the dominant state sector, improved price systems (with better links to world market prices), and the "hardening" of financial constraints are expected to bring significant efficiency gains. All reforms include measures to achieve a substantial opening to the outside world, ranging from decentralization of the authority to trade abroad to liberalized provisions for the entry of foreigners into the domestic economic system (mainly in the form of joint ventures or free trade zones).

31. In Hungary and Poland, the reform agenda was extended radically in 1989, and now aims at the establishment of fully-fledged market economies in which the role of state planning is reduced to largely macro-economic functions. Broadly similar aims came to the fore in Czechoslovakia after the political overturn at the end of 1989, but are still in the course of being formulated. These countries now envisage a significant and rapid reduction of state-owned industries through privatization and a substantial role for foreign direct investment. The difficult issue facing these countries is how to manage the transition from centrally planned to market systems, and this -- especially in Poland -- in the face of sharply deteriorating economic performance. Poland has opted for a shock cure in the hope of thus shortening the transition period, whereas in the other two countries the appropriate pace is still to be decided.

32. In the German Democratic Republic, central planning of any kind is of course no longer on the agenda, and the issue is now largely one of how best to manage integration with an existing and strong market economy and not how to re-fashion a separate economic entity -- a task which has its own difficulties, but should be incomparably easier. With the currency unification at the beginning of July 1990, economic policy autonomy has essentially been abandoned.

33. The immediate prospects for eastern Europe and the Soviet Union are bleak. Governmental programmes for 1990 focus on the twin aims of transforming economic systems and stabilizing economies in disarray. These are tasks of a large order and frequently involve contradictory demands. Inflationary processes are likely to yield only slowly to moderate deflationary policy

measures, and where policy is strong (as in Poland) the cost of a recessionary downturn will be high. Balance of payments constraints have increased for most countries, including now the Soviet Union, and this reduces the leeway for domestic policy.

34. Although the problems and prospects facing the eastern countries are fairly daunting, the ability to implement effective policies to deal with them and reap the longer-term benefits could be greatly increased by the adoption of consistent reform measures. In eastern Europe, the political legitimacy conferred on the governments that emerged after the free parliamentary elections in 1990, and by a significant programme of technical and financial support by the western market economies, should help in facing the costs of reform.

2. East-west trade and payments

35. East-west trade in 1989 was characterized by a slackening of eastern export growth and a substantial pick-up in the volume of eastern imports. Both trends became more pronounced in the early months of 1990. They evolved against the background of a rapid, although slowing, expansion of world trade and momentous changes in the political environment of east-west relations.

36. After rising some 8 per cent in value and perhaps 5 per cent in volume in 1989, total **eastern exports to the west** contracted in the first quarter of 1990 by an estimated 8 per cent in volume (table 3).[2] Export performance varied considerably between the eastern countries. In Czechoslovakia and Hungary, exports to the west grew rapidly in 1989 and early 1990, while Poland's deliveries to the west recovered sharply in 1990 after having come to a standstill in the second half of 1989. The exports of the other east European countries fell in the first quarter of 1989, as did those of the Soviet Union. The fall was particularly large in Bulgaria and Romania.

37. **Eastern imports from the west**, which had expanded strongly in 1989, quickened to some 16 per cent in volume in the first quarter of 1990. This reflected mainly the very fast expansion of Soviet imports, which is now in its third year. In eastern

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[2] Unless otherwise noted, growth rates for the first quarter of 1990 reflect change from the same period in 1989. The value data shown in table 3 derive entirely from eastern national sources, since the western data used in the more detailed analysis in United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990 (chapter 4.2) are not yet available for the most recent period.

Europe, where import growth had been moderate in 1989, only Czechoslovakia and Romania registered an upswing in early 1990. In Romania the increase follows nine years of contraction that saw imports from the west drop from $4 billion in 1980 to $900 million in 1989. The imports of Bulgaria, the German Democratic Republic and Hungary stagnated or declined in 1990 after substantial growth in 1989, whereas those of Poland contracted sharply.

38. The **trade surplus with the west** of the east European countries increased in 1989, but the surplus in **convertible-currency trade** narrowed owing to a sharp fall in the surplus with developing countries. The Soviet Union incurred a **convertible-currency deficit** in 1989, owing to a steep rise (to $6.5 billion) in its trade deficit with the west and a fall in its surplus with developing countries. As a result of the changes in trade flows in the first quarter of 1990, eastern trade balances with the west and with the convertible-currency area as a whole deteriorated considerably. The east European surplus in convertible currencies swung into deficit (a $1 billion turnround), and the Soviet Union incurred a $3.4 billion first-quarter deficit, more than twice as large as that for all of 1989. The deterioration of the external balance was particularly pronounced in Romania, followed by Czechoslovakia, the German Democratic Republic and Bulgaria. Hungary and Poland, on the other hand, improved their external position in the first quarter of 1990, Poland registering a convertible-currency surplus of $0.8 billion which exceeded that for 1989 as a whole.

39. In 1989, the east's **current account in convertible currencies** swung from a surplus of $3 billion in 1988 to a deficit of $6 billion, owing to unfavourable movements in the accounts of both eastern Europe and the Soviet Union.[3] The trade results for the first quarter of 1990, together with higher net interest payments -- stemming from higher international interest rates in 1990 and rising levels of external indebtedness -- suggest that the convertible-currency current account deficits of most eastern countries widened in the early part of the year. Hungary and Poland were exceptions. In Poland, in particular, the steep rise of the trade surplus more than offset higher net interest payments and yielded a current account surplus.[4] This

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[3] See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, table 4.3.1.

[4] Rynki zagraniczne, 17 May 1990.

allowed the authorities to build up reserves by $1.7 billion,[5] although it should be noted that only a small share of interest obligations were settled.[6]

40. A host of factors -- the development of output and demand, changes in trade policies, and the implementation of reforms and macro-economic stabilization policies in the east -- shaped the eastern countries' trade flows with the west, although the influence of each factor appears to have varied considerably from country to country.

41. The import demand of the developed market economies, the major convertible currency market for eastern goods, appears to have remained buoyant in the early part of 1990, perhaps slowing somewhat from the rapid pace of the preceding two years. Hungarian and Polish exports have also benefitted from the liberalization of western trade restrictions since the beginning of 1990.

42. All of the eastern countries experienced varying degrees of decline in industrial production in 1989-1990, which in certain cases appear to have directly reduced their exports. This appears to have been the case in the German Democratic Republic, where the fall in output has been due in part to labour force emigration. In the Soviet Union, the production of oil, still the predominant source of convertible currency revenues, has continued to diminish. Oil production fell a further 5 per cent (and coal by 6 per cent) in the first four months of the year,[7] which probably led to further reductions in the country's crude and petroleum product deliveries to the west in early 1990.[8] To some extent, east European output and exports were constrained by shortfalls of imports from the Soviet Union, including crude oil. Preliminary data for the early months of 1990 indicate that exports of petroleum products to the west from these countries,

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5 Financial Times, 1 June 1990.

6 Rynki zagraniczne, 17 May 1990.

7 Financial Times, 11 June 1990.

8 Soviet deliveries of petroleum and petroleum products declined by some 13 per cent in the first two months of 1990 relative to the same period in the previous year. IEA, Monthly Oil and Gas Statistics, Paris, 17 April 1990, and previous issues.

refined largely from Soviet crude, continued to fall.[9] However, another cause of the decline in east European industrial production -- the fall in Soviet import demand -- seems to have actually fostered the growth of exports to the west. East European enterprises have made greater efforts to redirect deliveries to the convertible currency area in order to compensate for the drop in their exports to the Soviet Union. This was clearly the case in Poland, where exchange rate policy supported such efforts by a steeper devaluation of the zloty against the dollar than against the rouble. Aside from lower Soviet demand, east European exports to the Soviet market also fell because of trade policy measures taken by the east European countries to avoid the buildup of trade surpluses in roubles.[10] It is believed that, in general, the scope for such a shift is not large in the short term because of the limited appeal to westerners of goods produced for the Soviet market. However, certain products -- food, raw materials, some semi-manufactures and consumer goods could be redirected if their prices were made sufficiently attractive.

43. The implementation of macro-economic stabilization policies and economic reforms has had a considerable impact on the external sectors of several eastern countries. Hungary and Poland have adopted IMF-approved programmes. The resulting compression of domestic demand has curtailed imports and induced producers to compensate by boosting exports (largely to the west since the eastern market is so weak). As a result, Hungary's imports stagnated in the first quarter of 1990, despite a further liberalization of the trade régime at the beginning of the year. Unlike in recent years, there was little use of the exchange rate in Hungary to promote exports. Elements of Poland's radical economic reform, including the introduction of internal currency

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9 During January-February, east European exports of crude oil and petroleum products declined by 29 per cent relative to the same period in 1989. IEA, Monthly Oil and Gas Statistics, loc cit. Some east European countries are reported to have contracted for additional supplies of Middle East crude to make up for the shortfall in supplies from the Soviet Union, but on the whole these appear to have been insufficient to maintain petroleum product deliveries.

10 For example, the Hungarian authorities temporarily suspended licences for exports of Ikarus buses to the Soviet Union. International Herald Tribune, 17-18 February 1990.

convertibility[11] and a large real devaluation of the zloty (much sharper against the dollar than against the transferable rouble) contributed to the upturn in exports to the convertible currency area. On the other hand, Polish imports, which had been climbing steeply, plunged in the first quarter of 1990. The combination of restraints on domestic demand, zloty devaluation and the activation of Poland's tariff schedule (and taxes on certain imports) led to an unexpectedly large reduction in the quantity of imports.[12] Consequently there was a trade surplus in the first quarter instead of the deficit which had been expected.

44. However, aside from Hungary and Poland, recent trade régime changes in eastern Europe have not been significant. After the recent elections, reforms are expected to accelerate in Czechoslovakia. In Bulgaria, and Romania, discussions indicate that real reforms may begin soon. In Czechoslovakia, the currency retention scheme, introduced several years ago, and the more recent acquisition of foreign trade rights by enterprises are believed to have had a positive impact on exports. On the other hand the devaluation of the koruna at the beginning of the year probably had little effect on trade. In Romania, administrative measures were used to cut exports (which may also have been affected by the drop in industrial production) and sharply raise imports so as to improve internal supply, particularly as regards foodstuffs. Overall, it appears that foreign trade reforms have had only a limited effect on the shaping of the east's trade flows with the west. Macro-economic stabilization measures appear to have been more important.

45. Given the financial markets' unfavourable assessment of economic developments in the east in recent months, it is probable that some eastern countries running current account deficits in convertible currencies will have to implement adjustment measures because of growing limits to the availability of credit. Already at the beginning of the year commercial banks were reported to be scaling down their lending to the eastern

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11 The term "internal currency convertibility" as used here refers to an exchange régime under which domestic companies are obligated to surrender all foreign currency earnings to the domestic monetary authority at the prevailing rate of exchange. By the same token they and residents have the right to purchase foreign currency, at the same rate of exchange, in order to import.

12 Polish imports from the convertible currency area had been expected to rise by 13 per cent in 1990. Rzeczpospolita, 14 December 1989.

area, owing to a perception of greater risk identified with the process of economic reform and, in the case of several countries, to rapidly growing indebtedness. The cautiousness of banks was reinforced when news of payments difficulties in several eastern countries emerged. In March, Bulgaria -- where indebtedness had been increasing rapidly -- announced the suspension of payments of principal on its commercial obligations.[13] This was followed by reports that the Soviet Union had fallen behind on the settlement of short-term trade credits and that some creditor banks had withdrawn deposits from Hungarian banks. The resulting illiquidity led the Hungarian government to request a $500 million bridging loan from the Bank for International Settlements until funds from the IMF and the World Bank become available. In the wake of the publicized payments problems of these three countries, international banks were reported to have curtailed lending to them and to have lowered their credit ratings. It is thus likely that in the near future the access of all eastern countries to commercial credits will be constrained and will be more costly. In these circumstances, new officially-backed credit lines and, for those countries which are already members of the Bretton Woods organizations, multilateral facilities will take on additional importance. Financing from the new European Bank for Reconstruction and Development will not be available until 1991.[14] A successful rescheduling of bank obligations will be necessary if Bulgaria is to obtain the breathing space to pursue its reforms.[15]

46. The recent rapid growth of Soviet imports from the west presumably reflects decisions to alleviate growing domestic shortages and the increasing enterprise autonomy in the sphere of foreign trade and borrowing rights. In 1989, Soviet imports from the west had risen by some 20 per cent in value, which increased the country's trade deficit with the west to $6.5 billion and contributed to an estimated $10 billion rise in external

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13 In negotiations with creditor banks, Bulgaria is asking for a postponement of repayments of principal coming due until 1993. The country intends to pay scheduled interest payments, amounting to some $600 million in 1990. Financial Times, 22 June 1990.

14 It should be remembered that Bulgaria and Czechoslovakia will not become members of the IMF until the autumn of 1990 and credits will be available only later.

15 Poland's debts have already been rescheduled. See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, p.219.

indebtedness.[16] Mainly because of a further large increase in imports, the Soviet Union's trade deficit reached a record $3.8 billion in the first quarter of 1990. In May 1990, reports of widespread delays in Soviet repayment of short-term suppliers credits began to surface. Although the Soviet authorities have announced that they are taking steps to resolve these difficulties, it appears that international banks have not reversed their purely commercial decision to curtail lending. Among other repercussions, the international credit rating of the Soviet Union slipped, raising the costs of borrowing.

47. The question arises why payments by the Soviet Union were delayed when it had some $15 billion on deposit with BIS reporting banks at the end of 1989[17] and gold reserves estimated at over $30 billion. One explanation centres on the implications of the economic reforms which opened the way to a decentralization of foreign borrowing away from Vnesheconobank to individual enterprises and ministries. It seems that Soviet enterprises had obtained non-guaranteed credits from foreign suppliers, beyond their capacity to repay, without the guarantee of the Bank.[18] Consequently, western creditors would have to evaluate risks of lending to Soviet enterprises more carefully, however difficult that might be under present circumstances.

48. Beyond these "technical" problems it also appears that Soviet demand for financing increased rapidly when the government resorted to imports to meet pressing internal needs. It is likely that the Soviet Union financed at least part of its large first-quarter trade deficit by drawing heavily upon its BIS assets.[19] As regards the Soviet Union's gold stock, it has been

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16 See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, p.211.

17 BIS, International Banking and Financial Market Developments, Basle, May 1990.

18 According to Deputy Prime Minister S. Sitarian, Chairman of the State Commission for Foreign Economic Relations, the stereotype of the Soviet organization, backed in all cases by the government, was not valid today. Western firms will have to build up the same kind of financial relations with Soviet enterprises as prevail among themselves. Izvestiya, 22 May 1990.

19 BIS data for the end of the first quarter are not yet available. It might be noted that some seasonal drawdown of assets is normal.

reported that some of it has been used as collateral to raise short-term credits to pay for imports.[20]

49. Although internal pressures for a further increase in imports may be building up in the Soviet Union, it is doubtful whether they can be financed.[21] Further declines of both Soviet oil production and international oil prices have tended to aggravate the country's trade position (although some relief has been forthcoming from lower prices for cereals). Low and falling gold prices have reduced potential revenues from gold sales as well as the collateral value of gold reserves.[22]

50. Since multilateral financing is not currently an option for the Soviet Union, and its access to commercial credits is apparently constrained (or at least more expensive), the country will have to rely increasingly on official bilateral sources of credit. However, for western governments to make available new credit facilities on the scale required to support the level of net borrowing undertaken in 1989 would require major and rapid policy decisions. The DM5 billion ($3 billion) government guaranteed bank credits recently announced by the Federal Republic of Germany falls into this category;[23] similar loans from other western countries will presumably be under discussion at the Group of Seven meeting in Houston. Unless these are forthcoming, it seems likely that the Soviet authorities will be obliged to cut the growth rate, and possibly even the level, of imports.[24]

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[20] Financial Times, 27 June 1990.

[21] An extrapolation of trade trends in the first quarter to the entire year would yield a trade deficit of the Soviet Union with the west of some $16 billion.

[22] The recent fall in gold prices has been attributed to factors other than the operations of the Soviet Union. Financial Times, 13 June 1990.

[23] Financial Times, 27 June 1990.

[24] It might be noted here that the large increase in Soviet imports during the past two years (from $21 billion in 1987 to $33 billion in 1989, plus an additional large increment in the first quarter of 1990), has not reduced domestic shortages. This may indicate the seriousness of the overall supply situation, at least for certain goods, and suggests that any import cutback could further aggravate the situation. On the other hand, the failure of imports (continued...)

51. It is against the background of the trade prospects and the deteriorating Soviet economy, which at the initial stages may be weakened even further as more radical reforms are undertaken, that the case for economic assistance is increasingly being discussed in the west and in the Soviet Union itself.[25]

52. Any international support measures for the Soviet Union which may emerge are likely to reflect an approach similar to that of the PHARE initiative of the Group of 24.[26] Launched in July 1989 and co-ordinated by the Commission of the European Communities, the objective of the programme has been to provide support for economic reform and restructuring in Hungary and Poland. To this end many western countries are liberalizing access to their markets, establishing new credit lines, offering to provide a variety of technical assistance, taking measures to stimulate foreign direct investment and, in the case of Poland and Romania, providing emergency food aid. The G-24, working

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[24] (...continued) to noticeably improve supplies may simply reflect various internal problems (e.g., in the distribution system), in which case a curtailment of imports might not have an immediate visible effect on retail sales.

[25] Until recently Soviet commentators limited consideration of aid to technical assistance. For example, see M. Maximova, "How can the west contribute to perestroika (A Soviet economist's perception)", paper presented to the Malente Symposium VII, On the Way to Stronger East-west Economic Relations &m. Opportunity and Challenge, Malente, Federal Republic of Germany, 16-18 October 1989. More recently, Professor Stanislav Shatalin, an adviser to President Gorbachev, has come out in favour of assistance (Financial Times, 29 May 1990). In the west, Chancellor Helmut Kohl and President François Mitterand have emerged as strong supporters of an aid initiative in favour of the Soviet Union. The issue was discussed by heads of state at the EC Summit in Dublin on 23 June 1990, but no consensus on a course of action emerged. EC President Delors indicated that the EC may be ready to offer a substantial aid package to the Soviet Union (Financial Times, 23 June 1990).

[26] See United Nations Economic Commission for Europe Economic Survey of Europe in 1989-1990, New York, 1990, section 4.4, "International Initiative in Support of Eastern Reforms".

closely with the IMF and the World Bank, have adopted a case-by-case approach, tailoring relief packages to the specific conditions and needs of each country. Conditionality has played a central role, as aided countries are required to undertake meaningful reforms and democratization and to adopt stabilization programmes approved by the IMF.[27] Following the political changes of last year, other eastern countries -- Bulgaria, Czechoslovakia, the German Democratic Republic, Romania and Yugoslavia -- have now been invited to join the PHARE programme. The European Community is presently examining requests for financial assistance from these countries amounting to over $10 billion.[28]

3. The effects of the eastern reform process on the rest of the world

53. The underlying objective of the economic reforms in the eastern economies is to raise their productivity and standards of living to levels approaching those in western Europe. Real output per head in the countries of eastern Europe in the mid-1980s was on average some 40 per cent lower than in the Federal Republic of Germany -- and given the uncertainty surrounding such estimates, the actual figure could be much lower. Moreover, their relative position has almost certainly deteriorated since then. The population of the six countries of eastern Europe is roughly equal to that of France and the United Kingdom combined, while that of the six plus the Soviet Union is only about three per cent lower than the population of OECD Europe. Clearly, if these countries were to succeed in significantly narrowing the gap between themselves and the west, even at a more modest rate than western Europe has narrowed the economic distance between it and the United States in the post-war period, then they would constitute a significant source of growth in the world economy. Moreover, since such a

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27 The G-24 has relied heavily upon the IMF in the execution of the support packages for Hungary and Poland, making the disbursement of various credits to these countries conditional upon their acceptance and implementation of reform and stabilization measures. The reasoning has been that this support is intended to promote fundamental reform (which may first require stabilization measures to be taken) rather than to simply prop up existing inefficient structures. The absence of Soviet membership in the IMF would seemingly preclude a similar role for that institution in any international support effort.

28 International Herald Tribune, 12 June 1990.

development would be accompanied by the gradual inclusion of the eastern countries into the global, multilateral trading system, it could make an important contribution to world-wide utility through a more efficient allocation of global resources.

54. These effects will be evident over the long run. The problems facing the reforming economies are immense and their solution will take time and require considerable assistance from the west. Nevertheless, once the process of reform is under way, east-west trade is likely to receive a major boost. Although west European investment in the east may eventually replace some investment in the west, in the short to medium term it is likely to depend on capital goods produced in the west. This is a development which is likely to get under way during the 1990s. The unification of Germany will also provide a separate boost to domestic investment in the early 1990s insofar as unification leads to a re-organization of production in both economies.

55. Improved growth and the entry of the eastern countries into the multilateral trading system will also improve the prospects for trade between the reforming economies and the developing countries. However, it is likely that improved competitiveness will enable the countries of eastern Europe to regain some or all of the market share they have lost to the newly industrialized economies of South East Asia, especially in the west European market for manufactured goods. The east Europeans' competitiveness will also benefit eventually from their being gradually drawn into the more specialized division of labour within an integrated European economy. (This refers to the spontaneous integration that is likely to occur among geographically close, industrialized (or industrializing) economies. Special institutional arrangements between the eastern countries and the EC or EFTA would, of course, accelerate the process.) This, again, is a development which could get under way during the 1990s.

56. The more immediate concern of some developing countries is that financial resources may be diverted from them to eastern Europe and the Soviet Union. Since commercial bank lending to the developing countries is already low or non-existent and is unlikely to expand in eastern Europe in the near future, their concern is mainly to do with foreign direct investment by private companies and with official development assistance. It is probable that there will be some switch of western private investment to eastern Europe, although on what scale is impossible to say at present. However, the switch to the east may be as much at the expense of western Europe and North America as the developing countries. Again, such a switch is likely to develop slowly. Foreign enterprises will remain cautious about

investing significant sums in eastern Europe until the reform processes are firmly established and until progress has been made in the areas of property rights, convertible currency régimes, and in building the institutional infrastructure necessary for efficient market economies. Only when changes have been made in these areas will it be possible to obtain reasonable calculations of rates of return on investments in the east.

57. The matter of grant aid is likely to be the more immediate issue for developing countries. Some organizations expressed the view that aid for eastern Europe will have to be at the expense of developing countries.[29] The President of the Commission of the European Communities has suggested that aid to the six east European countries would require a large **addition** to the Community's budget, but as yet it is not clear whether all member countries would support such an increase. Fiscal policy in the market economies is still dominated by the objectives of lowering budget deficits and cutting the size of public expenditure. Within this context the member countries of the OECD have not made any special effort to reallocate public expenditure so as to be able to meet the OECD development aid target of 0.7 per cent of GNP. Unless specific measures to the contrary are taken, it appears that the fears of developing countries about the diversion of foreign aid are not altogether without foundation.

58. The most immediate effect on the rest of the world, and on the developing countries in particular, is likely to be higher interest rates. Bond yields in the Federal Republic of Germany have already risen as a result of fears that unification of the two German states will boost inflation and, because of the close integration of the European economies, this has already had a generally hardening effect on west European interest rates in general. Insofar as reductions in defence expenditure (the "peace dividend") are used to reduce government expenditure, the consequent tightening of fiscal policy should eventually ease the upward pressures on interest rates.

59. Some of the concerns about the effects of German unification appear to be exaggerated, as noted above in sections 1 and 4, but the essential point about unification in particular, and the eastern reform process in general, is that there is bound to be an increase in the demand for investible funds. In recent years the main international sources of loanable funds have been Japan and the Federal Republic itself. If real rates of return are high in eastern Europe then foreign private capital will switch from countries such as the United States (and, in Europe, from France, Italy, the United Kingdom and southern Europe). As a

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[29] Financial Times, 12 December 1989.

result of German unification, the Federal Republic's current account surplus is likely to be invested at home rather than abroad. This does not mean that German nominal interest rates have to remain high. Bond yields may have risen because of the perception that Federal Government expenditure will increase as a result of the transition costs after unification (social security support, subsidized training, housing, etc.) and, given the anti-inflationary stance of monetary policy, this will have to be financed by government borrowing. But if rates of return to private investment in the east prove to be as high as some observers think, then private capital will eventually take on most of the task of restructuring. Insofar as this attracts private capital from the rest of the world German nominal interest rates could fall while the exchange rate remains firm. However, countries which have to attract foreign capital in order to finance large budget deficits, may be forced to raise interest rates still further in order to compete with higher rates of return elsewhere. Thus, the reduction of the United States budget deficit, a process which may now be helped by large cuts in defence expenditure, could help to relieve the upward pressure on world interest rates. This would directly benefit the indebted developing countries and ensure that an increasing proportion of world savings can be employed in the development of both eastern Europe and the developing countries. But the global competition for foreign direct investment will be more intense than ever before.

TABLE 1

Eastern Europe and the Soviet Union: Basic economic indicators, 1976-1990
(Average annual and annual growth rates, in percentages)

Country or group, indicator	1976-1980	1981-1985	1985	1986	1987	1988	1989	1990 Jan-March
Eastern Europe								
Net material product . . .	3.6	2.2	3.7	4.6	3.2	3.0	-1.5	..
Industrial output[a] . . .	5.6	2.8	4.1	4.6	3.5	3.6	-0.2	-13.4
Agricultural output[a] . . .	1.9[b]	1.1[b]	-1.1	5.3	-0.8	1.4	-0.1	..
Gross investment	2.7	-0.7	3.9	3.9	4.7	2.5	-2.2	..
Exports	6.5	4.8	2.4	0.3	1.2	4.0	-3.0	-14.2
Imports	4.1	0.4	5.5	5.3	1.8	2.9	0.2	-5.8
Soviet Union								
Net material product . . .	4.3	3.2	1.6	2.3	1.6	4.4	2.4	-2.0
Industrial output[a] . . .	4.5	3.6	3.4	4.4	3.8	3.9	1.7	-1.2
Agricultural output[a] . . .	1.7[b]	1.1[b]	0.1	5.3	-0.6	1.7	0.8	..
Gross investment	3.3	3.5	3.0	8.3	5.7	6.2	0.6	-5.4
Exports	4.9	1.5	-4.3	10.0	3.3	4.8	-0.3	-7.0
Imports	5.9	5.8	4.7	-6.0	-1.6	4.0	8.9	6.0

Source: Secretariat of the United Nations Economic Commission for Europe, based on national statistical publications and plan fulfilment reports.

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a Gross output

b Annualized change in the five-year average production levels from the average of the preceding five years.

TABLE 2

Eastern Europe and the Soviet Union: Trade balances, 1985-1990
(Billion US dollars or transferable roubles)

						Jan-March		
	1985	1986	1987	1988	1989	1989	1990	1990[a]
Eastern Europe with:								
World	5.9	1.2	3.0	6.1	5.2	2.0	0.5	-1.3
Socialist countries (billion TR) .	-0.4	-2.4	0.5	4.3	4.1	1.5	1.6	5.6
Developed market economies	3.7	0.8	0.5	0.3	1.4	0.9	0.1	-2.4
Developing countries	2.4	1.8	2.3	2.2	0.5	-0.1	-0.3	-0.5
Soviet Union with:								
World	3.9	8.1	11.7	3.4	-5.4	-2.1	-6.0	-22.3
Socialist countries (billion TR) .	2.0	3.8	2.1	-0.5	-2.4	-1.1	-1.6	-4.6
Eastern Europe (billion TR) . .	0.9	2.6	0.1	-2.4	-4.1	-1.0	..	..
Developed market economies	-0.9	-3.9	0.5	-2.7	-6.5	-1.6	-3.8	-15.7
Developing countries	2.4	6.6	7.9	6.9	5.0	1.3	0.4	0.8

[a] Extrapolated from first-quarter trends of exports and imports.

TABLE 3

East-west trade: value, volumes and trade balances, 1989-1990
(Percentage change and million US dollars)

	Value change				Volume change				Trade balance		
	Exports		Imports		Exports		Imports				
	1989	1990[a] QI	1989	1990[a] QI	1989	1990 QI	1989	1990[a] QI	1989	1989 QI	1990 QI
Bulgaria	4.8	-20.3	-1.7	1.7	3	-25	-1	-2	-1373	-350	-415
Czechoslovakia . . .	10.9	8.9	-1.6	30.3	10	7	-	28	71	209	52
German Dem. Rep. . .	9.5	-9.4	6.7	-3.8	8	-13	8	-5	-1032	33	-70
Hungary	12.6	15.3	10.8	0.6	12	12	13	-1	283	-38	79
Poland	5.2	8.5	6.3	-19.0	5	10	-6	-19	364	211	576
Romania	-1.1	-40.1	-5.3	329.1	-3	-44	-9	290	3081	821	-138
Eastern Europe . .	8.3	-4.5	4.3	9.4	7	-6	2	7	1395	888	84
Soviet Union	7.8	-1.3	21.1	27.2	3	-10	22	24	-6516	-1 574	-3791
Eastern Europe and the Soviet Union .	8.1	-2.9	12.8	19.9	5	-8	12	16	-5121	-686	-3707

Source: ECE Common Data Base. Data refer to trade with "developed market economies" in the grouping employed in the national statistics of eastern countries (i.e., excluding Yugoslavia). Value change is measured in US dollars. Values and trade balances reflect eastern trade reports; volume changes are ECE secretariat estimates.

[a] Relative to first quarter of 1989.

FORM NO. 75
(6-83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: October 18, 1990

NAME	ROOM NO.
Messrs. J. Linn	N-11-051
P. Isenman	S-13-145
G. Lamb	S-13-119

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

REMARKS:

FROM:	ROOM NO.:	EXTENSION:
Alexander Shakow	E-8065	81368

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cc: J Halsen
S Mint
C Michalopoulos

THE WORLD BANK/INTERNATIONAL FINANCE CORPORATION

OFFICE MEMORANDUM

DATE: October 12, 1990

TO: Mr. Alexander Shakow, EXTDR

FROM: David Loos, NYO

EXTENSION: 7-2265

SUBJECT: Address by Professor Stanislav S. Shatalin to the Second Committee

1. Professor Shatalin, member of the Presidential Council of the USSR, one of Mr. Gorbachev's economic gurus, addressed the Second Committee of the UN on the subject of "The transition to a market economy in the Soviet Union.".

2. In his remarks, Professor Shatalin made the following points:

Profound changes had taken place in the past year in the Soviet Union, but primarily in political terms. While it was clear that a new economic system had to be built in the Soviet Union, it was also evident that economic restructuring could not be effected overnight. The radical economic reforms called for in the earlier proposals were not comprehensive. Moreover, no one anticipated how far-reaching and complex the process would be. Republics were currently erecting barriers between themselves which could lead to the economic collapse of the country if this were not checked. He said that he was working on an economic program which would serve as a compromise among three programs (Gorbachev's, Yeltsin's, Shatalin's). The Supreme Soviet will discuss this "harmonized" program next Monday, October 15. The main principles and underlying factors of the program are as follows:

a. A free enterprise system should be implemented.

b. A convertible rouble, at least internally. The Government deficit had to be brought under control. Government expenditures had to be cut back with spending on defense and national security being reduced.

c. Acceptance that the Soviet Union was a union of sovereign states. The political reality was that the USSR as a unitary state with control from the top no longer existed. The heads of the various states had to play significant roles in the planning and implementation of any economic program. However, it was also recognized that some form ~~of~~ central control must be applied on issues like defense, outer-space activities, national strategic matters, some infrastructure projects, health and communications. There would have to be special funds for development and for social development and assistance to the less developed republics.

d. Agrarian reform was essential. Farming techniques were outdated. A third of this year's harvest would be lost due to incompetence. Private ownership of farmland would be permitted, but the extent of land purchased, which would be available even to city dwellers, would be strictly limited. Neo-capitalism would not be permitted.

e. A shift to a market system demanded sacrifice. It was necessary, therefore, to protect the poorest groups in society. The current program had been criticized for not going far enough in the protection of vulnerable groups. The problems were of varying degrees among the regions.

f. There was a lot of "hot money" floating around, which if harnessed could provide a boost in the shift to a market economy.

g. They were convinced that they would not succeed without cooperation from the world community, both in the east and west. While the USSR had paid bills on time in the past, this was no longer the case. Current and upcoming payments would be postponed. Thus, the country was in dire need of credit and looked to the international community to provide economic assistance.

h. Very few people in the USSR knew what a market economy was, let alone how to manage one. Not having lived, worked or studied in a market economy, Soviet economists found it difficult to develop comprehensive plans for moving towards one. They were generally poorly trained. The USSR, therefore, needed financial and economic experts to train its people, and wanted to commence sending its graduate students to the west.

i. In the past, assistance to Third World countries had been given on an ideological basis. Billions of roubles had been provided to countries strictly because of their ideological slant. This had to change. The USSR would join the rest of the world and provide assistance on the basis of need.

3. In summing up, Mr. Shatalin asserted that the USSR had moved very far and very expeditiously in putting a new political system in place. The country was moving towards democracy. While a new economic order will be given genuine political support from the highest levels, economic reform would take time. It would not be accomplished in "500"

days. Indeed, it was difficult to place a time-frame on it.

4. Mr. Shatalin's address was followed by a short question and answer period:

Q. What criteria would be used in guiding pricing policy?

A. The USSR needs to use every instrument to eliminate the budget deficit and stabilize the consumer market. If the stabilization program was successful, it would be possible to let prices float.

Q. What will be the role of the exchange rate?

A. Until the economy is stable, the rouble cannot be made completely convertible. As expected, the rouble will soon be devalued. A free market will be created gradually, and when this is done, the rouble could be traded on the open market, and its true value assessed.

Q. How close are you to the target budget deficit of 60 billion roubles?

A. The budget deficit is much larger than 60 billion roubles. It is likely to be of the order of 150 billion roubles, or 85 billion according to western calculations. The USSR had to take strict measures in eliminating the deficit. They wished to copy the Federal Reserve Bank system of the United States, incorporating the 15 Central Banks of the USSR into a single federal system, - the Union Reserve Bank, which would be a single juridical body.

Q. What about Soviet membership in GATT, IMF, World Bank and G7?

A. He maintained that he was not an expert in this area. Nevertheless, he foresaw the USSR becoming a full member of GATT and adhering to its decisions at the Uruguay Round. He said, tongue in cheek, that they would like to join the G7 if they were considered a developed country. He did not comment on the issue of joining the Bank and the Fund.

ACC/1990/CRP.1
5 October 1990
Original: English

ADMINISTRATIVE COMMITTEE ON CO-ORDINATION
Second regular session of 1990
New York, 22-23 October 1990

THE ECE ECONOMIES IN THE MID-1990S

Paper prepared by the Economic Commission for Europe

ECE.ACC (WP51)

90-25068

THE ECE ECONOMIES IN THE MID-1990S

CONTENTS

OVERVIEW

1. The contrast in Europe between economic performance in the west and in the erstwhile centrally planned economies of the east has become even more marked in the first half of 1990. Economic growth continues strongly in the market economies while in the east there is general and deepening recession.

2. The economic performance of western Europe and North America remained quite favourable in 1989, although on average the pace of expansion tended to moderate. This reflects largely the impact of tighter monetary policies designed to prevent inflation from accelerating. Output growth slowed down in North America but remained broadly unchanged in much of western Europe. There was also a deceleration in the pace of economic activity in Japan, although GDP growth was still higher there than in the other two regions. Growth differentials between these three regions tended to narrow in the course of 1989. Total output in the market economies grew on average by some 3.5 per cent, compared with over 4 per cent in 1988.

3. Expectations for 1990 are for a continuation of relatively strong performance in the ECE market economies. There will be some further slow-down in output growth, and this will tend to ease the strains which high activity levels have put recently on the utilization of available resources. Fixed investment will again be the major support for growth. In western Europe the forecast deceleration in output growth is small, except for the United Kingdom. The outlook for the United States is surrounded with some uncertainty, but growth in 1990 is now expected to be around 2 per cent. Inflation rates have generally tended to stabilize since last October and in many countries there have been tentative signs of deceleration in recent months. Nevertheless, official concerns are focused on the high rates of capacity utilization in western Europe and on the possible inflationary consequences of the German monetary union. Although fears of the latter may well be exaggerated, monetary policies are likely to remain cautious and avoid any general reduction in interest rates until there is a decisive downturn in average inflation rates. Nevertheless, despite high interest rates, private consumption growth and fixed investment in western Europe generally remain strong: forecasts for growth in the Federal Republic have been raised since the beginning of the year and the secretariat now expects average west European growth to be about 3 per cent this year. For the ECE market economies as a whole, GDP growth in 1990 is expected to average 2.5 per cent, compared with 3 per cent in 1989.

4. Economic activity in eastern Europe and the Soviet Union slowed progressively throughout 1989 and went into a recession in the final months of the year, which has continued and generally deepened in the first quarter of 1990. In the Soviet Union,

output rose by less than 2.5 per cent in 1989, down from 4.5 in 1988. Output fell in absolute terms in three of the six east European countries in 1989 and declined by 1.5 per cent for the group as a whole. Worsening output trends were accompanied by rising inflationary pressures or open inflation, which turned into a classical hyper-inflation in Poland. Together with the domestic balance, external balances generally deteriorated.

5. Many of these processes accelerated in 1990, but for reasons which varied much more widely among the countries of the region than was the case last year. In the first quarter of 1990, output was below the level of the same period of 1989 in **all** the eastern countries, with very sizeable falls in some. In aggregate, the region's industrial production declined by almost 5 per cent. Inflation, open or repressed, accelerated in most countries. Exports generally fell steeply, largely because of supply problems; imports also declined in most countries, but much less than exports, or increased -- notably in Romania and the Soviet Union -- and balance-of-payments constraints tightened considerably in the region.

6. Social or political upheavals played an important role in the 1989 downturn, but deteriorating macro-economic control -- central planning systems are being dismantled, but have not yet been replaced by viable market institutions -- and the inflationary impact of growing fiscal deficits appear to have been the main causes. The resulting internal market imbalances were transmitted among the eastern countries through the intra-CMEA trading system, which has shown signs of disintegration as member countries strove to avoid incurring surpluses in transferable roubles that might never be convertible into goods.

7. Economic policies set for 1990 were very diverse: they range from those assigning priority to radical and very rapid systemic change in conjunction with fiscal and monetary austerity to eliminate inflation (the Polish "shock therapy") to those giving short-term priority to stabilization as a prerequisite for more far-reaching measures of systemic reform in the future (the Soviet case). Many of the new interim governments in eastern Europe merely struggled to keep their economies running, pending mandates for systemic change from the elections in the first half of 1990. If the austerity policies, where attempted, have largely achieved their initial goals -- although, particularly in Poland, at the cost of a far deeper recession than expected -- policies aimed at stabilizing economic activity in the old economic framework have generally failed. This became clear by mid-1990, but governments have encountered considerable difficulties in obtaining a consensus for new solutions. The policy landscape at mid-year is thus dominated by uncertainty.

The only certain element appears to be that the recession in eastern Europe and the Soviet Union is far from having run its course.

1. Eastern Europe and the Soviet Union

(i) Developments in 1989 and early 1990

8. The objectives that the countries of eastern Europe and the Soviet Union had laid down in their respective national economic plans for 1989 envisaged an acceleration of **NMP growth**, from an average 3 per cent reported for eastern Europe in 1988 and the 4.5 per cent registered in the Soviet Union to some 4.5 per cent and 6 per cent, respectively. These targets were predicated on the expectation of substantial efficiency gains and fairly strong output growth in industry as well as in agriculture throughout the area.

9. Policy targets on the **utilization** of national output (domestic absorption) tended towards austerity in eastern Europe, while in the case of the Soviet Union the policy stance appears to have been still fairly permissive. By late 1988, when these plans were being formulated, inflationary pressure -- and the state budget deficit which was feeding it -- had become a serious policy concern in the Soviet Union, yet policy makers still found it very difficult to face up to the full dimensions of the problem. In most of the east European countries (apart from Hungary and Poland), the inflationary problem and its monetary policy and public deficit origins were still kept under wraps in the policy statements for 1988-1989, but the evident worsening of balance-of-payments constraints (in part also revealed in the public statistics only in early 1990 after the changes in the power structure) forced the hand of policy makers.

10. Within the constraints on total domestic absorption, **consumption** appears to have been favoured relative to **accumulation** in the plans for 1989. Targets for average wages and retail sales volume indicate that fairly high growth was aimed at in Bulgaria, the German Democratic Republic, Poland and the Soviet Union, whereas a more restrictive stance prevailed in Czechoslovakia, Hungary and Romania. **Investment** targets, by contrast, were restrictive (negative or below planned NMP growth) in Czechoslovakia and the Soviet Union, but appear to indicate that some rise in the investment rate may have been intended in a number of other countries (Hungary, Poland, Romania). However, given the tense situation in consumer markets combined with the priority assigned by policy makers to consumption to ease social tensions, as well as balance-of-payments pressures, the leeway for investment outlays was evidently quite narrow everywhere.

11. Regarding the overall pace of output growth, the policy stance for 1989 varied substantially among countries. In eastern Europe, the countries most actively engaged in economic reform -- Hungary and Poland, and also Czechoslovakia, anticipated some slowing of NMP growth, whereas in Bulgaria, the German Democratic Republic and Romania the targets implied a pronounced upswing from the 1988 performance. In all countries, efficiency gains were to feed this expansion, as indicated by sectoral targets, formulated in **gross** output terms, which generally were lower than those for NMP.

12. At the same time, most countries hoped to gain some flexibility in the **foreign trade** sector by placing a lid on total domestic absorption and by boosting exports. This was to enable countries to continue with their external adjustment efforts, first introduced in the early 1980s, as well as with structural change and economic reform.

13. The growth objectives for 1989 over a wide range of output and consumption targets proved, in retrospect, to have been overly optimistic. In early 1989, the ECE secretariat had suggested that a target of 3.5 per cent aggregate growth for the group as a whole would be more realistic. Official growth rates were deemed to be too ambitious, in part because of prevailing internal market imbalances and difficulties with the reform programmes in countries that had already put them in train. It was already evident that the constraints on intra-CMEA trade were tightening, largely because of adverse changes in the Soviet Union's terms of trade at a time of slowing or declining Soviet export supplies. This in turn would restrict the ability of eastern Europe to export and, in some cases, to operate near full capacity.

14. Even that judgement in the end proved to have been optimistic. In eastern Europe, aggregate NMP actually fell in 1989 (see table 3), reflecting performances ranging from 1-2 per cent growth in Czechoslovakia and the German Democratic Republic to a 10 per cent fall in Romania. Three countries (Bulgaria, Hungary and Romania) reported a decline in NMP produced. In Poland it stagnated. In the event, only Czechoslovakia almost succeeded in reaching its 1989 aggregate output target. In the Soviet Union, growth in 1989 slowed to just under 2.5 per cent, and perhaps less if the widespread doubts of Soviet economists about the official deflators are warranted.

15. On the whole, the 1989 output results were the worst since the post-war stabilization. In addition to three countries actually in recession (defined as a fall in net real output), several others were clearly close to it, as indicated by the

downward trend of output in successive quarters of 1989 and the results for the first three to four months of the current year.[1]

16. The socio-political events of 1989 were only in part responsible for the economic deterioration. Labour disputes, demonstrations and chaotic emigration obviously contributed to the slow-down. But the current weakness had deeper roots in the continuing inability of policy makers in eastern Europe and the Soviet Union to regain a growth path with sustained significant increases in output per head. The paltry gains in average labour productivity reflected largely low capital- and resource-use efficiency. This is a phenomenon of long standing in all the economies that used to rely mainly on detailed central planning for resource allocation.

17. Most large production sectors contributed to the downturn. Aggregate **gross industrial output** stagnated in eastern Europe in 1989. In the Soviet Union it grew by less than 2 per cent, the lowest growth rate registered in the post-war period; however, the output of consumer manufactures ("sector B") advanced faster than industry as a whole, by 4.5 per cent -- a reflection of the high priority that the Soviet leadership has recently been placing on improving consumer market supplies. The weakness of aggregate east European industrial production reflected a significant contraction of output in Hungary, Poland and Romania (-2 per cent) and near stagnation in Czechoslovakia. Only Bulgaria and the German Democratic Republic reported real growth in 1989 (above 2 per cent), in both countries in spite of a substantial outflow of skilled workers since mid-1989 and the disorganization caused by political disturbances later in the year. The cumulative effect of these factors, however, was increasingly felt in both countries in the last quarter.

18. Generally, industrial production deteriorated throughout 1989. In the last quarter, output fell in absolute terms in all eastern countries but Czechoslovakia. It declined further, generally at increasing rates, in **all** countries in the first three to four months of 1990. In the first quarter of 1990, output was below the level of a year earlier by 8-9 per cent in Bulgaria, 3 per cent in Czechoslovakia, 5 per cent in the German Democratic Republic, 8 per cent in Hungary and by almost

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[1] In the context it should be noted, however, that conclusions about recent trends are somewhat hazardous owing to the large changes in statistical reporting practices now occurring in the region. The downturn in a number of countries may in fact have occurred earlier but have been hidden by deceptive statistics.

one-third in Poland and one fifth in Romania. An absolute downturn occurred also in the Soviet Union (see table 1).

19. **Agricultural** performance also remained well below expectations in 1989. The **construction** sector probably registered a sharp contraction, judging from the information on investment activity in 1989, as did the **transport** sector in a number of countries.

20. Information on developments in the **allocation** of national income in 1989 is still sketchy. There is little doubt, however, that intentions regarding **absorption levels** could not be implemented in most countries. In Hungary and Poland, austerity was maintained -- as originally planned -- but at levels of aggregate absorption sharply lower than intended. Elsewhere in eastern Europe and in the Soviet Union, however, widening consumer market imbalances and measures to improve supplies to ease social tensions resulted in worsening external balances -- in some cases by sizeable margins -- in spite of cut-backs in investment outlays.

21. Aggregate **consumption** grew very little in real terms in most countries in 1989, or contracted -- as in Hungary, Poland and Romania. Although rising fast in nominal value, retail sales in real terms increased only marginally in several of these economies. Money incomes generally grew more rapidly than nominal retail sales, which further aggravated domestic market imbalance. This occurred in spite of efforts to boost production for the domestic market, to increase consumer imports and encourage savings through more differentiated interest rates. An especially large increase in retail sales was reported by the Soviet Union. A substantial share of the overall rise stemmed, however, from the rapid increase in the sale of alcoholic beverages, an item that had deliberately been placed under official supply constraints for social reasons in the mid-1980s, with deleterious consequences for macro-economic balance. Though part of the increase was made possible by the earmarking of defence industry capacities and inventories for civilian uses, emergency imports -- which contributed to a sharp deterioration of the external accounts -- also had to be called upon. None the less the consumer markets remained severely disturbed throughout the year, as is suggested by the rapid spread of local rationing schemes and other non-market arrangements to "distribute the shortages".

22. The volume of **gross investment** (and in some cases nominal investment outlays) clearly contracted in eastern Europe in 1989; in the Soviet Union it grew only marginally. This marked a sharp break with the trends of the preceding three years, when investment volume growth had outpaced the expansion of total

output. Policy makers in several countries, including the Soviet Union, have been looking for ways of curtailing investment outlays. In that sense, the results of 1989 must have been encouraging. However, the micro-economic aims associated with the easing of the investment ratio -- improved efficiency in the investment process and in the use of capital -- were not achieved. Moreover, in the reforming countries the hoped-for replacement of budget financing by enterprise financing does not appear to have improved investment discipline. This has been mainly due to chronic rigidities in the distribution system for investment goods and unabated administrative controls over investment activity.

23. The foreign trade sector remained a constraining factor in all countries of the group in 1989 and early 1990. Although import volume in most countries increased faster (or fell less) than export volume, which eased domestic market imbalances, balance-of-payments concerns generally held this in fairly narrow boundaries. None the less, the external balances deteriorated in both eastern Europe and -- substantially -- the Soviet Union.

24. In CMEA relations, the trade-constraining tendencies inherent in a structure of predominantly bilateral arrangements appear now to be moving the system onto a downward spiral. At its origin is the deterioration of the Soviet terms of trade <u>vis-à-vis</u> eastern Europe which stemmed from the lagged introduction of world market prices into the CMEA trade price structure and caused the Soviet trade balance with eastern Europe to swing into deficit in the second half of the 1980s. In 1989 and early 1990 several east European countries (notably Hungary and Poland) took special measures to curb rouble exports in an attempt to stave off sizeable surpluses in transferable roubles. The Soviet Union, on the other hand, introduced export constraints of its own on manufactured consumer goods to protect the supply to domestic markets. In addition, Soviet deliveries of fuels and raw materials fell short of commitments owing to production and, probably, transport difficulties.

25. In the event, the volume of Soviet exports to eastern Europe appears to have contracted slightly in 1989 -- by perhaps 1-2 per cent -- while Soviet imports from eastern Europe fell somewhat more steeply -- by 2-3 per cent; nonetheless, the Soviet trade deficit rose from 2.5 billion roubles in 1988 to over 4 billion roubles in 1989. The downturn became much steeper, and the imbalance widened, in the first quarter of 1990, when intra-CMEA trade declined by some 10 per cent in volume (table 2).

26. External payments constraints were largely responsible for the weak trade performance with non-CMEA partners in 1989. Imports from these partners increased in both eastern Europe and

the Soviet Union, in some cases as a consequence of the deliberate choice of policy makers around mid-year to improve domestic supplies through consumer goods imports. As a result, the trade balance of the Soviet Union with the convertible currency area registered a $6 billion turnround, swinging from surplus to a deficit of about $1.5 billion. A substantial proportion of this change -- roughly $2 billion -- was on account of a declining Soviet surplus with the developing countries. Matters were less dramatic in eastern Europe's relations with third partners. None the less the trade surplus of $2.5 billion with the market economies in 1988 contracted to some $2 billion in 1989. The early months of 1990 produced a sharp deterioration in these balances (table 2.)

(ii) Prospects for 1990

27. Policy objectives for 1990 for most countries of the area are in a state of flux in mid-1990. Only the Soviet Union had adopted an explicit annual plan of the old variety that is still -- at least formally -- in force. It attempted to stabilize the economy, but this effort clearly has not worked. Remedial measures are under consideration, but they impose serious costs for which social acceptance has to be found. Similar issues arise with the transformation plans of some east European countries.

28. Current economic policy in the eastern countries is dominated by preoccupation with regaining economic, social and political stability, in conjunction with preparations for systemic change. In some countries, notably Hungary and Poland, with Czechoslovakia lagging only as regards the scheduling, a social consensus already prevails, and formal economic stabilization programmes are at the heart of short-run economic policy or are being formulated. In these cases, regaining order in monetary and fiscal affairs is considered a prerequisite for moving towards a more market-oriented environment. In other countries, particularly Bulgaria and Romania, official intentions have been more conservative in the early months of 1990, but more radical changes appear to be in the making after the recent elections. In Romania, the new government has announced the intention of turning decisively towards market-oriented reforms, presumably without central planning.

29. Economic **reforms** under way in the eastern countries accelerated dramatically in 1989, together with political change. In the economic sphere, these aim, to one degree or another, at improving performance through increased use of markets and through closer integration into the world economy.

30. In the Soviet Union, and probably also in Bulgaria and Romania (where the formulation of objectives is still at an early stage), reforms basically envisage a transformation of the existing centrally planned system through the use of monetary and financial instruments and market channels to replace the "command" system of physical resource allocation and output determination. Much increased enterprise autonomy, demonopolization of the enterprise structure, room for non-state economic activity alongside the dominant state sector, improved price systems (with better links to world market prices), and the "hardening" of financial constraints are expected to bring significant efficiency gains. All reforms include measures to achieve a substantial opening to the outside world, ranging from decentralization of the authority to trade abroad to liberalized provisions for the entry of foreigners into the domestic economic system (mainly in the form of joint ventures or free trade zones).

31. In Hungary and Poland, the reform agenda was extended radically in 1989, and now aims at the establishment of fully-fledged market economies in which the role of state planning is reduced to largely macro-economic functions. Broadly similar aims came to the fore in Czechoslovakia after the political overturn at the end of 1989, but are still in the course of being formulated. These countries now envisage a significant and rapid reduction of state-owned industries through privatization and a substantial role for foreign direct investment. The difficult issue facing these countries is how to manage the transition from centrally planned to market systems, and this -- especially in Poland -- in the face of sharply deteriorating economic performance. Poland has opted for a shock cure in the hope of thus shortening the transition period, whereas in the other two countries the appropriate pace is still to be decided.

32. In the German Democratic Republic, central planning of any kind is of course no longer on the agenda, and the issue is now largely one of how best to manage integration with an existing and strong market economy and not how to re-fashion a separate economic entity -- a task which has its own difficulties, but should be incomparably easier. With the currency unification at the beginning of July 1990, economic policy autonomy has essentially been abandoned.

33. The immediate prospects for eastern Europe and the Soviet Union are bleak. Governmental programmes for 1990 focus on the twin aims of transforming economic systems and stabilizing economies in disarray. These are tasks of a large order and frequently involve contradictory demands. Inflationary processes are likely to yield only slowly to moderate deflationary policy

measures, and where policy is strong (as in Poland) the cost of a recessionary downturn will be high. Balance of payments constraints have increased for most countries, including now the Soviet Union, and this reduces the leeway for domestic policy.

34. Although the problems and prospects facing the eastern countries are fairly daunting, the ability to implement effective policies to deal with them and reap the longer-term benefits could be greatly increased by the adoption of consistent reform measures. In eastern Europe, the political legitimacy conferred on the governments that emerged after the free parliamentary elections in 1990, and by a significant programme of technical and financial support by the western market economies, should help in facing the costs of reform.

2. East-west trade and payments

35. East-west trade in 1989 was characterized by a slackening of eastern export growth and a substantial pick-up in the volume of eastern imports. Both trends became more pronounced in the early months of 1990. They evolved against the background of a rapid, although slowing, expansion of world trade and momentous changes in the political environment of east-west relations.

36. After rising some 8 per cent in value and perhaps 5 per cent in volume in 1989, total **eastern exports to the west** contracted in the first quarter of 1990 by an estimated 8 per cent in volume (table 3).[2] Export performance varied considerably between the eastern countries. In Czechoslovakia and Hungary, exports to the west grew rapidly in 1989 and early 1990, while Poland's deliveries to the west recovered sharply in 1990 after having come to a standstill in the second half of 1989. The exports of the other east European countries fell in the first quarter of 1989, as did those of the Soviet Union. The fall was particularly large in Bulgaria and Romania.

37. **Eastern imports from the west**, which had expanded strongly in 1989, quickened to some 16 per cent in volume in the first quarter of 1990. This reflected mainly the very fast expansion of Soviet imports, which is now in its third year. In eastern

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[2] Unless otherwise noted, growth rates for the first quarter of 1990 reflect change from the same period in 1989. The value data shown in table 3 derive entirely from eastern national sources, since the western data used in the more detailed analysis in United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990 (chapter 4.2) are not yet available for the most recent period.

Europe, where import growth had been moderate in 1989, only Czechoslovakia and Romania registered an upswing in early 1990. In Romania the increase follows nine years of contraction that saw imports from the west drop from $4 billion in 1980 to $900 million in 1989. The imports of Bulgaria, the German Democratic Republic and Hungary stagnated or declined in 1990 after substantial growth in 1989, whereas those of Poland contracted sharply.

38. The **trade surplus with the west** of the east European countries increased in 1989, but the surplus in **convertible-currency trade** narrowed owing to a sharp fall in the surplus with developing countries. The Soviet Union incurred a **convertible-currency deficit** in 1989, owing to a steep rise (to $6.5 billion) in its trade deficit with the west and a fall in its surplus with developing countries. As a result of the changes in trade flows in the first quarter of 1990, eastern trade balances with the west and with the convertible-currency area as a whole deteriorated considerably. The east European surplus in convertible currencies swung into deficit (a $1 billion turnround), and the Soviet Union incurred a $3.4 billion first-quarter deficit, more than twice as large as that for all of 1989. The deterioration of the external balance was particularly pronounced in Romania, followed by Czechoslovakia, the German Democratic Republic and Bulgaria. Hungary and Poland, on the other hand, improved their external position in the first quarter of 1990, Poland registering a convertible-currency surplus of $0.8 billion which exceeded that for 1989 as a whole.

39. In 1989, the east's **current account in convertible currencies** swung from a surplus of $3 billion in 1988 to a deficit of $6 billion, owing to unfavourable movements in the accounts of both eastern Europe and the Soviet Union.[3] The trade results for the first quarter of 1990, together with higher net interest payments -- stemming from higher international interest rates in 1990 and rising levels of external indebtedness -- suggest that the convertible-currency current account deficits of most eastern countries widened in the early part of the year. Hungary and Poland were exceptions. In Poland, in particular, the steep rise of the trade surplus more than offset higher net interest payments and yielded a current account surplus.[4] This

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[3] See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, table 4.3.1.

[4] Rynki zagraniczne, 17 May 1990.

allowed the authorities to build up reserves by $1.7 billion,[5] although it should be noted that only a small share of interest obligations were settled.[6]

40. A host of factors -- the development of output and demand, changes in trade policies, and the implementation of reforms and macro-economic stabilization policies in the east -- shaped the eastern countries' trade flows with the west, although the influence of each factor appears to have varied considerably from country to country.

41. The import demand of the developed market economies, the major convertible currency market for eastern goods, appears to have remained buoyant in the early part of 1990, perhaps slowing somewhat from the rapid pace of the preceding two years. Hungarian and Polish exports have also benefitted from the liberalization of western trade restrictions since the beginning of 1990.

42. All of the eastern countries experienced varying degrees of decline in industrial production in 1989-1990, which in certain cases appear to have directly reduced their exports. This appears to have been the case in the German Democratic Republic, where the fall in output has been due in part to labour force emigration. In the Soviet Union, the production of oil, still the predominant source of convertible currency revenues, has continued to diminish. Oil production fell a further 5 per cent (and coal by 6 per cent) in the first four months of the year,[7] which probably led to further reductions in the country's crude and petroleum product deliveries to the west in early 1990.[8] To some extent, east European output and exports were constrained by shortfalls of imports from the Soviet Union, including crude oil. Preliminary data for the early months of 1990 indicate that exports of petroleum products to the west from these countries,

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5 Financial Times, 1 June 1990.

6 Rynki zagraniczne, 17 May 1990.

7 Financial Times, 11 June 1990.

8 Soviet deliveries of petroleum and petroleum products declined by some 13 per cent in the first two months of 1990 relative to the same period in the previous year. IEA, Monthly Oil and Gas Statistics, Paris, 17 April 1990, and previous issues.

refined largely from Soviet crude, continued to fall.[9] However, another cause of the decline in east European industrial production -- the fall in Soviet import demand -- seems to have actually fostered the growth of exports to the west. East European enterprises have made greater efforts to redirect deliveries to the convertible currency area in order to compensate for the drop in their exports to the Soviet Union. This was clearly the case in Poland, where exchange rate policy supported such efforts by a steeper devaluation of the zloty against the dollar than against the rouble. Aside from lower Soviet demand, east European exports to the Soviet market also fell because of trade policy measures taken by the east European countries to avoid the buildup of trade surpluses in roubles.[10] It is believed that, in general, the scope for such a shift is not large in the short term because of the limited appeal to westerners of goods produced for the Soviet market. However, certain products -- food, raw materials, some semi-manufactures and consumer goods could be redirected if their prices were made sufficiently attractive.

43. The implementation of macro-economic stabilization policies and economic reforms has had a considerable impact on the external sectors of several eastern countries. Hungary and Poland have adopted IMF-approved programmes. The resulting compression of domestic demand has curtailed imports and induced producers to compensate by boosting exports (largely to the west since the eastern market is so weak). As a result, Hungary's imports stagnated in the first quarter of 1990, despite a further liberalization of the trade régime at the beginning of the year. Unlike in recent years, there was little use of the exchange rate in Hungary to promote exports. Elements of Poland's radical economic reform, including the introduction of internal currency

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9 During January-February, east European exports of crude oil and petroleum products declined by 29 per cent relative to the same period in 1989. IEA, Monthly Oil and Gas Statistics, loc cit. Some east European countries are reported to have contracted for additional supplies of Middle East crude to make up for the shortfall in supplies from the Soviet Union, but on the whole these appear to have been insufficient to maintain petroleum product deliveries.

10 For example, the Hungarian authorities temporarily suspended licences for exports of Ikarus buses to the Soviet Union. International Herald Tribune, 17-18 February 1990.

convertibility[11] and a large real devaluation of the zloty (much sharper against the dollar than against the transferable rouble) contributed to the upturn in exports to the convertible currency area. On the other hand, Polish imports, which had been climbing steeply, plunged in the first quarter of 1990. The combination of restraints on domestic demand, zloty devaluation and the activation of Poland's tariff schedule (and taxes on certain imports) led to an unexpectedly large reduction in the quantity of imports.[12] Consequently there was a trade surplus in the first quarter instead of the deficit which had been expected.

44. However, aside from Hungary and Poland, recent trade régime changes in eastern Europe have not been significant. After the recent elections, reforms are expected to accelerate in Czechoslovakia. In Bulgaria, and Romania, discussions indicate that real reforms may begin soon. In Czechoslovakia, the currency retention scheme, introduced several years ago, and the more recent acquisition of foreign trade rights by enterprises are believed to have had a positive impact on exports. On the other hand the devaluation of the koruna at the beginning of the year probably had little effect on trade. In Romania, administrative measures were used to cut exports (which may also have been affected by the drop in industrial production) and sharply raise imports so as to improve internal supply, particularly as regards foodstuffs. Overall, it appears that foreign trade reforms have had only a limited effect on the shaping of the east's trade flows with the west. Macro-economic stabilization measures appear to have been more important.

45. Given the financial markets' unfavourable assessment of economic developments in the east in recent months, it is probable that some eastern countries running current account deficits in convertible currencies will have to implement adjustment measures because of growing limits to the availability of credit. Already at the beginning of the year commercial banks were reported to be scaling down their lending to the eastern

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11 The term "internal currency convertibility" as used here refers to an exchange régime under which domestic companies are obligated to surrender all foreign currency earnings to the domestic monetary authority at the prevailing rate of exchange. By the same token they and residents have the right to purchase foreign currency, at the same rate of exchange, in order to import.

12 Polish imports from the convertible currency area had been expected to rise by 13 per cent in 1990. Rzeczpospolita, 14 December 1989.

area, owing to a perception of greater risk identified with the process of economic reform and, in the case of several countries, to rapidly growing indebtedness. The cautiousness of banks was reinforced when news of payments difficulties in several eastern countries emerged. In March, Bulgaria -- where indebtedness had been increasing rapidly -- announced the suspension of payments of principal on its commercial obligations.[13] This was followed by reports that the Soviet Union had fallen behind on the settlement of short-term trade credits and that some creditor banks had withdrawn deposits from Hungarian banks. The resulting illiquidity led the Hungarian government to request a $500 million bridging loan from the Bank for International Settlements until funds from the IMF and the World Bank become available. In the wake of the publicized payments problems of these three countries, international banks were reported to have curtailed lending to them and to have lowered their credit ratings. It is thus likely that in the near future the access of all eastern countries to commercial credits will be constrained and will be more costly. In these circumstances, new officially-backed credit lines and, for those countries which are already members of the Bretton Woods organizations, multilateral facilities will take on additional importance. Financing from the new European Bank for Reconstruction and Development will not be available until 1991.[14] A successful rescheduling of bank obligations will be necessary if Bulgaria is to obtain the breathing space to pursue its reforms.[15]

46. The recent rapid growth of Soviet imports from the west presumably reflects decisions to alleviate growing domestic shortages and the increasing enterprise autonomy in the sphere of foreign trade and borrowing rights. In 1989, Soviet imports from the west had risen by some 20 per cent in value, which increased the country's trade deficit with the west to $6.5 billion and contributed to an estimated $10 billion rise in external

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13 In negotiations with creditor banks, Bulgaria is asking for a postponement of repayments of principal coming due until 1993. The country intends to pay scheduled interest payments, amounting to some $600 million in 1990. Financial Times, 22 June 1990.

14 It should be remembered that Bulgaria and Czechoslovakia will not become members of the IMF until the autumn of 1990 and credits will be available only later.

15 Poland's debts have already been rescheduled. See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, p.219.

indebtedness.[16] Mainly because of a further large increase in imports, the Soviet Union's trade deficit reached a record $3.8 billion in the first quarter of 1990. In May 1990, reports of widespread delays in Soviet repayment of short-term suppliers credits began to surface. Although the Soviet authorities have announced that they are taking steps to resolve these difficulties, it appears that international banks have not reversed their purely commercial decision to curtail lending. Among other repercussions, the international credit rating of the Soviet Union slipped, raising the costs of borrowing.

47. The question arises why payments by the Soviet Union were delayed when it had some $15 billion on deposit with BIS reporting banks at the end of 1989[17] and gold reserves estimated at over $30 billion. One explanation centres on the implications of the economic reforms which opened the way to a decentralization of foreign borrowing away from Vnesheconobank to individual enterprises and ministries. It seems that Soviet enterprises had obtained non-guaranteed credits from foreign suppliers, beyond their capacity to repay, without the guarantee of the Bank.[18] Consequently, western creditors would have to evaluate risks of lending to Soviet enterprises more carefully, however difficult that might be under present circumstances.

48. Beyond these "technical" problems it also appears that Soviet demand for financing increased rapidly when the government resorted to imports to meet pressing internal needs. It is likely that the Soviet Union financed at least part of its large first-quarter trade deficit by drawing heavily upon its BIS assets.[19] As regards the Soviet Union's gold stock, it has been

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16 See United Nations Economic Commission for Europe, Economic Survey of Europe in 1989-1990, New York, 1990, p.211.

17 BIS, International Banking and Financial Market Developments, Basle, May 1990.

18 According to Deputy Prime Minister S. Sitarian, Chairman of the State Commission for Foreign Economic Relations, the stereotype of the Soviet organization, backed in all cases by the government, was not valid today. Western firms will have to build up the same kind of financial relations with Soviet enterprises as prevail among themselves. Izvestiya, 22 May 1990.

19 BIS data for the end of the first quarter are not yet available. It might be noted that some seasonal drawdown of assets is normal.

reported that some of it has been used as collateral to raise short-term credits to pay for imports.[20]

49. Although internal pressures for a further increase in imports may be building up in the Soviet Union, it is doubtful whether they can be financed.[21] Further declines of both Soviet oil production and international oil prices have tended to aggravate the country's trade position (although some relief has been forthcoming from lower prices for cereals). Low and falling gold prices have reduced potential revenues from gold sales as well as the collateral value of gold reserves.[22]

50. Since multilateral financing is not currently an option for the Soviet Union, and its access to commercial credits is apparently constrained (or at least more expensive), the country will have to rely increasingly on official bilateral sources of credit. However, for western governments to make available new credit facilities on the scale required to support the level of net borrowing undertaken in 1989 would require major and rapid policy decisions. The DM5 billion ($3 billion) government guaranteed bank credits recently announced by the Federal Republic of Germany falls into this category;[23] similar loans from other western countries will presumably be under discussion at the Group of Seven meeting in Houston. Unless these are forthcoming, it seems likely that the Soviet authorities will be obliged to cut the growth rate, and possibly even the level, of imports.[24]

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[20] Financial Times, 27 June 1990.

[21] An extrapolation of trade trends in the first quarter to the entire year would yield a trade deficit of the Soviet Union with the west of some $16 billion.

[22] The recent fall in gold prices has been attributed to factors other than the operations of the Soviet Union. Financial Times, 13 June 1990.

[23] Financial Times, 27 June 1990.

[24] It might be noted here that the large increase in Soviet imports during the past two years (from $21 billion in 1987 to $33 billion in 1989, plus an additional large increment in the first quarter of 1990), has not reduced domestic shortages. This may indicate the seriousness of the overall supply situation, at least for certain goods, and suggests that any import cutback could further aggravate the situation. On the other hand, the failure of imports (continued...)

51. It is against the background of the trade prospects and the deteriorating Soviet economy, which at the initial stages may be weakened even further as more radical reforms are undertaken, that the case for economic assistance is increasingly being discussed in the west and in the Soviet Union itself.[25]

52. Any international support measures for the Soviet Union which may emerge are likely to reflect an approach similar to that of the PHARE initiative of the Group of 24.[26] Launched in July 1989 and co-ordinated by the Commission of the European Communities, the objective of the programme has been to provide support for economic reform and restructuring in Hungary and Poland. To this end many western countries are liberalizing access to their markets, establishing new credit lines, offering to provide a variety of technical assistance, taking measures to stimulate foreign direct investment and, in the case of Poland and Romania, providing emergency food aid. The G-24, working

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[24] (...continued) to noticeably improve supplies may simply reflect various internal problems (e.g., in the distribution system), in which case a curtailment of imports might not have an immediate visible effect on retail sales.

[25] Until recently Soviet commentators limited consideration of aid to technical assistance. For example, see M. Maximova, "How can the west contribute to perestroika (A Soviet economist's perception)", paper presented to the Malente Symposium VII, On the Way to Stronger East-west Economic Relations &m. Opportunity and Challenge, Malente, Federal Republic of Germany, 16-18 October 1989. More recently, Professor Stanislav Shatalin, an adviser to President Gorbachev, has come out in favour of assistance (Financial Times, 29 May 1990). In the west, Chancellor Helmut Kohl and President François Mitterand have emerged as strong supporters of an aid initiative in favour of the Soviet Union. The issue was discussed by heads of state at the EC Summit in Dublin on 23 June 1990, but no consensus on a course of action emerged. EC President Delors indicated that the EC may be ready to offer a substantial aid package to the Soviet Union (Financial Times, 23 June 1990).

[26] See United Nations Economic Commission for Europe Economic Survey of Europe in 1989-1990, New York, 1990, section 4.4, "International Initiative in Support of Eastern Reforms".

closely with the IMF and the World Bank, have adopted a case-by-case approach, tailoring relief packages to the specific conditions and needs of each country. Conditionality has played a central role, as aided countries are required to undertake meaningful reforms and democratization and to adopt stabilization programmes approved by the IMF.[27] Following the political changes of last year, other eastern countries -- Bulgaria, Czechoslovakia, the German Democratic Republic, Romania and Yugoslavia -- have now been invited to join the PHARE programme. The European Community is presently examining requests for financial assistance from these countries amounting to over $10 billion.[28]

3. The effects of the eastern reform process on the rest of the world

53. The underlying objective of the economic reforms in the eastern economies is to raise their productivity and standards of living to levels approaching those in western Europe. Real output per head in the countries of eastern Europe in the mid-1980s was on average some 40 per cent lower than in the Federal Republic of Germany -- and given the uncertainty surrounding such estimates, the actual figure could be much lower. Moreover, their relative position has almost certainly deteriorated since then. The population of the six countries of eastern Europe is roughly equal to that of France and the United Kingdom combined, while that of the six plus the Soviet Union is only about three per cent lower than the population of OECD Europe. Clearly, if these countries were to succeed in significantly narrowing the gap between themselves and the west, even at a more modest rate than western Europe has narrowed the economic distance between it and the United States in the post-war period, then they would constitute a significant source of growth in the world economy. Moreover, since such a

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27 The G-24 has relied heavily upon the IMF in the execution of the support packages for Hungary and Poland, making the disbursement of various credits to these countries conditional upon their acceptance and implementation of reform and stabilization measures. The reasoning has been that this support is intended to promote fundamental reform (which may first require stabilization measures to be taken) rather than to simply prop up existing inefficient structures. The absence of Soviet membership in the IMF would seemingly preclude a similar role for that institution in any international support effort.

28 International Herald Tribune, 12 June 1990.

development would be accompanied by the gradual inclusion of the eastern countries into the global, multilateral trading system, it could make an important contribution to world-wide utility through a more efficient allocation of global resources.

54. These effects will be evident over the long run. The problems facing the reforming economies are immense and their solution will take time and require considerable assistance from the west. Nevertheless, once the process of reform is under way, east-west trade is likely to receive a major boost. Although west European investment in the east may eventually replace some investment in the west, in the short to medium term it is likely to depend on capital goods produced in the west. This is a development which is likely to get under way during the 1990s. The unification of Germany will also provide a separate boost to domestic investment in the early 1990s insofar as unification leads to a re-organization of production in both economies.

55. Improved growth and the entry of the eastern countries into the multilateral trading system will also improve the prospects for trade between the reforming economies and the developing countries. However, it is likely that improved competitiveness will enable the countries of eastern Europe to regain some or all of the market share they have lost to the newly industrialized economies of South East Asia, especially in the west European market for manufactured goods. The east Europeans' competitiveness will also benefit eventually from their being gradually drawn into the more specialized division of labour within an integrated European economy. (This refers to the spontaneous integration that is likely to occur among geographically close, industrialized (or industrializing) economies. Special institutional arrangements between the eastern countries and the EC or EFTA would, of course, accelerate the process.) This, again, is a development which could get under way during the 1990s.

56. The more immediate concern of some developing countries is that financial resources may be diverted from them to eastern Europe and the Soviet Union. Since commercial bank lending to the developing countries is already low or non-existent and is unlikely to expand in eastern Europe in the near future, their concern is mainly to do with foreign direct investment by private companies and with official development assistance. It is probable that there will be some switch of western private investment to eastern Europe, although on what scale is impossible to say at present. However, the switch to the east may be as much at the expense of western Europe and North America as the developing countries. Again, such a switch is likely to develop slowly. Foreign enterprises will remain cautious about

investing significant sums in eastern Europe until the reform processes are firmly established and until progress has been made in the areas of property rights, convertible currency régimes, and in building the institutional infrastructure necessary for efficient market economies. Only when changes have been made in these areas will it be possible to obtain reasonable calculations of rates of return on investments in the east.

57. The matter of grant aid is likely to be the more immediate issue for developing countries. Some organizations expressed the view that aid for eastern Europe will have to be at the expense of developing countries.[29] The President of the Commission of the European Communities has suggested that aid to the six east European countries would require a large **addition** to the Community's budget, but as yet it is not clear whether all member countries would support such an increase. Fiscal policy in the market economies is still dominated by the objectives of lowering budget deficits and cutting the size of public expenditure. Within this context the member countries of the OECD have not made any special effort to reallocate public expenditure so as to be able to meet the OECD development aid target of 0.7 per cent of GNP. Unless specific measures to the contrary are taken, it appears that the fears of developing countries about the diversion of foreign aid are not altogether without foundation.

58. The most immediate effect on the rest of the world, and on the developing countries in particular, is likely to be higher interest rates. Bond yields in the Federal Republic of Germany have already risen as a result of fears that unification of the two German states will boost inflation and, because of the close integration of the European economies, this has already had a generally hardening effect on west European interest rates in general. Insofar as reductions in defence expenditure (the "peace dividend") are used to reduce government expenditure, the consequent tightening of fiscal policy should eventually ease the upward pressures on interest rates.

59. Some of the concerns about the effects of German unification appear to be exaggerated, as noted above in sections 1 and 4, but the essential point about unification in particular, and the eastern reform process in general, is that there is bound to be an increase in the demand for investible funds. In recent years the main international sources of loanable funds have been Japan and the Federal Republic itself. If real rates of return are high in eastern Europe then foreign private capital will switch from countries such as the United States (and, in Europe, from France, Italy, the United Kingdom and southern Europe). As a

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[29] Financial Times, 12 December 1989.

result of German unification, the Federal Republic's current account surplus is likely to be invested at home rather than abroad. This does not mean that German nominal interest rates have to remain high. Bond yields may have risen because of the perception that Federal Government expenditure will increase as a result of the transition costs after unification (social security support, subsidized training, housing, etc.) and, given the anti-inflationary stance of monetary policy, this will have to be financed by government borrowing. But if rates of return to private investment in the east prove to be as high as some observers think, then private capital will eventually take on most of the task of restructuring. Insofar as this attracts private capital from the rest of the world German nominal interest rates could fall while the exchange rate remains firm. However, countries which have to attract foreign capital in order to finance large budget deficits, may be forced to raise interest rates still further in order to compete with higher rates of return elsewhere. Thus, the reduction of the United States budget deficit, a process which may now be helped by large cuts in defence expenditure, could help to relieve the upward pressure on world interest rates. This would directly benefit the indebted developing countries and ensure that an increasing proportion of world savings can be employed in the development of both eastern Europe and the developing countries. But the global competition for foreign direct investment will be more intense than ever before.

TABLE 1

Eastern Europe and the Soviet Union: Basic economic indicators, 1976-1990
(Average annual and annual growth rates, in percentages)

Country or group, indicator	1976-1980	1981-1985	1985	1986	1987	1988	1989	1990 Jan-March
Eastern Europe								
Net material product . . .	3.6	2.2	3.7	4.6	3.2	3.0	-1.5	..
Industrial output[a] . . .	5.6[b]	2.8[b]	4.1	4.6	3.5	3.6	-0.2	-13.4
Agricultural output[a] . . .	1.9[b]	1.1[b]	-1.1	5.3	-0.8	1.4	-0.1	..
Gross investment	2.7	-0.7	3.9	3.9	4.7	2.5	-2.2	..
Exports	6.5	4.8	2.4	0.3	1.2	4.0	-3.0	-14.2
Imports	4.1	0.4	5.5	5.3	1.8	2.9	0.2	-5.8
Soviet Union								
Net material product . . .	4.3	3.2	1.6	2.3	1.6	4.4	2.4	-2.0
Industrial output[a] . . .	4.5[b]	3.6[b]	3.4	4.4	3.8	3.9	1.7	-1.2
Agricultural output[a] . . .	1.7[b]	1.1[b]	0.1	5.3	-0.6	1.7	0.8	..
Gross investment	3.3	3.5	3.0	8.3	5.7	6.2	0.6	-5.4
Exports	4.9	1.5	-4.3	10.0	3.3	4.8	-0.3	-7.0
Imports	5.9	5.8	4.7	-6.0	-1.6	4.0	8.9	6.0

Source: Secretariat of the United Nations Economic Commission for Europe, based on national statistical publications and plan fulfilment reports.

[a] Gross output

[b] Annualized change in the five-year average production levels from the average of the preceding five years.

TABLE 2

Eastern Europe and the Soviet Union: Trade balances, 1985-1990
(Billion US dollars or transferable roubles)

	1985	1986	1987	1988	1989	Jan-March 1989	Jan-March 1990	1990[a]
Eastern Europe with:								
World	5.9	1.2	3.0	6.1	5.2	2.0	0.5	-1.3
Socialist countries (billion TR) .	-0.4	-2.4	0.5	4.3	4.1	1.5	1.6	5.6
Developed market economies	3.7	0.8	0.5	0.3	1.4	0.9	0.1	-2.4
Developing countries	2.4	1.8	2.3	2.2	0.5	-0.1	-0.3	-0.5
Soviet Union with:								
World	3.9	8.1	11.7	3.4	-5.4	-2.1	-6.0	-22.3
Socialist countries (billion TR) .	2.0	3.8	2.1	-0.5	-2.4	-1.1	-1.6	-4.6
Eastern Europe (billion TR) . .	0.9	2.6	0.1	-2.4	-4.1	-1.0	..	..
Developed market economies	-0.9	-3.9	0.5	-2.7	-6.5	-1.6	-3.8	-15.7
Developing countries	2.4	6.6	7.9	6.9	5.0	1.3	0.4	0.8

[a] Extrapolated from first-quarter trends of exports and imports.

TABLE 3

East-west trade: value, volumes and trade balances, 1989-1990
(Percentage change and million US dollars)

	Value change				Volume change				Trade balance		
	Exports		Imports		Exports		Imports				
	1989	1990[a] QI	1989	1990[a] QI	1989	1990 QI	1989	1990[a] QI	1989	1989 QI	1990 QI
Bulgaria	4.8	-20.3	-1.7	1.7	3	-25	-1	-2	-1373	-350	-415
Czechoslovakia . . .	10.9	8.9	-1.6	30.3	10	7	-	28	71	209	52
German Dem. Rep. . .	9.5	-9.4	6.7	-3.8	8	-13	8	-5	-1032	33	-70
Hungary	12.6	15.3	10.8	0.6	12	12	13	-1	283	-38	79
Poland	5.2	8.5	6.3	-19.0	5	10	-6	-19	364	211	576
Romania	-1.1	-40.1	-5.3	329.1	-3	-44	-9	290	3081	821	-138
Eastern Europe . .	8.3	-4.5	4.3	9.4	7	-6	2	7	1395	888	84
Soviet Union	7.8	-1.3	21.1	27.2	3	-10	22	24	-6516	-1 574	-3791
Eastern Europe and the Soviet Union .	8.1	-2.9	12.8	19.9	5	-8	12	16	-5121	-686	-3707

Source: ECE Common Data Base. Data refer to trade with "developed market economies" in the grouping employed in the national statistics of eastern countries (i.e., excluding Yugoslavia). Value change is measured in US dollars. Values and trade balances reflect eastern trade reports; volume changes are ECE secretariat estimates.

[a] Relative to first quarter of 1989.

To PI
cc: GL-done

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E.1
Held at Gosplan
Thursday, October 18, 1990 at 11:00 a.m.

Soviet representatives

Mr. Stepanov
Mr. Revyakin
Mr. Semyonov
Mr. Okorokov
Ms. Dubrovina

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Wolf
Miss Christensen
Mr. DeMilner*

Mr. Semyonov began a discussion of economic relations with Eastern Europe. He expected the trend of falling trade to continue. There were two factors involved, one was the drop in contractual prices of energy resources. Also, because of economic difficulties, the volume of oil and raw material exports has declined by 10-20 percent compared to contractual values. The price of oil sold to CMEA in 1990 was rub 70/mt ($16+/bl.) 1/ The price is determined on the basis of a five-year moving average of world prices, and this year was less than $15 per barrel at the official rate (sic.).

Exports of oil products to some countries declined sharply because they have their own refining capacity. But the situation revealed the constraints involved in switching by CMEA countries to other sources of supply (lack of storage tanks and railway transport capacity). Countries with port facilities fared better than Czechoslovakia and Hungary.

The Soviets intended to meet contractual commitments, but because of force majeure could not. To fill the gap, efforts have been made to establish direct contacts between producers and CMEA purchasers to mobilize marginal production; although not significant in individual cases, in the aggregate it has contributed significantly to total deliveries. For example, contacts between Czechoslovakia and the producers of the Tyumen region have resulted in additional deliveries of 1/2 mmt. Another approach has been to offer sales for hard currency--which was, in any case, the alternative market for the Soviet producers. Such sales have taken place outside of protocols. A total of around 300 thousand mmt have been sold to two or three countries on this basis.

1/ Mr. Okovokov provided data in a subsequent meeting that indicated prices generally in the range of rub 90-100 per ton.

Mr. Revyakin wished to elaborate on this topic, noting that he hoped that the Fund would accurately reflect the situation in its report. One aspect of the situation was that both the demand for and production of oil had been affected by the changes in the productive system brought about by perestroika. Production will decline further in 1991, despite efforts to stabilize it at the 1990 level through strong stimulus for exports; a significant portion of foreign exchange earnings will be retained by producers. Still, planners are worried that domestic obligations will not be met. A 25 percent retention for oil producers is under consideration; this would be colossal stimulus.

The intention to convert to world prices and hard currency payment in 1991 is firm. This will not be a problem for the former GDR but other CMEA members will have difficulties.

The reason for the decline in oil production was related to the rate of investment. To maintain output, it is necessary to drill about 100 new wells every five years. There was difficulty in meeting this rate in the current plan and this is a major reason for the decline in output. Output is likely to decline by 10 percent over the next five years for this reason. Oil output for 1990 will be down by 5 percent, about the same as the decline in the first nine months of the year. It is hoped that production may be expected to be equal to that of 1990.

The Yamburg Agreement provides for natural gas deliveries to East Europe from the Tyumen field through 1998. Up to 90 percent of deliveries are based on this long-term agreement. In 1991, the USSR will make full delivery of contracted volumes; somewhat up from 1990.Regarding the CMEA non-energy trade, no significant changes are expected, although some change in composition may occur. USSR deliveries are based on protocols; although there has been little deviation from these agreed amounts, pulp deliveries have been affected by the Green movement. This has been offset somewhat by expanded trade through direct economic contracts.

Future non-energy trade will be in two categories; (1) state orders for which the income received will be retained by the Union for purposes such as investment and debt service; (2) the rest will be carried out through direct contracts, and is harder to predict; this trade is expected to be two-thirds of total exports in 1991. Because of restructuring, the composition of trade may change and the Soviets may lose some regular customers, as East European countries redirect their imports. For this reason, the Soviet export volumes of non-energy imports to drop.

Regarding the terms of trade with East Europe, the authorities were reluctant to venture opinions. Mr. Revyakin thought that the major portion of trade would be in a market framework. If suppliers on both sides are able to be flexible on prices and other conditions, chances are that trade flows could be maintained. The parties know each other and there is an infrastructure in the form of maintenance arrangements and spare parts that imparts an inertia to these flows. Ikarus buses are an example of how trade could be maintained if prices are revised; much of this production has no ready market in Western Europe.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E.2
Held at Gosplan
Monday, October 22, 1990 at 9:30 a.m.

Soviet representatives

Mr. Bezrukov
Mr. Reviakin
Mr. Okovokov

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild*
Mr. Wolf
Mr. DeMilner
Ms. Christensen
Ms. Cheasty

OECD representatives

Mr. Shafer
Mr. Hagemann

External Sector Issues

As promised in the previous meeting, information was provided on joint ventures. As of January 1, 1990 1,274 joint ventures were registered with an aggregate authorized capital of rub 3.3 billion, of which rub 1.4 billion had been subscribed in foreign currency. Somewhat more than 10 percent of the foreign capital subscriptions had been received by VEB. Altogether joint ventures had received 68 foreign currency credits amounting to rub 760 million in total. About rub 110 million of these credits (15 percent) were extended by VEB, the remainder was received from foreign banks, including rub 180 million (27 percent) with VEB's guarantee. The maturities of these credits ranged from several months to more than 10 years. According to Goskomstat data, of the 1,274 firms registered on January 1, 1990 only 473 were operational.

The following oil prices for exports to CMEA countries in 1990 were provided by Mr. Okorokov (c.i.f. prices in rubles per ton):

Romania	95.13
Hungary	96.3
Bulgaria	108.61
CSFSR	96.8
GDR	95.28
Poland	93.81

Small amounts had been sold against convertible currency or bartered (e.g., against meat with Hungary). The gas price was about rub 70 per m3 in 1990. Debt to CMEA countries was limited to joint gas investment projects (Yamburg) and somewhat more than rub 2 billion under IBEC clearing.

The discussion was devoted primarily to the balance of payments projection for 1991. Gosplan had not made its own forecast yet but had begun to discuss it the preceding Saturday. A copy of the staff's scenarios for 1991 and its sensitivity assumptions was given and explained to the Gosplan representatives. Mr. Reviakin said that by and large his views coincided with those of the Fund staff, especially with respect to energy export volumes. The price for oil exports (US$30/barrel), however, appeared high. The value of imports seemed alright but its realization would depend on the mobilization of financial resources in the international capital market. To maintain imports in convertible currencies at their nominal 1990 level in 1991, new borrowing of rub 3-4 billion would be required.

Mr. Reviakin thought that the services account had not been well projected. It would be useful for the Fund staff to follow the format of the settlements balance, as supplied by the Ministry of Finance. The staff explained that this was indeed the case. The main items had been assumed unchanged from 1989 except that: (i) interest payments were higher because they included interest on the financing gap and (ii) DM 3.5 billion of disbursements from the German loan and grant package had been assumed for 1991, of which DM 2.2 billion had been assumed to represent additional imports of services. Mr. Reviakin agreed with this approach and said that the inflows from Germany had been correctly estimated. However, his estimates of possible financial resources were higher if both existing agreements and negotiations underway were taken into account. Debt service obligations were particularly heavy in 1991, but he did not foresee a continuation of the deposit loss that had occurred in 1990. He therefore supported the staff's assumption that rub 3 billion of short-term debt would be rolled over in 1990. There was also likely to be some reduction in medium- and long-term debt service but Gosplan's calculations had not been finished yet and "one more meeting" was required. On debt service owed to the USSR, Mr.Reviakin said that he expected only rub 0.3 billion in 1991, mainly in the form of services. The USSR's own arrears, however, would be repaid, as assumed by the staff.

With regard to the staff's projection for trade with CMEA, Mr. Reviakin wanted to know what the East Europeans were thinking about the issue of settling in convertible currency. The possibility of offsetting part of the USSR's surplus with converted TR claims against the USSR aside, 1/ he did not see any justification in continuing with clearing arrangements for the settlement of trade with Eastern Europe. He thought that Eastern European countries should either borrow in international capital markets or adjust their economic policies. He asked the staff to reflect this view in its report. Mrs. Ter-Minassian replied that the East Europeans were likely to disagree with the trade projection because they believe that the terms of

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1/ The staff's scenario envisaged that for Poland, CSFSR, Hungary and the former GDR.

trade loss will be greater. The oil price shock on top of the transition to world market prices might be too much for these countries and thus require transitional clearing arrangements. The objective should, however, remain to establish a multilateral system of payments within one or two years.

With regard to the effect of exchange rate policy on the bop outlook, Mr. Reviakin said that with the pending devaluation, the direct effect of the exchange rate would be felt for the first time. Much preparatory work had been done for this to happen. The devaluation cum withdrawal of DVKs would mean that enterprises would lose liquidity. In the past, when a producer sold for export, the intermediating FTO paid him immediately in rubles, irrespective of the timing of the actual export. In the past two years, the corresponding amounts had been credited to the exporter's account on the basis of the world market price and the applicable DVK. Now, there would be no more automatic crediting. The producer would need to borrow if he wanted to produce for export and he would receive U.S. dollar proceeds (with a surrender requirement) when he sells his exports. Part of the dollars retained would presumably have to be sold to repay the credit. However, per U.S. dollar received, the exporter would obtain more rubles than before. 1/

1/ While the process described is logical, it is not clear how the liquidity tightening would come about. One possibility is a tightening of credit in the economy. The other one is the delayed receipt of payments resulting from decentralization of trading rights as exporters export directly and provide export financing instead of the FTOs.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E.3
Ministry of Foreign Economic Relations
Tuesday, October 23, 1990 at 10:00 a.m.

Soviet representatives

Mr. Grekov
Mr. Seltsovksi
Ms. Simonova

IMF representatives

Mr. Calvo
Mr. Flickenschild
Ms. Christensen
Mr. DeMilner*

OECD representative

Mr. Shafer

Mr. Seltovski began with a survey of developments concerning trade data, including a number of methodological changes that will be put into effect in 1991. Overall, the changes will serve to bring Soviet data more into line with international reporting standards. These changes are also motivated by the need to respond to the changing administrative structure of foreign trade over the past four years. In 1986 only ten organizations had foreign trade rights. On August 27, 1986 this authority was extended to include many ministries and large industries. This scale was further expanded in a directive of the Council of Ministers on December 2, 1988. More recently, on April 1, 1989, the right was extended to all organizations deemed competent to operate in this area. So far some 20,000 participants are registered, although of these perhaps only 6,000 are really active. Of total trade, some 60 percent is still conducted by MVES. Large industries account for most of the rest. Small industry trade participation has grown from 2 percent in 1989 to 8 percent in the first half of 1990.

The right to trade involves essentially the right to enter into contracts for foreign trade. While one can import anything except for a short list of mostly internationally proscribed goods, licenses are required for many export operations. The system of regulation has three parts: (1) registration; (2) licensing; (3) providing customs declarations.

The foreign trade statistical methodology in 1991 will reflect the following changes:

a. Next year there will be a single administrative document for customs, designed along EC standards. This will replace the present system made up of reporting by customs forms for the majority of new and small firms and the direct reporting by large enterprises.

b. Next year coverage will be extended to movement of all goods and production affecting national income. This will close the gap that existed because of non-reporting of noncommercial transactions (gifts, unrequited transfers, disaster relief, etc.).

c. Nonmonetary gold exports will be included for the first time in category 28, although it is not known whether it will be separately identified or merely be contained in the aggregate as are diamonds, platinum and precious stones. gold exports, said Mr. Seltsovski were on the order of $1.7 billion a year or so ago. The staff cited estimates of this figure was $3-3 1/2 billion. He acknowledged that it may have grown. The staff also noted that Goskomstat officials had stated quite clearly that gold was included in the trade data. Mr. Seltsovski said that as author of its red book on trade data he was sure of his facts. Gold sales he noted were managed by Gosbank.

d. Re-export transactions that do not transit Soviet territory will no longer be included in trade data. The case of Iraqi oil, was used as an example. The total of such trade (exports plus imports) were the 4 billion in recent years. A query about the swapping of USSR oil deliveries to Cuba for Venezuela oil sales to Spain was met with surprise. Current methods would reflect the physical movements and thus reflect only oil exports to Spain.

e. Imports will be switched from an f.o.b. to a c.i.f. basis. Exports will remain f.o.b. This is expected to raise imports by rub 3 billion.

f. Exports and imports of large projects (including turnkey) will no longer be registered in gross terms which include services but also goods of different categories. Instead, service costs will be excluded and appropriate classifications will be given to the constituent parts. The affected amounts have been about rub 1.0 billion in imports and rub 0.8 billion in exports.

g. Timing of trade movements in 1991 will be recorded according to the stamp of customs approval following international practice. Previously, trade recording coincided with crossing of the border.

h. The classification scheme will be changed from the CMEA's Unified Commodity Classification to the international standard, or Harmonized System.

As a result of these (and some other minor) changes, Soviet data will be on an internationally comparable basis beginning in 1991. Data for 1990 will be published in both new and old formats.

Mr. Seltsovski provided the staff representatives with data showing; the seasonal patterns of trade in oil, oil products, gas, and grain trade. (He noted that grain imports in the first half of 1990 were 26 mmt out of a contractual volume of between 40 and 45 mmt).

Remarking on oil trade, Mr. Grekov noted that the Soviets stood to gain very little in 1990 from the higher oil prices. It seems large volumes of oil exports were diverted from CMEA to hard currency markets in mid year, apparently as a result of the payments crisis. For the remainder of 1990, the direction of oil exports would be predominantly toward CMEA in order to try to meet contractual obligations by year end. Soviet interests were guided in part by ensuring needed deliveries of CMEA exports to the USSR. He estimated total crude oil exports this year at 110 mmt and oil products at 50 mmt, compared to 127 mmt and 57.4 mmt last year. Gas exports might be somewhat better than last year's 101 bcm.

Mr. Grekov felt reasonable estimates of 1990 exports could be obtained by extrapolating 1990 H1 data. However, in 1991, this picture was very unclear. MVES needs data from Gosplan in order to enter into trade contracts for next year. So far those figures, usually available by this time of the year, have not been produced. If they are received by mid-November, there need not be a disturbance in trade flows. Even if they are further delayed, it is unlikely that things will simply break down; the Soviets have longstanding trade contacts, and in any case an increasing amount of direct trading will take place.

The authorities were reluctant to discuss the DVK or exchange rate matters, and suggested MinFin as the best source. DVKs, introduced three years ago, were intended to provide differential export incentives to manufacturers of finished goods but have not been very effective, because of the constraints imposed by the system of state orders for domestic consumption. DVKs averaged about 1.5 for exports and about 1.7 for imports, yielding a modest net income to the budget. Complaints have been that many of the high coefficients for machinery exports were not justified. Far more effective as an incentive has been the foreign exchange retention scheme, whereby exporters can retain between 15-80 percent of their export earnings in foreign exchange. The higher percentages went to products containing a higher value added. The problem with this scheme had to do with fairness and that the biggest export earners-raw materials producers--didn't receive it.

Import taxes have existed on paper since 1981 but with half the rates set at zero and the rest--up to 5 percent--not collected, the system has no practical significance. On August 13, 1990, Dicree No. 815 imposed significant taxes on a wide range of imports for the remainder of 1990, retroactive to July 1. This apparently was undertaken as a revenue measure rather than in the hope of stanching the flow of imports.

The staff noted that in the MVES export statistics presented by major commodity groups, the share of unclassified and other had increased from 23 percent in 1980 to 30 percent in 1989, and wondered if this could be evidence of increasing diversification of Soviet exports. The Soviet officials had no such evidence, explaining that this phenomenon resulted mainly from classification problems associated with lack of proper completion of customs forms by new exporters.

The Soviet officials were unable to explain the observed jump in the net transportation, insurance, and freight item in the balance of payments for 1986-87.

Documents received:

1. Tables on seasonality of oil, gas and grain imports

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E-4
Held at the Ministry for Foreign Economic Relations
Tuesday, October 23, 1990 at 2:00 p.m.

Soviet representatives	IMF representatives
Mr. Mikhailov	Mr. Flickenschild
Mr. Kamyshnikov	Ms. Christensen
Mr. Balykin	Mr. DeMilner*

The meeting was devoted to the trading system and its regulation, and how it would be affected by the reform process.

There were no drastic changes so far in the arrangements for trade licenses. The most recent figures were 8,000 export and 3,500 import licenses issued by MVES and about 1,600 by other ministries. They expected that in the reform period, MVES, in consultation with the republics would prepare a list of licensed trade flows that would then be approved by the government. The list of items involved would be very short; 15-20 items, including energy, cotton, fertilizers, timber and wood pulp. This would constitute the all-union list, to which republics could, by agreement with the customs office, add items of their own choosing. No political problems were anticipated in this area.

Quotas on exports would be spelled out for each republic. The authorities believed that over time export quotas would be replaced by import quotas. These would not be for balance of payments reasons, but social-political reasons arising from concerns over standards, ecology.

On October 15, licensing requirements were imposed for imports from Hungary and Czechoslovakia (the intention was to include GDR, but this was omitted by a drafting error). This was done to avoid further running up of the trade deficit which on January 1 will have to be negotiated in hard currency. The restrictions applied only to goods imported in excess of protocol amounts. There have been no other measures to restrict imports.

Applications for licenses have reached 16,000 at MVES; 12,000 have been issued (see above), 2,100 rejected and 2,000 are under consideration. The normal lag is 7-10 days. Only 100-150 take more than 30 days because of special circumstances or lack of proper information.

Import licenses did not (except in the cases of Hungary and Czechoslovakia) cover commodities, but a small set of items including printed matter, audio-visual-use material, artists' work, bank operations, and other services. Also, Republics have imposed limits (quotas) on barter trade, which are not controlled by MVES.

A new import tariff regime was in preparation (Mr. Kamyshnikov was the principal author) as was a new schedule of export taxes for introduction on January 1, 1991. Import tariffs will be uniform for all partner countries except for the United States, in which case tariffs are twice as high, until the MFN issue is resolved. The customs law will be approved by the Supreme Soviet and will give authority to set rates to the Council of Ministers. The Harmonized System will be employed and rates will be set for 1,590 items, with a range from 5-100 percent. The system is modeled closely on other tariff systems (such as in the EC) which were studied carefully in the course of this work. The average (unweighted) tariff will be 15-20 percent.

The authorities noted that in the consultation process, none of the Republics had any challenges to the draft. Only after it is implemented will the real impact become visible, they thought. They agreed that the tariff system in isolation from the exchange rate policy was not very revealing. They also felt a value of rub 3 or even 6 per U.S. dollar was not a sufficient devaluation.

The authorities acknowledged that the structure of the new system would bias imports toward finished goods. An article summarizing the proposed tax system was given to the missiosn.

The authorities also provided a copy of the August 13 decree on import taxes and emphasized that the indicated tariff rates were for 1990 only. 1/ These rates (up to 2,000 percent) were imposed for revenue purposes, rather than to slow imports they thought.

The authorities also provided lists of prohibited goods, both for imports and for exports.

Documents received:
(1) Decree No. 815 of August 13, 1990
(2) List of prohibited imports and exports
(3) Summary of the New Trade Taxes (article)

1/ Mr. Voitenkov (Gosbank) informed us separately that these taxes would be maintained in 1991 at rates that would offset the effect of the devaluation (i.e., at presumably one-third the current level). The separate rates for imports from Socialist countries would be abolished.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E.5
Held at the Ministry of Oil Production
Wednesday, October 24, 1990 at 10:00 a.m.

Soviet representatives

Mr. Lishinets

IMF representatives

Mr. Flickenschild*
Mr. Wolf
Mr. DeMilner

OECD representative

Mr. Shafer

IEA Representative

Mr. Granzer

On the part of the Fund, the meeting had been requested to learn more about near-term prospects for production, consumption and net exports of oil and gas. The Fund staff and Mr. Shafer left for other meetings after these issues had been discussed. A separate minute of the entire meeting will be prepared by Mr. Granzer.

Mr. Lishinets said that he would answer all questions relating to the competence of his ministry. The ministry is in charge of the development of oil deposits, production and delivery of oil to the refineries for refining or to Sovneftexport for exporting. The production of gas falls under the purview of Gasprom, a separate, independent state concern. Refining and processing of oil are under the control of the Ministry of the Petrochemical Industry. Hence the functions of the Oil Ministry are limited to crude oil. As to gas, the Ministry was only involved with the production of associated gas and small gas deposits enclosed within the oil regions. These amounts of gas account for 15 percent of national output.

Under the Ministry's supervision, 45 independent conglomerates deal with the production of oil. Mr. Lishinets provided the following output data (in millions of tons per annum):

	1989	1990	1991
Oil	589	560	528
Gas liquids	1/	19	19
Total		580	547

In addition, to the 547 mt to be produced under state orders, there would be another 13 mt from the Oil Ministry (8 mt), Gasprom (1.5 mt) and the Ministry of Geology (3.5 mt).

Mr. Lishinets provided the following reasons for the decline in output. First, a reduction of capital investment. Outlays for operational drilling were cut by 10 percent for 1989 and by another 10 percent in the first nine months of 1990. To maintain output at a level of 600 million tons a year, however, capital investment would have to be raised by 10 percent a year to offset the falling tendency of the average yield of wells. Capital investment data were as follows (in billions of rubles a year):

	1989	1990		1991 1/
		Plan	Estimate	
Total	15.8	15.6	14.6	16.0
Of which:				
Central investment	...	...	6.0	3.9

1/ Not approved yet.

Second, interethnic strife in Azerbaijan affected the production of oil drilling machinery in 1990. As a result of equipment shortages, 15,000 out of 160,000 operational wells are lying idle. Third, because of lack of funds 100 out of 1,500 drilling brigades were dissolved in 1989. Fourth, the rising level of the Caspian Sea had corroded drilling platforms and other oil pipeline infrastructure. As a result, wells producing 1.5 mt had to be discontinued. Fifth, because of lack of funds, development of the Tengiz deposit is delayed. By 1995, the field had been projected to yield 30 mt, with an increase to 50 mt thereafter. Now, only 3 mt would be produced by late 1990. Similarly, the Okhotski shelf was not producing anything yet, against a projected output volume of 2.5 mt for 1990. 2/ The rest of activity was still exploratory, including the Barents Sea where only two gas fields had been found so far. Except for Tangiz's, no new developments were envisaged for the near future and therefore production had to fall. By 1995, national production would at best be 540 mt. Only

1/ It would seem that natural gas liquids of 19 mt would be missing to bring output to the officially reported total of 607 mt in 1989.

2/ This deposit would be the only producing off-shore deposit with the exception of the Caspian Sea.

Western capital could lead to a substantially higher level of output. Mr. Lishinets mentioned Chevron (joint venture in the Tangiz field) and the recent visit by oilmen to Azerbaijan. Technologies to deal with heavy oil extraction and complex geologies were badly needed, as were hydraulic rupture, horizontal drilling and thermal technologies.

Future increases could come from untapped reserves (no data given) and an increase in "depth of refining" from its current low level of 60-63 percent. Domestic consumption was assured for the medium-term future but exports would decline, e.g., by 50 percent (sic!) or 50 mt in 1991.

Mr. Lishinets confirmed that wholesale prices for oil would be raised on January 1, 1991 by 130 percent from rub 30/ton to rub 70/ton. With the new corporate tax of 45 percent, however, the principle of self-financing would not be achieved for the oil industry. There should be tax relief for one year to boost investment. Beyond that, he hoped that the planned continued increase in domestic prices, as envisaged in President Gorbachev's guidelines, would provide resources for investment.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of External Sector Meeting No. E-6
Held at Gosbank
on Monday October 22 at 11:00 a.m. and
Wednesday, October 24, at 11:00 a.m.

Soviet representatives	IMF representatives
Mr. Mozhaiskov	Mrs. Ter-Minassian
Mr. Voitenkov	Mr. Blejer
Mr. Belagurov	Mr. Flickenschild*
Mr. Menshikov	Mr. Lindgren
	Mr. DeMilner

Mr. Mozhaiskov outlined the new exchange rate system that was expected to take effect on January 1, 1991. The Gosbank's proposal was before the Council of Ministers which would have the final say on the issue. There would be four rates: the official rate, the commercial rate, the special rate and the market rate. The official rate (about rub 0.6 = US$1) would be maintained. The Ministries of Finance and Foreign Affairs had questioned the wisdom of this proposal, but Mr. Mozhaiskov defended it by pointing out that it was the only rate with a solid economic underpinning because it was based on purchasing power parity with the United States, although admittedly at controlled prices and excess demand on the USSR side. Later in the discussion, it became clear that the true reason appears to have been the desire to shelter Soviet external claims in rubles from the forthcoming depreciation of the ruble. No transactions will in future take place at the official rate.

A new commercial rate of rub 1.8-2.0 = US$1 would be introduced. All transactions included in the foreign exchange allocation plan including service on government foreign debt would be effected at this rate. Initial capital investment of joint ventures also can be repatriated at the commercial rate. Their profits can be remitted from foreign exchange retained or the necessary foreign exchange can be acquired in the free market (see below). Also, joint ventures without exports, which can demonstrate that they engage in import substitution, could apply to the State Commission for Foreign Exchange to get approval to acquire foreign exchange for profit remittances. Exchange surrenders could be made at this rate, too. The proposed level of rub 1.8-2.0 would ensure that 90 percent of exports are profitable (in the sense that at this rate, the exporter's local currency proceeds are at least as high as the domestic wholesale price). A rate of rub 3.5 = US$1 would have made 100 percent of exports profitable. The proposed rate would also mean that budget efficiency would remain, although at a reduced rate since domestic resale prices would not be raised to pass on the devaluation to consumer and industrial users. Budget efficiency, currently at 4-5, meant that each invaluta ruble of imports yields more than one ruble (currently, rub 4-5). If highly subsidized children's clothing is excluded, current budget efficiency rises to 6-8. The commercial rate wold also apply for accounting and customs valuation purposes.

The special exchange rate for tourists would be maintained at ten times the level of the official rate.

The free market rate would reflect supply and demand. Supply would come from foreign exchange retention and sales of officially held foreign exchange acquired at the commercial rate. Only juridical persons would have access, to acquire exchange for payments not contemplated in the foreign exchange allocation plan. Gosbank had considered two alternatives for the free market. First, a central market could be set up in Moscow with republic exchanges that would be coordinated so as to avoid large discrepancies in sales. Second, instead of coordination, the various markets could be limited by arbitrage conducted by authorized banks that could operate in these markets subject to proper prudential guidelines. Mr. Mozhaiskov preferred the second option.

The DVK system will be withdrawn with the introduction of the commercial exchange rate.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit - October 17-26, 1990

Minutes of External Sector Meeting No. E.7
Held at the Council of Ministers
Thursday, October 25, 1990, 11:00 a.m.

Soviet representatives

Mr. Demchuk
Deputy Head of Economic Committee
of the Council of Ministers

Fund representatives

Mr. Flickenschild
Mr. Wolf
Ms. Christensen*
Mr. DeMilner

CMEA Trade

The meeting dealt with developments in CMEA trade during 1990 and 1991.

1. Developments in 1990

Mr. Demchuk summarized the basic features of CMEA trade in the past: five-year plans in each member country supplemented with bilateral five-year cooperation plans between individual countries, annual plans and trade protocols. In the last annual protocols covering 1990, the following trade turnover was envisaged:

(In billions of transferable rubles)

	Planned Trade Turnover	Estimated Annual Trade Turnover	of which: Exports	Imports
Bulgaria	11.3	9.7	4.7	5.0
Czechoslovakia	11.3	10.5	4.7	5.8
Cuba	9.0	7.4	3.8	3.6
GDR	13.0	8.0	3.4	4.6
Hungary	7.9	7.3	3.4	3.9
Mongolia	1.3	1.2	0.8	0.4
Poland	10.6	9.6	4.0	5.6
Romania	5.9	4.7	2.6	2.1
Vietnam	2.3	2.0	1.2	0.8
Total	72.6	60.4	28.6	31.8

Total planned trade turnover (exports and imports) for 1990 was TR 73 billion, which was significantly less than envisaged in the five-year plan. For example, planned turnover with the GDR and Poland was some TR 2 billion less than in 1986 (the first year of the five-year plan) and in both cases increases had been foreseen. The estimated trade turnover for 1990 was much smaller than planned at TR 60 billion reflecting a sharp drop in Soviet exports to the CMEA area, which was partly reflected in reduced imports (Note: the projected outcome for 1990 does not appear to take into account latest trade data. For example, for the GDR, the actual trade turnover for January-August 1990 exceeded the turnover projected for 1990 as a whole).

Mr. Demchuk also mentioned that oil production was expected to be significantly reduced in the fourth quarter of 1990 (no figures mentioned) and there would be no step-up in exports to the CMEA countries in that quarter as had been reported in the Western press. For 1990 as a whole, export deliveries of oil to socialist countries would be 75 percent of the 1989 level.

Only a very small part of trade with CMEA countries had hitherto been conducted on an enterprise-by-enterprise basis; most trade was still taking place according to state orders.

2. <u>CMEA trade in 1991</u>

From 1991 there would no longer be five-year trade agreements between CMEA countries and trade would become decentralized. The developments in CMEA trade based on freely convertible currencies and world market prices were difficult to predict. Although balance in trade with individual countries would be aimed at, realistically it would be difficult to achieve with some countries (e.g., Vietnam and Mongolia). Moreover, the USSR had to run trade surpluses with some countries to pay for non-trade expenditures (including stationing of troops) and repayment of debt. Trade through state bodies would account for about 32 billion valuta rubles (half of trade turnover in 1990). On the import side, state trade would cover basic needs such as spare parts and components (the USSR economy was highly dependent on specific supplies from other CMEA countries) and some finished manufactured products (e.g., locomotives and ships). On the export side, oil, cotton, and other raw materials would be covered by state trade. Soviet goods, particularly finished goods, would face severe competition from abroad. State exports of oil would be halved to all countries and perhaps reduced by more than one half to the Socialist countries. Production of oil would amount to 540-550 million metric tons. In practice, however, the total reduction would be smaller because of non-state trade. As an example was mentioned recent deals of Czechoslovakia, one with the Russian Republic to provide oil from the Tyumen region in Central Siberia (1.5 million tons of crude oil) and another with enterprises (500,000 tons), in both cases supplies over and above state orders.

The projected trade turnover covered by state trade for 1991 was:

(In billions of valuta rubles)

Bulgaria	4.8
Czechoslovakia	6.1
Cuba	4.1
GDR	2.0
Hungary	2.7
Mongolia	0.9
Poland	4.6
Romania	5.4
Vietnam	1.1
Total	31.7

The payments situation vis-a-vis CMEA countries would not be favorable because of debt from large current account deficits of the USSR during 1990 with all European CMEA countries except Romania which would be partly repaid. The following current IBEC liabilities of the USSR were outstanding:

GDR: More than TR 3.5 billion, but it was tentatively agreed that the repayments should be dealt with after 1995.

Poland: More than TR 3 billion. This balance was not so great a concern to the Soviets because Poland owed another TR 5 billion in investment loans and the Soviets hoped that this would partially cover the current account debt. However, the Polish government was of a different opinion.

Czechoslovakia and Hungary: Those two countries were of greatest concern since the current account deficit totaled more than TR 1 billion with each country and there were no offsetting Soviet claims as in the case of Poland. In addition, the USSR had another loan outstanding with Czechoslovakia because it also ran a deficit in 1989.

Bulgaria: The current account deficit accumulated during 1990 was not major.

Romania: The USSR had claims on Romania.

Non-European CMEA countries: The USSR had a surplus vis-a-vis those countries, which had already high debt outstanding vis-a-vis the USSR.

Other socialist countries: The current account deficit with China was growing rapidly and that with Yugoslavia not diminishing. Settlement in hard currency, replacing settlement in clearing Swiss francs, had already been agreed with China.

There was only agreement with Hungary on the exchange rate to be used for the IBEC balances. That rate (TRs 0.92 per U.S. dollar) had been arrived at by comparing prices in CMEA trade with world market prices when the original debt was contracted. With Cuba, Mongolia and Viet Nam that had liabilities of TR 36 billion outstanding against the USSR, it would be necessary to use "soft" exchange rates.

A new intergovernmental agreement had been signed with Germany concerning the former GDR in which it was agreed that the rate to convert transferable ruble balances into U.S. dollars had to be agreed by July 1, 1991. With Bulgaria, the rate was to be agreed within three months (but the balances were small); the rate for Czechoslovakia was to be agreed within 2-3 months--there was major disagreement; the Soviet preferred a rate close to US$1 = TR 1 while the Czechoslovak Government argued for US$1.3 = TR 1; the negotiations with Hungary were protracted--there were two particular problems: the Hungarians insisted on preferential agricultural prices which the Soviets did not reject but did not want included in the agreement; in addition, the Hungarians wanted a credit agreement because they expected to run large deficits vis-a-vis the USSR; the position of the USSR was that such deficits were difficult to predict and possible credit arrangements would have to be negotiated when they occurred. With Poland, there were also major disagreements and the negotiations were expected to be protracted. There was no agreement with Romania.

More generally, the bargaining stance of the USSR toward transitional arrangements had toughened during 1990. When the Prime Minister had announced in Sofia in January 1990 that world market prices would be used in CMEA trade from 1991, he also stated that a transition period was envisaged. However, since then the position had changed with the deterioration in the USSR's own balance of payments position. Nevertheless, the USSR would not succeed in pure settlements in convertible currencies. Thus, state trade would mainly be conducted through clearing accounts although at world market prices. Clearing mechanisms were also envisaged for Cuba, Mongolia and Viet Nam with a large share of state orders; otherwise commitments would not be honored.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit - October 17-26, 1990

Minutes of External Sector Meeting No. E-8
Held at Gosbank
Thursday, October 25, 1990 at 2:00 p.m.

Soviet Representatives	Fund Representatives
Mr. Voitenkov	H. Flickenschild
Mr. Souvarov	B. V. Christensen
	L. DeMilner*

The discussion covered matters relating to the exchange rate system, the DVKs, foreign currency accounts, retention accounts, and the effect of devaluation on these arrangements.

Mr. Voitenkov stated that the impending devaluation would probably occur through the introduction of a new commercial rate rather than a change in the official rate. [He noted that he himself had opposed this idea when he was at MinFin.] This arrangement was defended by Mr. Mozhaiskov as necessary to provide a favorable basis for negotiating the settlement of Soviet Union's claims abroad. The major debtor involved was India which owed some rub 9 billion. At present, there is an arrangement with India by which the ruble rate is set with respect to a basket of 5 currencies. Some sort of compromise would likely be reached in any eventual settlement of these claims. He said there was unlikely to be any such hard bargaining with debtors such as Pakistan and Syria. Remaining claims totalled rub 15 billion and were held by various African countries as a result of arms shipments and were considered uncollectible.

Apart from this context the "official" rate would have no practical significance. All current account and capital transactions would take place at the new commercial rate. A "special" rate, 10 times that of the commercial rate, would continue to be available to tourists. [The volume of these transactions was limited--estimated at rub 300 million a year.]

As to the choice of the threefold devaluation of the exchange rate, one rationale given was the criterion of providing profitability to 90 percent of exports. It was clear, however, that this would not be an equilibrium rate in terms of equating supply and demand, but rather stemmed from a PPP approach to the exchange rate which was rather embedded in the minds of decision makers who had studied this topic back in the 1960s.

Transactions would continue to be made in the foreign exchange auction market but this form of internal convertibility would likely be very limited. Supply of foreign exchange was provided from enterprise retention accounts, from joint ventures, and, in principle, by government intervention. Regardless of the rates set in the auction market, the commercial exchange rate would be used for accounting and customs valuation purposes at all times.

With respect to the foreign exchange accounts--A, B, and V, these had no relation to the ER. Mr. Voitenkov reviewed the nature of these accounts as background; A accounts were for foreign exchange deposits by non-residents, B and V were for residents, depending on whether the source of foreign exchange was a regular flow or a one-time transfer. Basically, these accounts could be used to buy foreign exchange for travel abroad, to use in hard currency stores, or to buy rubles. The mission was given to understand that the conversion rate for foreign travel was the official exchange rate, that for the hard currency shops was 4.6 to 1, and for buying rubles was 10:1; the 1 being the official rate. These accounts cannot be traded among citizens nor can they be used for the foreign currency auctions.

In the new system, A accounts (denominated in FE), would be unchanged while the ruble-denominated amounts of B and V accounts would grow threefold so that no one is punished. 1/

For travel to capitalist countries there was a limit of rub 2,000 per citizen that could be utilized once per year. For travel to socialist countries the amount of currency that could be purchased was 2 or 3 times higher. The problem was that reserves were inadequate to meet the potential demand. In the reform program it is proposed to have an all-Union foreign exchange reserve fund. As it is now, republics don't want to spend their own foreign exchange for Union purposes; nevertheless, people come from all the republics to Moscow to purchase their foreign exchange. The idea behind the all-Union fund was to establish some sort of norms for the use of these funds. One worry was that the new immigration law would provoke an enormous increase in demand for foreign exchange. Because of this, consideration was being given to allowing individual citizens access to the foreign exchange auctions. This demand could easily be handled through the Savings Bank, which could take applications to determine demand, and purchase appropriate sums in the auctions. Much remained to be decided in this area. For now it was envisioned that such an foreign exchange exchange would exist only in Moscow. The exchange would be made up of 5-10 banks and forex dealers.

The DVK system would be dismantled; however if the devaluation took place on November 1, it would be hard to implement all the institutional

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1/ According to Mr. Voitenkov, B and V accounts can be held in foreign currencies and in valuta rubles. The statement refers to the latter type of accounts.

changes before the end of the year. The DVK system It covered only a small portion of trade (less than 1/5) and it never worked as intended. Introduced by decree #1992 in 1986, it was supposed to intermediate between domestic and external prices. Budget income from the existing price equalization scheme was on the order of rub 40-50 billion. The idea was to introduce an incentive for exports by providing higher profitability. In fact, some additional rub 5-6 billion was channeled to enterprises as a result, but had little stimulative effect of its own. Firms already received bonuses for meeting export targets, premiums, and other benefits.

In principle, the DVK system differed from the equalization scheme; the former was a fixed parameter calculation, whereas the latter was essentially a residual. This meant that changes in world prices would impact firm earnings if mediated through the DVK system. In practice, this was a fiction because DVK coefficients were being changed all the time. Moreover, the goods covered did not have volatile prices like gas and oil, and were usually sold under long-term contractual arrangements.

Prediction of the effects of the forthcoming devaluation were difficult because of the changes taking place simultaneously in the trading system. The devaluation per se was not so important as the changes in trade taxes and subsidies accompanying the devaluation when determining new taxes. Account wa taken of the shift in CMEA trade terms and the recnetly declared sincrease in domestic whoelsae prices. Crude oil at the old exchange rate would bring rub 70 per ton, after devaluaton it woullllld bring rub 210 per ton. 1/ This will be a tremendous windfall for the industry, and because it is based on mineral deposits that are part of the country's resource endowment it will be taxed at a rate of about 70 percent. [Mr. Voitenkov confirmed that industry costs are calculated on a variable cost basis, leaving out the cost of capital.] The amount of oil that could be diverted to export markets is limited by transportation and storage capacity, and in any case would be confined to amounts remaining after fulfilling state orders.

For export taxes a distinction would be made betwen two categories: (1) oil, gas, coal, ferrous metals, and lumber for which profits would be taxed by 70 percent and (ii) other export goods, where no export tax would be applied.

A sample calculation for machinery exports was given: machinery produced was worth rub 8 billion at external prices but rub 13 billion at domestic prices. The budget paid rub 5 billion in subsidies to equalize prices. Now, after devaluation, the earnings would be rub 24 billion (3 x 8). This rub 24 billion would be retained by the industry and the budget deficit could decline by rub 5 billion.

1/ At the same time, the domestic price of oil will rise from R 30/ton to R 70/ton.

[Mr. Voitenkov noted that no one had calculated the weighted average of DVK rates.]

On the import side, costs would initially rise 3 times. The original idea was to eliminate subsidies. Some industries will have to be modernized and for this imported capital goods will be needed. At present, planning for this requires a 2-year lead time for foreign exchange requests. However, because of the external payments problem a lot of these capital goods orders will have to be cut back. As it is, much waste has occurred because of lack of internal communication and coordination; equipment ordered long ago arrives for a factory now closed down, and sits and rots. This occurs because of division of responsibility and accountability.

Other imports of necessities such as medicines and grain will continue to enjoy subsidies, but these will not be automatic and will have to be shared by republics. The subsidies will be decreased over time, but gradually. Other imports such as consumer goods will receive no subsidies. Previously such goods if imported at a cost of rub 1 were sold at rub 5, with rub 4 going to the budget; now they will be imported at rub 3 and still sold at rub 5, so the budgetary revenue is cut in half but consumer prices will be unchanged. This adjustment in the future will likely be done through import taxes. Retail prices may go up anyway, but not because of the devaluation. It is expected that revenue from import taxes will drop to 1/3; with taxes on imports from socialist countries being reduced to zero.

The devaluation is not expected to have the same effects as in a full market economy, in part because of the existence of monopolies; and the auction rate for foreign exchange would continue to differ from the new commercial ER. Over time, the right policies will bring these two rates together. Higher taxes would limit the excess profits of firms. Closing off-balance accounts will increase the flow of hard currency sold on the exchange. Fiscal policy could further reduce the auction rate, but would be unpopular.

Regarding retention coefficients, Mr. Voitenkov said there had been many proposals, but the current version had rates ranging from 20-80 percent. The exact rate depended on the product, not the industry, and was correlated with the amount of value added. It was acknowledged that the current system of retention rates was quite chaotic and ad hoc.

With respect to the retention balances of enterprises, there exist both "on" and "off" balance accounts. Both will be protected from devaluation, but time limits will be given for the conversion of "off" balance accounts. There is a total of rub 2 1/2 billion in these accounts.

On the effects of pre-announcing the devaluation on the timing of payments, Mr. Voitenkov remarked that payments were already being advanced or retarded to the maximum possible extent.

Mr. Voitenkov also provided the mission with a draft of his forthcoming article on exchange rate developments and plans for Economics and Life.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit - October 17-26, 1990

Minutes of External Sector Meeting No. E.9
Held at the Gosplan
October 26, 1990, 12:30 p.m.

Soviet representatives	Fund representatives
Mr. Okorokov	Ms. Christensen*

Mr. Okorokov, Head of the CMEA section of Gosplan, discussed: (1) the general principles for CMEA trade in 1991; (2) prospective developments in trade; and (3) relations with individual CMEA countries.

1. General principles for CMEA trade in 1991

World market prices would be applied on a strict basis in trade with all CMEA countries from the beginning of 1991. While this implied that the USSR would benefit from higher receipts of exports of oil and gas at current world market prices, it also implied that the USSR could not expect to receive any preferential treatment on its exports of machinery and equipment which might face severe competition.

CMEA trade would be affected not only by changes in relative prices and in the payments system, but also by changes in the organization of trade. In the USSR (as in CMEA partner countries), increasing emphasis would be put on direct enterprise trade deals. State trade would encompass oil, gas and other raw materials on the export side and raw materials, components (according to certain specifications), medicine, and means of transportation (locomotives, vessels, and aircraft) on the import side. However, state order trade would not necessarily encompass the totality of trade in these products. For example, it was envisaged that besides state exports of oil, there would exist direct regional (republican) or enterprise exports of oil.

The trading partners of the USSR were interested in settling part of their trade with the USSR through a clearing account. In the trade agreement with Czechoslovakia, for example, there was reference to an indicative list of traded goods between the two countries. Although the clearing mechanism was not mentioned explicitly, the Czechoslovak authorities interpreted the agreement as settling payments for exports and imports for the indicative list through a clearing account. The Soviet authorities, however, preferred not to view the list as an obligation, stressing the "indicative" nature of the agreement. Similarly, they did not necessarily envisage payments through a clearing account. They recognized, however, that the lack of appropriate banking facilities in both countries might necessitate such arrangements on a temporary basis.

2. Developments in trade

The developments in 1991 were discussed on the basis of the staff's illustrative scenario. For exports of oil and oil products Mr. Okorokov confirmed that a slight decline in volume terms could be expected in 1991. The 50 percent decline which had been mentioned in other meetings of the mission referred to the share of oil trade to be conducted under state orders. In addition, direct enterprise trade deals were expected. The exports of raw materials were expected to stagnate (in volume terms) at best. In particular, the behavior of the republics was unpredictable. For exports of machinery, equipment, chemicals and light industry products, the experience with Soviet trade performance in Yugoslavia could serve as an example, as trade was conducted in clearing dollars which was close to convertible currencies. Soviet exports of machinery and equipment had declined considerably due to lack of competitiveness (price and quality). It could be expected that some categories of goods would hardly be sellable abroad in any market (CMEA or non-CMEA). Consequently, either existing production would have to supply the domestic market or some production lines be discontinued. In terms of the likely decline in ruble prices (at the present exchange rate), the staff's assumption of a decline by 40 percent from the present level for all exports, excluding oil, gas and raw materials, and unchanged ruble prices for raw materials seemed reasonable. Mr. Okorokov suggested considering a range of price declines of 30-50 percent for these products. On the import side, some decline in the volume could be expected, as a large share of trade would be conducted directly by enterprises through retained foreign exchange. These enterprises would want to diversify their sources of foreign supplies to satisfy domestic consumers. The price assumption of the staff (a decline in the ruble price by 40 percent at the official exchange rate) seemed to be in the right order of magnitude, although it was difficult to make exact projections.

3. Relations with individual CMEA countries

In trade with the former GDR, significant changes could be expected. Soviet exports of metallurgical products were expected to decline substantially. Similarly, exports of oil and oil products would decline by 14 percent, as Germany was interested in reducing its reliance on the USSR as a supplier of oil. There was still no agreement on the use of the outstanding transferable ruble balances with Germany but the USSR would argue for debt forgiveness or long maturities. It was confirmed that trade with the former GDR continued to be settled through IBEC during the second half of 1990 with the exception of certain transactions agreed beyond the annual protocols. The framework for trade with the former GDR in 1991 was not yet agreed. Shortly, a Soviet delegation would go to Germany to negotiate this framework. From the Soviet side, it was hoped that the indicative lists for traded goods be maintained for those goods which were of primary importance to the USSR. Such lists might indicate either the volume or the value (preferably the latter) to be exchanged during 1990. Such an agreement would ensure stability in trade.

In relations with other CMEA countries such as Cuba, Mongolia and Viet Nam, the USSR would strive for balance in trade. However, inevitably it would run surpluses. Mr. Okorokov mentioned that relations with Cuba were particularly complex and the USSR would still have to support it.

MEMORANDUM FOR FILES

October 25, 1990

Subject: Treatment of Gold Exports in Trade Statistics

During the September and October missions, the staff has received conflicting information about whether gold exports were included in the published statistics for total exports. Officials from the Ministry of Foreign Economic Affairs claimed that gold was excluded while representatives from Goskomstat argued that gold was included in the officially published statistics.

On October 23, 1990, the Goskomstat representatives were asked once again to verify whether gold exports were in fact included, as they had claimed before. The end result was as follows. According to the present statistical methodology, gold exports should be included. Each year a report form was sent to Vneshekonombank (by the gold exporter) which, however, never responded. Therefore, de facto gold exports were excluded from the published trade statistics.

B. Vibe Christensen

cc: Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Kopits
Mr. Wolf
Mr. DeMilner

MEMORANDUM FOR FILES

October 24, 1990

Subject: USSR - External Debt and Debt Service, Foreign Exchange Accounts and Auctions

On October 18, 1990, Messrs. Flickenschild and DeMilner and I met with representatives of the Vneshekonombank (VEB), which was followed up by a meeting on October 23 attended by myself. The Soviet representatives included Mr. Vishnev, Senior Manager, Mr. Potemkin, Head of the Foreign Currency Auction Department, Mr. Chicherin, Manager of Money Markets, Mr. Kolatukhim, Manager of Banking Development and Research, and Mr. Zabazhoz, Manager of Credit and Analysis. The meetings dealt with further information on arrears, external debt and debt service, foreign currency accounts, foreign currency auctions and forward cover transactions.

1. Arrears

The staff received an updated table on external arrears showing the stock outstanding at rub 2.9 billion or US$5.3 billion on October 15, i.e., an increase by US$0.9 billion since September 6, 1990 (Attached). The arrears comprised arrears to foreign suppliers while there were no arrears on financial credits. The figure included only those payments which had been presented to the VEB but not other outstanding obligations between domestic and foreign enterprises. It was thus a minimum estimate of arrears. The largest amount of arrears were vis-a-vis Germany (US$0.7 billion), Japan and Italy (each US$0.7 billion) and Switzerland and the United States (each US$0.4 billion). The VEB confirmed that no arrears were outstanding on debt contracted or guaranteed by the VEB. The arrears covered not only payments relating to direct enterprise imports but also to imports by ministries which had continued to follow planned imports despite the lack of foreign exchange.

2. External debt service obligations

The debt service projections of the authorities given to the staff during the Annual Meetings through the EC Commission (Mr. Larsen) did not reflect the latest projections, which the staff received from Mr. Ivanov. According to the latest calculations, debt service obligations on medium- and long-term debt would remain almost unchanged from US$7.8 billion in 1990 to US$7.7 billion in 1991. The future debt service obligations took into account outstanding obligations projected by end-1990. The following disbursements could be expected in the second half of 1990. De Beers: US$1.0 billion (of which US$0.7 billion remained undisbursed), Germany: DM 5 billion plus DM 1 billion (agricultural credit) plus DM 2 billion (October disbursement) of the DM 3 billion loan which was part of the DM 15 billion financial package agreed prior to German unification. From Italy, no disbursements were expected during 1990 because of parliamentary and other internal difficulties in approval of the loans (US$2.5 billion). However, they could be expected in 1991. Finally, some minor loans had been disbursed (presumably from Kuwait and Oman as mentioned by Mr. Ivanov). Because of the present political situation, nothing could be expected from Japan. But new commitments might be forthcoming from France in connection with the forthcoming visit of Mr. Gorbachev (October 28-29). The debt service projections took into account debt service repayable in commodities (which was relatively small) with the exception of the de Beers loan against diamond imports.

The situation on <u>short-term debt</u> remained critical. Reductions in credit lines and deposits totalled rub 6.3 billion from the beginning of the year. For 1990 as a whole the decline was projected at rub 7.8 billion leaving only rub 3.0 billion in outstanding short-term obligations. The almost elimination of short-term debt had resulted in a severe drain on reserves, which were now at an absolute minimum level. Although no figures could be provided on reserves, it was confirmed that reserves had fallen further since in the first half of 1990 (a decline by US$6 billion from end-December 1989 to end-June 1990 to a level of US$8 billion, according to the BIS). Foreign banks were unwilling to renew credit lines/deposits when reserves were falling. It was hoped that rub 3.0 billion could be rolled over in 1991 if reserves remained stable, but it was uncertain.

The figure for the reduction in short-term debt did not take into account gold swaps. While it was confirmed that gold swaps of different varieties were used during 1990 (again no figures), gold was <u>not</u> used as collateral for loans, as had been suggested in the Western press.

The staff had requested statistical clarification concerning the debt service obligations for commercial credits which were not broken down into interest and principal. After contacting foreign trade organizations to obtain information about the average interest rate, the VEB representatives mentioned that the interest component could be estimated by assuming an interest rate ranging 7.6 percent to 10.0 percent per annum (following international trends) between 1985-90. While borrowing costs usually was 1/4-1/2 percentage points above LIBOR, in 1990 the margin had increased to 4-5 percentage points on some new credits.

3. <u>External debt</u>

A clarification was given on the breakdown of debt between short-term and medium-term debt (provided through Mr. Ivanov) since the totals of those debts differed from earlier figures given to the staff. The new totals included undisbursed commitments of "operational balances" and therefore were higher than the previous external debt figures. With adjustments to reflect disbursed debt only, the outstanding stock of short-term credit was as follows:

USSR: External Debt

(In billions of rubles; end of period)

	1985	1986	1987	1988	1989	1990
Total external debt	22.1	21.3	23.9	26.1	32.9	29.9 1/
Of which:						
Short-term	5.3	5.0	5.0	6.8	10.8	3.0 2/
(In % of total)	(24.0)	(23.5)	(21.8)	(26.1)	(32.8)	(10.0)

1/ Staff projection.
2/ Official projection.

No exact information was available on external borrowing which had not been contracted or guaranteed by the VEB. Such borrowing required licensing from VEB. Between the beginning of 1989 (when such transactions had been allowed) and October 1990, total licenses issued amounted to rub 1.7 billion. The actual use of these licenses, however, was not known.

On final maturities for new medium-term and long-term financial credits, the following information was provided:

1985	5.9 years	1988	7.4 years
1986	7.2 years	1989	6.8 years
1987	6.6 years	1990	8.2 years

4. Foreign currency accounts

In October 1990, the deposits in the foreign currency accounts for juridical and physical residents and nonresidents, including joint ventures, amounted to rub 0.5 billion (accounts A, B and V). In addition, the on- and off-balance sheet obligations of the VEB to provide foreign exchange to enterprises (retention rights) amounted to rub 2.6 billion. The ruble amount of the on-balance sheet deposits would be adjusted in line with any further depreciation (i.e., if the official exchange rate changed from rub 0.6 to rub 1.8 per U.S. dollar, the deposits would increase to rub 7.8 billion). It was also intended to treat off-balance sheet claims in the same way.Finally, rub 0.5 billion were deposits held for commercial letters of credit issued in the favor of foreign suppliers to the USSR. The VEB representatives hinted that the sum of these three official obligations (rub 3.6 billion or US$6.5 billion) corresponded to the size of outstanding foreign exchange reserves of the VEB.

5. Foreign currency auctions

The staff received up-to-date information on the amount and exchange rate of each of the convertible currency auctions held up to October 1990 (attachment). The amounts remained minimal and the exchange rate (latest : rub 24 per US dollar) could not be considered indicative for market equilibrium rates. As from October 1990, auctions would be conducted twice a month compared with once a month previously. To date, the VEB had not intervened in the auctions although it was under consideration for the future if the exchange rate remained high. 1/ From October 25, 1990, access to the auctions would be widened to include joint ventures and manufacturing cooperatives.

Further changes were under consideration for 1991. There would be foreign exchange auctions in several (not all) republics and in free-trading zones. This might give rise to different exchange rates although it was hoped that arbitrage would reduce the differences in rates. It was not yet clear which share of total foreign exchange earnings would be channeled through the official or free markets. The Soviet officials were studying the experience of other countries, including China and Yugoslavia, but had so far received no technical assistance from the West.

6. Forward cover

Forward contracts in foreign exchange had been minimal. The transactions had taken place mainly in rubles against U.S. dollars and deutsche marks (90 percent). At the moment, no forward claims or liabilities of the VEB were outstanding. The VEB always covered itself against any forward commitments.

B. Vibe Christensen

cc: Mr. Whittome
Mrs. Ter-Minassian
Task Force Members
Mr. Robinson

1/ This information conflicts with that obtained from Mr. Potelev (VEB) during the first staff visit in August 1990.

Table 1. USSR: Arrears

Country	In millions of rubles
Australia	45.7
Austria	205.1
United Kingdom	164.9
Belgium	71.9
Hong Kong	27.7
Greece	7.6
Denmark	27.9
India	17.6
Iran	1.5
Iceland	0.5
Spain	15.8
Italy	377.7
Canada	4.8
China, People's Dem. Republic	9.5
Luxembourg	0.7
Malaysia	15.3
Malta	5.0
Netherlands	116.1
New Zealand	106.0
Norway	12.7
Pakistan	4.4
Portugal	6.6
United States	221.8
Singapore	26.8
Turkey	26.9
Uruguay	7.8
Germany (Federal Republic)	391.3
Finland	161.9
France	161.3
Switzerland	240.2
Sweden	67.3
Sri Lanka	0.5
Japan	380.4
Total	2,931.2 1/

Note: Arrears against import documentation (no financial credit arrears).

1/ Excludes clean transfer of funds against invoices presently directly to Soviet enterprises.

Table 2. USSR: Foreign Exchange Auctions

Date of Currency Auction	Total Amount Sold at Currency Auctions (mln. hard currency rubles)	Price at Currency Auctions in Soviet Rubles to	
		1 hard currency ruble	1 U.S. dollar ($1 - rub 0.6)
17/01/90	8.2	17.5	10.50
21/02/90	9.0	21.0	12.6
05/04/90	9.6	23.05	13.83
10/05/90	9.8	27.11	16.266
22/06/90	6.8	35.1	21.06
19/07/90	9.0	41.2	24.7
31/08/90	11.7	41.2	24.7
09/10/90	9.5	40.0	24.0

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of General Meeting No. 1
Held at the Offices of the Supreme Soviet
Wednesday, October 17, 1990 at 4:15 p.m.

Soviet representatives

Mr. Bunich, Vice Chairman
Commission on Economic Reform
of the Supreme Soviet
Mr. Bakarinov

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Kopits
Mr. Wolf*
Ms. Christensen

European Communities

Mr. Maslen

The meeting was devoted to a discussion of the reform program that President Gorbachev had submitted to the Supreme Soviet. Mrs. Ter-Minassian began by asking Mr. Bunich what his views would be of what would constitute an adequate reform program and how closely the program presented by Mr. Gorbachev would correspond to these views, which elements of this program would most likely attain the support of the Supreme Soviet, and what would be the implications of such a program for the economy in 1991.

1. Political background

Mr. Bunich noted that Mr. Gorbachev had attempted to reconcile the different proposals of the Abalkin and Shatalin groups by calling on an ad hoc group under the chairmanship of Mr. Aganbegyan. This team had worked out a program that was 90 percent based on the Shatalin proposal. Mr. Gorbachev had personally worked with the Aganbegyan team for at least 50 hours in elaborating this program.

Mr. Bunich said that the Gorbachev program differed from that of Shatalin in the following respects. First, it had transformed Mr. Shatalin ideas into more of a conceptual, ideological document. Second, the period of transition was now viewed as two years, rather than the 500 days envisaged in the Shatalin plan. Third, the new program had to take into account economic developments since the Shatalin plan had been conceived. Specifically, the Government had announced that agricultural procurement prices were to be raised effective January 1, 1991, which had led the peasants to withhold deliveries to state procurement agencies. The RSFSR had felt compelled, in the meantime, to advance the procurement price hikes to October 1, 1990 and to increase their size. These price rises had already, according to Mr. Bunich, had an impact on wholesale prices. 1/ The implication--although Mr. Bunich did not mention this explicitly--was that the initial price freeze aspect of the Shatalin plan would have to yield, and retail prices would have to be increased early on in the reform program.

The lack of specificity of the Gorbachev program had caused "outrage" in the RSFSR parliament, according to Mr. Bunich, and one could wonder what would be the reaction of the other republican parliaments. If the Supreme Soviet were to ignore these dissenting voices, relations between the union and the republics could deteriorate even further. But if execution of a reform program were to be delayed again, the population--which felt let down after years of promises--could be expected to react as well. Mr. Bunich's Commission had adopted a resolution that very morning to urge Mr. Gorbachev to enter into discussions with the Yeltsin group as soon as possible.

Mrs. Ter-Minassian asked whether the other republics would be willing to go along with a deal that was struck simply between the union and the RSFSR. Mr. Bunich said that until now all the republics, except the Baltics, had supported the Shatalin and then the Aganbegyan programs, but he could not say whether they would necessarily go along with a new compromise between the union and the Russian republic.

2. Economic aspects of the program

Mrs. Ter-Minassian asked for clarification of the pace of price liberalization envisaged in the new program. Mr. Bunich suggested that most of the liberalization of prices would occur in mid-1991, after which time some 70 percent of all prices---both producer and consumer--would be free. The Gorbachev plan would retain the feature of the Shatalin plan under which some 30 percent of prices--essentially staple consumer goods and "strategic" products--would be negotiated at the union level for application by all the republics. 2/ Mr. Bunich said that as the economy was opened up there would be a convergence of such prices, including for energy, towards world market prices, but he could not specify how quickly this opening up might take place.

He acknowledged that those goods that would continue to have administered prices tended to be those that were already highly subsidized. He appeared to indicate, however, that these prices would be raised so as to eliminate the price subsidies and that subsidies to loss-making enterprises would be reduced by 70 percent. In effect, the elimination of price subsidies on consumer goods would be replaced by income supplements, whereas the reduction of subsidies to loss-making enterprises would constitute a net gain to the budget. Mr. Bunich was unable to specify at this point the mechanism by which the population would be compensated for the abolition of

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1/ Presumably he meant wholesale prices in the food processing industry.

2/ This issue was left somewhat unclear. Mrs. Ter-Minassian had asked whether the prices of basic fuels and raw materials would be negotiated among the republics, as provided for in the Shatalin plan. Also, the mechanism by which these prices would be negotiated was left unspecified.

price subsidies. Most likely, in his view, there would be a program of full compensation for some groups of the population and partial compensation for others.

Mr. Bunich also pointed to possible budgetary savings through a 40 percent reduction in the government bureaucracy and a decline in state-supported investments. The 40 percent reduction did not mean simply a transfer of employment from the all-union to the republican bureaucracies as responsibilities were shifted. Asked whether such a decline was really feasible, he said there was no choice; it was an objective which might or might not be achieved. He did not view such personnel cuts as causing an unemployment problem, as there was a high demand in industry for well-qualified people.

As to the size of the budget deficit in 1990, Mr. Bunich thought it might amount to as much as rub 80 billion. In 1991, the deficit could reach rub 30-40 billion; in other words, more than the Shatalin plan had projected because it had not taken into account the aforementioned increases in agricultural procurement prices.

Asked what impact the freeing of 70 percent of all prices would have on the price level, Mr. Bunich said estimates had been made but in the end he did not divulge them. He noted a number of measures that would be taken to limit the upward movement in prices, including: (1) increasing the interest rate on household deposits; (2) programs of prepayment for consumer goods for later delivery at current prices; (3) the sale of assets to the population; (4) the sale of housing, garages, agricultural machinery and land for small garden plots (sales of the latter to some 6 million people were expected shortly); (5) diversion of construction materials to the housing sector; and (6) the further conversion of military production to consumer goods.

Asked how realistic it was to assume that asset sales could absorb significant amounts of household liquidity, Mr. Bunich suggested that in the first year of the program some rub 50 billion of an overhang of rub 240-250 billion could be so absorbed. The plan was to give away the majority of housing assets by transferring free of charge 20 square meters per person. If a family wanted housing space above this norm, it would face the choice of higher rents or buying the excess space.

Asked how the remaining rub 200 billion would be prevented from being channeled into the consumer goods market and putting upward pressure on the price level, Mr. Bunich said the interest rate on deposits--to be set at 15 percent to reflect the current inflation rate of 10 percent 1/--would be raised even higher if necessary.

Mr. Bunich maintained, in response to a question, that the prices to be liberalized in 1991 would be truly free and not subject to any type of regulation. Asked if he was not afraid of pricing abuses by monopoly

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1/ By this, Mr. Bunich probably had in mind an estimate of the underlying inflation rate; in other words, including repressed inflation.

producers, he noted that monopoly was not a problem unique to the Soviet Union and that in any event it would be relatively easy to quickly break up existing monopolies. Moreover, enterprises would effectively be subject to a progressive profits tax, and anti-monopoly agencies would be established at both the union and the republican levels. He considered that all such measures could easily be taken by mid-1991, when prices were liberalized. The main problem, in his view, was how to "saturate the market" with goods within a short period. In this connection, he expressed the opinion that at the present time the effective standard of living in Moscow was worse than in the rest of the country, which was a reversal of the traditional situation. Mr. Bunich was not specific about how the market could be effectively saturated with consumer goods within the next nine months. In this connection, Mrs. Ter-Minassian wondered what effect the announcement of the price liberalization to take place only after 6-9 months would have on the supply of goods. To this, Mr. Bunich said there was no easy answer, but also reminded the staff that the published reform program did not mention any figures. He did not preclude, however, the general adoption of a hoarding mentality.

Asked what role was envisaged for increased imports in restraining inflation. Mr. Bunich said that policy makers were rather concerned with the need to reduce imports in 1991 in view of debt service obligations of some rub 12.5 billion; indeed in some consumer good markets a decline in supply of 20 percent was foreseen. Nonetheless, the objective would be to try to at least sustain the present level of imports. Mr. Bunich did not view the increase in Soviet terms of trade due to higher oil prices or the change in the CMEA mechanism as having much of a positive effect on balance, since he was under the impression--although he pleaded lack of expertise in this area--that the decline in oil production and thus in export volumes would generally offset the positive terms of trade effects. Asked to comment on exchange rate policy in the Gorbachev reform program, Mr. Bunich noted that he was no expert in this area either and had no precise views.

Mrs. Ter-Minassian asked whether, if imports of consumer goods could be stepped up, they could be easily distributed given the present distribution bottlenecks, and how could this situation be improved in the short run. Mr. Bunich responded by noting that in his view the main problem was the lack of work incentives. In his role as president of the association of lease holders--in addition to his activities in the Supreme Soviet--he noted the above average productivity of workers employed in leasing activities--some 10.3 million he said--and of the 3.8 million workers in the cooperatives. Efficient distribution, in his view, depended on inputs being channelled through such non-state-owned entities. Mrs. Ter-Minassian agreed with the need to expand the scope for private initiative--including in road transport where presumably relatively little capital would be required--but that this would depend heavily on specifying property rights more clearly. Mr. Bunich noted, in this connection, that the President had recently issued a decree declaring the inviolability of all types of property, including that belonging to foreign investors.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of General Meeting No. 2
Held at the Council of Ministers
Thursday, October 18, 1990 at 10:00 a.m.

Soviet representatives	IMF representatives
Mr. Ivanov	Mrs. Ter-Minassian
	Mr. Calvo
	Mr. Blejer
	Mr. Flickenschild*
	Mr. Wolf

Mrs. Ter-Minassian and Messrs. Calvo, Blejer, Flickenschild and Wolf met with Mr. Ivanov of the Council of Ministers to discuss the mission's work program and learn about the status of efforts to arrive at a reform program acceptable to union and republic governments.

Mrs. Ter-Minassian said that the mission needed greater cooperation from the authorities in obtaining information in the external area and on military expenditure. However, the main focus of the present mission was a thorough discussion, at a technical level, of the reform program and the government's policy stance for 1991. In view of a remark by Mr. Ivanov that this was a difficult moment for the government in which it had to change its decisions and positions from day to day, Mrs. Ter-Minassian she suggested that, in the absence of a definitive program, technical discussions could be held on reform options. The main options needed to be evaluated in the areas of price and incomes policies; privatization and decentralization; and fiscal, monetary, exchange rate and external trade and payments policies. Mrs. Ter-Minassian outlined briefly the time schedule for the preparation of the report, which would require one more visit by the Personal Representatives of the four institutions involved in the study. This visit would probably take place in the week beginning December 3, 1990 and concluded by stressing the need for a more thorough assessment of external financing requirements, for which the assistance of the Soviet technical experts was indispensable.

Mr. Ivanov promised that a meeting would be arranged with the group that had prepared the latest version of the government's program. Mr. Yavlinski had offered his resignation on October 17 in protest over the government's recent price policy measures that had undermined the chances for success of the 500-day program. According to Mr. Ivanov, the parallel discussion of the reform programs by the Parliaments of the USSR and the RSFSR--although politically inevitable at this juncture--was a disaster technically.

Mr. Ivanov then explained the reasons for his two letters, noting that the Soviet authorities had been overburdened in recent months, with about one-half of their experts away on holidays while the reform debate was raging in Moscow. At the same time, additional demands had been brought to bear on them by the visits of the two groups (the EC Commission staff and the four organizations involved in the G-7 study) preparing studies on the Soviet economy. Several government agencies had refused to receive further visits. Mr. Ivanov then praised the "good example of the EC," which had already completed its study. On October 19 he would accompany Mr. Sitarian to Brussels to discuss its findings and recommendations with Mr. Delors.

Because of the enormous uncertainties, the government had not made any medium-term projections. Outside the government, Mr. Yurinenko (?) of the Institute for Forecasting had made his own projections and the mission was free to see him. For 1991, Mr. Vid of Gosplan had made some projections, which were still being discussed, and the mission could talk to him.

As to the government's latest reform proposal, the price section was the weakest part of the document. It was not clear and the Russian parliament was subjecting it to justified criticism. Mr. Yavlinski's resignation was mainly triggered by it. The version of the Committee on prices had been rejected. As to incomes policy, it was also weak. If price policy remained unclear, incomes policy also had to remain vague. The new version of the reform program contained no data on privatization. However, with an estimated rub 3 trillion of assets, the government was likely to absorb easily a liquidity overhang estimated at rub 400 billion. There was consequently no need for complete privatization. Foreigners would get national treatment and could acquire stocks and lease land. Under a new draft investment law (a copy was provided), foreigners could obtain 100 percent ownership in companies and long-term leases for the exploitation of natural resources. The draft law omitted portfolio investment by foreigners and granted incentives only to companies with a foreign participation of more than 30 percent. This threshold was seen as too high to attract foreign participation in large companies (i.e., Magnitogorsk). For this reason, the Committee that had prepared the draft had been disbanded and a new one had been formed to prepare another draft.

As to the balance of payments projections, Mr. Ivanov said that the Gosbank and the VEB had prepared several scenarios. The scenarios had shown that the poor infrastructure limited the growth potential for exports. The oil price increases had so far produced additional revenues of rub 1.5 billion, almost entirely as a result of the "switch of shipments from CMEA to Rotterdam."1/ At the same time, however, the USSR had lost exports resulting from the cessation of debt service payments in the form of oil by Iraq and Libya of 11 million tons. 2/

Pressed once more by the staff, Mr. Ivanov admitted that the Council of Ministers had prepared its own balance of payments projection for 1991. He promised to let the staff read it in his office on October 19 and have his experts answer any questions.

Mr. Ivanov provided a few more numbers, whose context and mutual consistency were not entirely clear. For all it is worth, he said that:

-- CMEA trade will contract by 30 percent in 1991;

-- there would be a trade surplus with CMEA-5 of US$4 billion in 1991. An expected surplus of rub 2 billion with the territory of the former GDR would be spent entirely in Germany;

-- the estimate of the additional export value attributable to the oil price increase had been raised from rub 16 billion to rub 20 billion for 1991;

-- convertible currency exports of rub 20 billion and debt service obligations of rub 12.5 billion would limit convertible currency imports to rub 7.5 billion in 1991;

-- apart from this problem, the balance of payments problem boiled down to how to distribute export revenues between the union, republics and enterprises;

-- debt service would drop from rub 12.5 billion in 1991 to rub 6.5 billion in 1992 and rub 5.5 billion in 1993 if there was no new borrowing; 3/

-- that rub 5 billion was needed until the end of 1990.

1/ Presumably, additional revenues of convertible currency (some US$2.6 billion) was meant without deducting the lost revenue in transferable rubles. If an average oil price of $35 per barrel is used, this would amount to about 10 million tons, an extremely high amount for a period of about two months if entirely attributed to switching oil from CMEA to the convertible currency market. Data for the first half of 1990 indicate average shipments for two months of 13 1/2 million tons to all Socialist countries and of 12 million tons to CMEA.

2/ Presumably, the annual rate of such imports was meant.

3/ These are the numbers already provided by VEB.

Mr. Ivanov also mentioned (i) that no gold pledges had been made because this would set a precedent on which all future lenders would insist and (ii) that Mr. Vid of Gosplan had prepared a list for foreign investors offering uncompleted projects, plants suitable for conversion, and 800 of 1,000 firms closed for environmental reasons. The latter, of course, would have to be upgraded to be environmentally acceptable.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of General Meeting No. 3
Held at the Institute for Economic Forecasting
Monday, October 22, 1990 at 5:45 p.m.

Soviet representatives

Professor Shatalin
Mr. Bakarinov

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer*
Mr. Flickenschild
Mr. Kopits
Mr. Wolf
Miss Cheasty
Miss Christensen
Mr. DeMilner

OECD representatives

Mr. Shafer

Mrs. Ter-Minassian asked Professor Shatalin about his views on plan, presidential program, its differences with the original Shatalin plan, and his assessment about the steps that should be taken to make it operational. Professor Shatalin started by mentioning that in his speech, the President said that the principles, ideology and logic of the guidelines are based on the original program of academician Aganbegyan presented by the President on September 10 to the Supreme Soviet and transmitted to all Republics and Autonomous Republics. In fact, four programs were received by the Republics and the Supreme Soviet: the Government (Ryzhkov) program, the Aganbegyan group program, the Shatalin program and the Aganbegyan analysis of options. Shatalin mentioned that the Aganbegyan Program was 99 percent based on his proposal, an assessment shared by the Abalkin group. The President established then a working group since the program was not adopted by the Supreme Soviet. That commission was to present a new program on October 15.

On the Shatalin program itself, Professor Shatalin said that the premise was to start with financial stabilization including some market intervention, such as sales of property, unfinished construction, and imports. After these steps, there would be liberalization of prices. That is the main difference with the Government program that starts with administrative price changes. What happened before October 15? The Government established a new list of administrative wholesale prices, something opposite by the Shatalin group. The Union Government increased the administrative price of grain while the Russian and other Republics increased the price of meat, a step legalized by the President. This is regarded as completely opposed to the 500-day program. These steps are conditioning already the new program.

The increase in administrative wholesale prices require a similar increase in retail price and that is why it was opposed by Shatalin. In fact, these steps are equivalent to implementing the Government program. What was being planned has, de facto, happened. Another 500-day program is needed now to stabilize the situation, but given the steps taken, and in order to avoid the inflation to be caused by the Presidential decrees, it will be necessary to be much more restrictive and new measures would have to be taken. For example, the process of privatization would have to be speeded up and the social programs would have to be revised.

In these circumstances, the implementation of the 500-day program would require that all the Republics agree to the simultaneous introduction of stabilization measures. But the discussions in the various parliaments do not appear likely to lead to a single, well-defined program. Professor Shatalin had expected more support for his program in the Republics, given his close working relation with many of these.

The problem that is being discussed now with the Republics is the single currency fund issue. But, in order to create conditions for agreement of the Republics to a specific stabilization program, it is necessary to have time. In the meantime, the only thing possible was to issue the general guidelines contemplating a single monetary, fiscal and exchange policy. The guidelines keep the <u>spirit</u> of the previous version of the Presidential program (Aganbegyan) and also of the 500-day program. But things have been sacrificed and the situation is more difficult.

The main thing about the Shatalin program that largely remains in the guidelines is the principle of free entrepreneurship and private property, as well as private ownership of land, and these are the core issues also in the 500-day Program. The President has now given up the idea of holding a referendum on land ownership and, although there will be some opposition, but this is very important progress. Also, the international cooperation issue has been well addressed by calling for the creation, with participation of the Republics, special fund to oversee the use of Western assistance to the country. It is important that Western aid is channelled to increase productivity in the economy and not to prolong the agony of the previous system. Without using Western methodology capabilities, it would not be possible to create a new efficient economy.

Mrs. Ter-Minassian remarked that the latitude given to the Republics in the determination of pace of reforms might not be consistent with maintaining the single economic space throughout the Union and sought Professor Shatalin's assessment of the likely macroeconomic effects of the the prsidential program, including thos of the planned price increases, the proposed tightening of financial policies and the likelihood of reducing the budget deficit to the targeted 3 percent of GDP level.

Professor Shatalin acknowledged that in the current political situation there must be serious doubts about the likelihood of containing the state budget deficit to that level. This is especially the case because output is likely to be lower than hoped for.

Mr. Kopits said that in the original Shatalin program the fiscal gap was to be eliminated. What was included in that program that could be incorporated into the present guidelines? Professor Shatalin answered that the conditions have changed and that the inflation prospects have worsened making the budget objective more dificult to achieve. Perhaps the original program was over-ambitious, although it was premised on coordinated policies.

Professor Shatalin emphasized the importance of foreign credit and foreign aid in restructuring and reforming the economy. The original program was counting on a more generous flow of foreign credits.

Mr. Shafer asked about the inflationary respects. It appeared to him that the presidential program involved price increases larger than he would have thought politically tolerable. Had the political and social changed? Professor Shatalin said that it is likely that the first prices to be liberalized would be non-essentials. The price of the basket of minimum necessities would be maintained. The issue that arises here is the compensation that would have to be introduced for the price rise of those goods which fall between the two categories. This has not been decided (indexation or other system). The more vulnerable groups in the population would have to be protected from price increases. At the same time, the stabilization measures and privatization would be introduced to limit the price increase of the unregulated goods.

Currently, we are witnessing the introduction of rationing to maintain a minimum standard of consumption in some regions but in fact it is not necessarily true that the rationing cards would be backed by an adequate supply of goods.

Mrs. Ter-Minassian questioned the desirability of large increases in wholesale prices, as oppposed to their liberalization. Professor Shatalin said that he shared this view but he stressed that the first step is the implementation of stabilization measures together with the maintenance of fixed prices for necessities. He said that following the introduction of a rigid structure of higher wholesale prices, it would not be easy to introduce also flexible economic policies leading to a market mechanism. In fact, 95 percent of the current program is based on administrative measures and makes it difficult to provide incentives to the market.

Mr. Wolf asked if the 30 percent increase in agricultural procurement prices this year does not in fact indicate that a new round of increases would be needed next year given that the retail prices are expected (according to Gosplan) to rise by 60 percent. Professor Shatalin said that there are many problems in agriculture that prevent a rapid supply response (infrastructure, transport, distribution, etc.) so the price increase probably would not raise production in the short run but in the longer run some response would be more likely. Therefore, within the next two years prices could be liberalized and would help to increase supplies. At the present time, the supply constraints include also the unavailability of imported inputs so that an increase in producer price may not have an important supply response. He said that more important than prices are property rights and improvements in the extremely poor agricultural infrastructures.

Office Memorandum

MEMORANDUM FOR FILES

October 31, 1990

Subject: Meetings with Academician Aganbegyan

Members of the mission met with Mr. Aganbegyan on October 23 and 25, 1990. The main points emerging from the discussions can be summarized as follows:

1. Political content

Mr. Aganbegyan, who is reportedly a close and trusted adviser to President Gorbachev, painted a cautiously optimistic picture of the evolving political situation, in particular the relations between the Union and the republics. He said that, although the Government was largely discredited and lacking strong leadership and therefore unable to carry out effectively a reform program, the President's standing remained strong, even in the face of republican posturing, as witnessed by: (a) the strong support in the Supreme Soviet of the USSR for both the emergency powers and the presidential reform program which had been just approved; (b) the fact that republican politicians, including Mr. Yeltsin, spoke quite differently in public and in private; and (c) the republics had agreed to sit down and discuss with the Union authorities their plans and budgets for 1991 and to participate in the inter-republican "currency fund committee" to deal with foreign exchange matters, including the administration of Western assistance.

The price for this more cooperative attitude had been, in part, the decision by the President to present guidelines, instead of a blueprint, for reform which left considerable leeway for individual republics to shape the context and pace of the reforms. Mr. Aganbegyan was hopeful that consultation and negotiations in the framework of the above mentioned committee on economic policy would prevent excessive and potentially disruptive differences in the speed of reforms among the republics.

2. Overview of reform program

Mr. Aganbegyan said that the first two imperatives of the reform program were to prevent major disruptions of production, especially in strategic sectors of the economy, and to stabilize the financial situation. The recent presidential decree ordering enterprises to maintain existing supply links and honor previous contracts until the end of 1991 was aimed to the first end. To the second end, the presidential program envisaged early action to absorb existing excess liquidity and to contain the budget deficit, and thus the rate of monetary growth in 1991. Various approaches were under consideration to tie up liquidity: a possible freezing of a part of deposits of enterprises with the banking system; increases in interest rates to a range of 6-10 percent initially and higher subsequently, if necessary; sales of bonds redeemable in consumer goods and of various types of government properties, including land plots and dwellings. 1/

As regards budgetary prospects for 1991, Mr. Aganbegyan recognized that the announced target for the state deficit of rub 30 billion bordered on the impossible, but he thought it should be possible--albeit difficult--to contain the deficit below the level (rub 60-70 billion) projected for this year. The measures envisaged to this end included: a reform of turnover taxes; sharp cuts in some types of spending (public investments to be nearly halved), defense (-20 percent) and administrative expenditures of the union (-40 percent). Subsidies to state enterprises would be cut by 70 percent, a move which would require the closing of some hundreds of firms. Foreign aid (except humanitarian aid) would be slashed, and efforts would be made to collect (or sell on the secondary market) some outstanding credits towards LDCs.

Mr. Aganbegyan recognized, however, that these measures would be insufficient to ensure adequate containment of the budget deficit, unless accompanied by a substantial cut in consumer subsidies. This would require increases (on the order of 30-40 percent) in the prices of such essential foodstuffs as milk, meat and grain products, on which subsidies are concentrated. Mr. Aganbegyan thought that these increases would take place in February-March of next year and would have to be accompanied by increases in social benefits (pensions and family allowances) sufficient to preserve living standards of the lower income groups. As for wage earners, compensation should not be full but limited to 50-70 percent. He noted, however, that it may be difficult to secure wage moderation, given the growing militancy of the trade unions.

Queried about the scope of price liberalization, Mr. Aganbegyan said that he expected that about 15-20 percent of retail prices would be freed before the end of this year. This percentage would increase during 1991 and might reach 70 percent by year end, if efforts to tighten financial policies and stabilize the economy proved successful. He did not feel confident to venture quantitative forecasts for output, inflation or the balance of payments for next year.

T. T.-M.

Teresa Ter-Minassian

cc: Mr. Whittome
Task Force
Ms. Christensen
Mr. Robinson

1/ Mr. Aganbegyan recognized that sales of housing were not likely to be successful until rents were increased.

To PI
cc: GL-done

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Fiscal Meeting No. F.1
Held at the Ministry of Finance
Wednesday, October 17, 1990 at 10:00 a.m.

Soviet representatives

Mr. Pushkin, Chairman,
Main budget committee
Mr. Smirnov, expert, foreign currency

IMF representatives

Mrs. Ter-Minassian
Mr. Kopits
Ms. Cheasty*

OECD representative

Mr. Hagemann

Opening Meeting

The meeting covered administrative arrangements for the fiscal team, and a preliminary discussion of the likely 1990 budget outturn and prospects for 1991.

Estimates for 1990

According to most recent Ministry of Finance estimates, the state budget outturn for 1990 is likely to be on target, so that no extra financing is necessary. The budget plan called for a deficit of R 60 billion, and the latest estimates (October 14) show a deficit of R 59.3 billion. This accuracy, however, hides large movements in the composition of the deficit. Most importantly, the Union budget deficit will be R 67 billion, instead of R 49 billion as planned, while the Republics' budget will show a surplus of R 8 billion rather than the planned R 11 billion deficit.

On the revenue side of the state budget, unexpected revenues of R 7 billion will be collected, offset by unplanned shortfalls of R 10.6 billion. Thus, the net revenue shortfall is expected to be R 3.6 billion. Turnover tax is expected to be R 1.4 billion greater than planned (because of higher than estimated production of alcohol and of cars); individual income taxes will be R 2.7 billion above budget (because of unanticipated wage increases); income from cooperatives will be up R 1.7 billion compared with plan; income from foreign activity will be R 0.4 billion higher than plan (with an increase of about R 2 billion in Customs revenue, offset by a shortfall of about R 1 1/2 billion in oil revenues, mainly because of a drop in volume, due to production constraints); and other revenues are expected to be up by R 0.8 billion. Despite the higher wages in the economy, social insurance contributions are projected to remain as in the Plan (because forecasts were excessively high).

The shortfalls are to come in enterprise taxation--with profit tax down by R 6.2 billion, because of an R 19 billion profits shortfall from R 250 billion in 1989, due to declining productivity in all branches of industry; the excess wage tax--down by R 1.1 billion, because of the many exemptions granted from the policy; levies and other nontax revenues--down R 3.1 billion; and other miscellaneous items down by R 0.2 billion. The authorities fear that the decline in enterprise taxation will continue through 1991.

Most of the unplanned revenue gains occurred in the republics (who, for instance, retain 3/4 of the turnover tax), while most of the shortfalls affected the Union budget. Of the R 6.2 billion shortfall in enterprise profit taxes, R 4.9 billion should have come from enterprises subordinate to the Union. Information on social insurance contributions is available only for the Union, so far, and at that level, contributions are broadly on track--expected to amount to R 30.1 billion compared with a planned figure of R 29.7 billion.

State budget <u>expenditure</u> is projected closely on track, with an increase of only R 0.3 billion compared to target. Again. however, the republics performed well while the Union performed poorly. Union expenditure originally planned was R 241 billion, while, after amendments, the outturn is projected to be R 279 billion. There were two main offsetting influences on expenditure: the decree of August 14, 1990, which cut spending in the second half of 1990, and a recent decree authorizing R 12.7 billion in extra outlays. Some further savings in expenditure--the deferral of some cultural projects, and savings on meat and milk subsidies due to under-production and -delivery--also help to explain the projected outturn.

The expenditure-cutting decree reduced expenditure by around R 4 billion, by annulling unspent allocations from the first half of the year, and permitting the Ministry of Finance to list--and have the Council of Ministers withdraw--non-essential expenditures for the rest of 1990. No funds will be allocated to construction projects for industrial use that have not already begun (the social sphere, especially housing, is exempt from this measure), and R 0.6 billion in grant aid to abroad has been cut.

Of the R 12.7 billion in additional spending, R 5.8 billion was voted to liquidate the 1957 loan, R 4.2 billion to cover the cost of higher procurement prices for cereals, R 1.5 billion to cover higher benefits for World War II veterans under the new Pension Law which came (partially) into effect on October 1, and R 1.2 billion for the Chernobyl clean-up. Outlays for foreign activity are also slightly higher than projected.

A complete set of figures for budgets of the republics has not been prepared, but the aggregate data for the Union budget are as follows:

USSR: Union Budget, 1990

(billion roubles)	Approved	Amended	Expected
Revenue	192.2	219.9	211.8
Expenditure	241.3	278.7	278.8
Deficit	-49.1	-58.8	-67.0

The outlook for 1991

Budgets are at present being prepared for all levels of government, though only the Union budget will be passed by the Supreme Soviet. At the beginning of next week, budget details will be sent to government, and by the end of the month the Ministry of Finance will have prepared its report on the 1991 Budget.

However, the budget preparers are working very much in the dark, because the President's Program, presented this week, will have budgetary implications if adopted. It calls for the state budget deficit not to exceed 2.5 to 3 percent of GNP (or R 25-30 billion). The feasibility of such a target has already been called into question, by Boris Yeltsin, who claimed yesterday (in a speech to parliament reported in today's newspapers)that the figure was too low. (Mr. Pushkin noted that the Shatalin program, which called for a zero deficit in 1991, had been too extreme, and was no longer under serious consideration.)

Initial budget requests for 1991, collected from lower levels of government, have been startlingly high, implying a state budget deficit of R 340 billion, if implemented. (Yeltsin denounced these as well, calling them "a crime against the nation".) Even the more realistic outlines being prepared in the Ministry of Finance (prior to incorporation of elements of the President's Program) suggest a big budgetary deterioration next year. The Union deficit would remain around the level of 1990 (i.e. R 67 billion), but given the new revenue-sharing and expenditure responsibility plans, the deficit of the republics would amount to R 100-120 billion, giving an overall state budget deficit of R 167-187 billion. 1/ Such a deficit while it takes into account wholesale price increases, does not assume any increase in retail prices. If retail prices do not change, subsidies could more or less double, to perhaps as much as R 230 billion. It must be noted,

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1/ The revenue-sharing assumptions used are based on Union Laws that have already been passed, notably the "Law on the Distribution of Powers between the Union and the Republics". The budget projection assumes, in general, that all reform laws passed by the Supreme Soviet (for instance, on individual and enterprise income taxes) remain in force during 1991.

however, that Ministry of Finance estimates were made without reports from the Russian and the Baltic republics, and from some ministries (who say they are self-financing and therefore did not even report revenue estimates). 1/

The task of budget preparers is also hampered by not knowing what the distribution of powers between the Union budget and the Republics' will be in 1991. On one extreme, the President's Program stresses the unity of the USSR, with a single market and a single currency, while, on the other, Yeltsin is considering even separate currencies, and borders around the republics. The President's Program envisages that defence, internal security, the single energy system, railroads and other communications, R & D, etc. will remain in the domain of the Union. However, even taking that assumption as given, there is room for differences in interpretation. For instance, the law allocating powers for the single energy system can be understood to imply only that management of the system (today's Ministry of Energy) will be subordinate to the Union, or, immensely more broadly, that the whole energy complex will be the responsibility of the Union. The 1991 draft Budget assumes the latter. And, the draft Budget includes a provision at the Union level for machine-building industries though the President's Program suggests that all machine-building except defence would become subordinate to the republics (implying, if so, a large revision in the budget).

The draft Budget also assumes that centralized measures to improve living standards will be carried out by the Union. However, these could well become the responsibility of the republics. The Budget splits educational expenditures so that all outlays that are important for the USSR as a whole are done by the Union, while, for instance, regular secondary and vocational schooling is run at the level of the republics. In any program, the social insurance system and pension funds will be moved off-budget.

The exact implementation of the new pension Law is still under discussion. While the pension law calls for a contribution rate of 37 percent, this rate is to be phased in only by 1993. Pensions in 1991 can be covered by a 26 percent tax (which would even generate a surplus of up to R 5 billion). One proposal is that the 37 percent rate should be introduced straight away, but 11 percentage points used to finance the economic stabilization funds, which could also receive revenue from a newly introduced tax on depreciation.

Finally, Mr. Pushkin clarified that expenditures on investment are scattered throughout the budget. Included in "investment in the economy" are industrial construction, and non-industrial construction (such as housing), carried out by budgetary institutions. Capital expenditure on defence is part of defence spending; investment in schools and hospitals is in socio-cultural outlays; and some investment activities are covered in "science" and "administration".

1/ Here Mr. Pushkin remarked that he felt the command system was being dismantled too rapidly, with a consequent loss of control by government of the system, its monitoring and its policies.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Fiscal Meeting No. 2
Held at the Ministry of Finance
Thursday, October 18, 1990, 10:30 a.m.
and Monday, October 22, 1990, 10:00 a.m.

Soviet representatives	IMF representatives
Ms. Babureena, Chief of Turnover Tax Department	Mr. Kopits
Mr. N. Grigoriyev	
Mr. Zhoukov, Division Head, Foreign Exchange and Research Dept.	

Indirect Taxation and Foreign Trade Subsidies

Turnover taxes

Ms. Babureena explained that at present turnover taxes are set as variable wedges between fixed retail and wholesale prices. The wholesale price consists of an average producer cost plus a mark-up--the latter ranging between 15 percent and 23 percent. More precisely, the tax wedge is the difference between (a) the retail price less the wholesale and retail margins, and (b) the average cost plus mark-up. More than 80 percent of consumer goods are currently subject to this method of taxation.

Effective January 1991, the mark-up will be set at 25 percent (with some variation permitted between the lowest rate for major urban centers and the highest for remote rural areas) and the average cost will be determined by the most efficient producer of a given commodity. Moreover, the tax wedge will be calculated as a last step, i.e, only after both wholesale and retail margins have been determined.

Ms. Babureena noted that the President's draft guidelines envisage free retail prices on a number of commodities, making difficult the calculation of turnover tax wedges. A list of goods is under preparation for which both the retail price and turnover tax would be set by republic or local authorities. (According to Mr. Zverev, Deputy Finance Minister of the RSFR, the Russian authorities intend to control all retail prices and collect all turnover taxes levied within their territory.) However, to the extent that the increases in key wholesale prices envisaged for 1991 are not matched by retail price hikes, turnover tax wedges will be reduced significantly, resulting in up to a 30 percent drop in turnover tax revenue, to R 80 billion. In any event, an attempt is underway to gradually adopt fixed ad valorem rates for an increasing number of goods. Domestic indirect taxation is not expected to be imposed on imports until the introduction of a value-added tax--scheduled to take place at the earliest in 1993.

Taxation of foreign trade

Mr. Zhoukov clarified the present import tax regime as consisting of three levies: the import tax proper, customs duty, and foreign exchange coefficients (DVK). At present, all three levies operate as wedges between domestic and world prices of imports. This implies that the revenue yield explains most of the difference in the value of imports expressed in ordinary rubles and invaluta rubles. Further, in practice, the import tax and customs duty are hardly distinguishable from each other. Both are determined by the controlled domestic retail price level, so that changes in the foreign price expressed in invaluta rubles alter the implicit tax or duty rate. Neither applies to capital goods imports, but the customs duty has a broader commodity coverage (at lower rates) than the import tax, which is imposed on less than 5 percent of the number of imported--all consumer--goods (at rates of up to 2,000 percent). Mr. Zhoukov confirmed that if there are domestic retail price differentials between domestically produced and imported goods, these are due for the most part to quality differentials.

In contrast, the implicit DVK rates are to be determined by foreign prices, whereby the rate or coefficient reflect changes in foreign prices. Although when introduced, in 1987, the DVK was applied to some 5,000 import items, its coverage has been gradually reduced; presently, it covers only machinery and equipment (including motor vehicles). Mr. Zhoukov observed that neither the DVK nor the import tax nor the customs duty served protective purposes.

The revenue from the three sources of import taxation cannot be disaggregated, except by broad product category. For 1990, the R 36.1 billion projected revenue can be broken down as follows: R. 17.4 billion from nonfood consumer goods, R 7.7 billion from foodstuffs, and R 11.0 billion from other goods. Mr. Zhooorikov indicated that only a small portion of the latter is attributable to the DVK, while the remainder is probably generated more or less evenly by the import tax and the customs duty.

As of January 1, 1991 [or November 1, 1990?], the DVK will be abolished and import taxation will take the form of fixed ad valorem rates. An import tax schedule covering about 200 items [95 commodity groups] was issued on August 13, 1990, under two columns (for goods originating in CMEA countries and for others) with rates ranging up to around 2,000 percent. Although in the future, the rates will not be adjusted to compensate for changes in foreign prices (whether due to changes in the exchange rate or in prices in foreign currency), concurrent with the scheduled depreciation of the ruble (from R. 0.6 to R 1.8 per U.S. dollar) import tax rates are to be reduced. Rates initially set at 300 percent or less will be lowered to zero, and those above 500 percent will be capped at 500 percent, so that they will range from 100 percent to 500 percent. Meanwhile, ad valorem duty rates, with a wider commodity coverage--up to 10,000 items classified according to the BTN--will average 7 to 10 percent [under MFN treatment], ranging up to 100 percent for a few goods. Despite the application of lower rates on semifinished goods, neither the tax nor the customs duty can have a protective role at a time of widespread commodity shortages, according to Mr. Zhoukov. Imports from CMEA partner countries and LDCs will be exempt from the duty.

The level of imports is expected to fall next year because of the foreign exchange constraint. At the current exchange rate, total imports are projected at R 45 billion, as compared to R 64 billion this year. Partly as a result of this decline, but given the offset of the devaluation with the reduction in rates, import tax revenue is projected to reach R 14.6 billion in 1991, made up by only R 2.1 billion from nonfood consumer goods, R 6.6 billion from foodstuffs, and R 5.9 billion from other goods. Customs duty yield is expected to reach R 6.1 billion.

On exports, the DVK coefficients also account for the difference between domestic and foreign prices. Such coefficients are applicable, just like for imports, on machinery and equipment, including motor vehicles. Tax coefficients range around 0.3 to 0.5, for equipment exports to CMEA where prices are relatively high. On the other hand, raw material exports, particularly oil and gas, are subject to implicit export taxation. On average, the implicit rate is around 60 percent, given by the difference between invaluta ruble prices and domestic producer prices. As of January 1991 [or Novmeer 1990?], the DVK system will be abolished also for exports. Consideration is being given to converting export taxes to explicit ad valorem rates on raw materials, but no decision has yet been taken in this area. Mr. Zhoukov mentioned that in 1991 oil and gas are projected to yield R 30 billion (following the devaluation), as any increase in foreign prices is likely to be more than offset by a significant fall in export volume. Mr. Zhoukov did not elaborate on the construction of the estimate, citing confidentiality reasons.

Foreign trade subsidies

Besides taxation, the DVK system involves subsidies both on imports and exports. Export subsidies granted through DVK coefficients include 2.5 for automobiles and 1.3 for trucks. All told, in 1990, out of a total of R 10 billion in budget outlays on these subsidies, R 5-6 billion account for import subsidies and R 5-4 billion for export subsidies. In addition, "subsidies to industry" have been granted for Intourist operations and merchant shipping. Mr. Zhoukov indicated that all such subsidies will be ended in 1991 [or in November 1990?], at the time of the devaluation and adoption of a more flexible exchange rate.

INTERNATIONAL MONETARY FUND

Minutes of <u>Fiscal Sector Meeting No. F.3</u>
Held at the Ministry of Finance
on October 18, 1990 at 2:30 a.m.

<u>Ministry of Finance Representative</u>

Mr. Ametov

<u>OECD Representative</u>

Mr. Hagemann*

<u>IMF Representative</u>

Ms. Cheasty

Social Security

This meeting had several objectives: (i) to clear up some points of detail regarding social security; (ii) to get Mr. Ametov's opinion regarding certain assumptions that might be needed in making medium and long-term simulations; (iii) to request additional data, in particular related to beneficiary populations and benefits; and (iv) reconcile the social security data with the state budget figures. (While much of the requested information was provided, not all data requirements were met.) These minutes are laid out by first presenting the questions posed, and then reporting the answers.

1. During their recent mission to Moscow, our colleagues learned from Goskomtrud that the pension reform proposal for a 37% payroll tax rate had been conditional on the freeing up of prices, so that enterprises could shift these costs to buyers.

   <u>Questions</u>: (a) Can you confirm that this is the case?; (b) Has any decision been reached as to the contribution rate that would apply? (Mention was made of a rate in the 25-26% range.)

   <u>Answer</u>: A decision had been reached to reduce the contribution rate from the planned 37% to 26%, and employees will as originally planned pay 1% from their wage toward social security. These rates would yield approximately Rb 117 billion in 1991. Of this total, 14% will be earmarked for the social security fund, and 86% will be assigned to the USSR Pension Fund. The pension fund will be used to pay (a) pensions, (b) an allowance for children up to age 1.5 (equal to 100% of the minimum wage for working mothers and 50% of the minimum wage for non-working mothers), and (c) the new family grant (equal to 50% of the minimum wage for <u>each child</u> age 1.5 to 6 if the per capita family income is less than Rb 140/month. All other social insurance benefits (family allowances, grants and allowances to low-income families, grants to single mothers, and burial expenses) are to be paid out of the social security fund. Republics will pay, from their own sources of revenue, such items as outlays for retirement homes, allocations to organizations which provide assistance to disabled at home, and the operational costs of local social security offices. These expenses amount to about Rb 2 billion.

2. Concerns have been raised by some union republics about the way in which the funds would be administered. In particular, many prefer that the money collected from the payroll tax remain in the republic in which it is collected, given the diversity of demographics across the

union. It has been suggested that there would be 15 affiliated funds, each republic having its own account with the central pension fund. Can you please elaborate on this?

Answer: For the moment, no republic has the status of an affiliate, as the "Union Treaty" that is currently under debate does not call for this. Goskomtrud remains favourable to the "affiliate fund plan, however. In Mr. Ametov's opinion, if the Russian proposal for social security pensions (see below) is enacted, the USSR plan as adopted in May will not be achievable.

3. Can a table of the state social security budget be provided showing the planned outlays and receipts, along with (a) information with which to accord this with the consolidated (ie. state) budget, and (b) the assumptions on which the projections are based?

Answer: Mr. Ametov provided a table (attached). The estimates for 1991 incorporate no assumptions about inflation or unemployment, and reflect benefit increases associated with policy only. The estimates do not reflect, however, any of the provisions called for in the guidelines proposed by Gorbachev (notably indexation and social assistance). As for a concordance with the state budget, he helped (see below), but suggested that the persons in charge of incorporating social security and social insurance in the state budget be contacted for details.

4. Have medium-term projections for balances of the Pension Fund of the USSR been updated based on the most recent data and policy measures? In relation to these, are the following available: (a) the average wage in each period on which the contribution receipts are based; (b) the number of pensioners and/or the average pension, and some indication of why the total differs from some of the figures provided to us in August (see Table 5 of draft); (c) number of beneficiaries and/or the average benefit of recipients of "allowances"?

Answer: Mr. Ametov indicated he would provide an updated table based on the new contribution rate noted above, along with the number of "covered" workers (ie those against whose wages the contributions are collected).

5. The receipts shown in the 1988r column of the historical table (big table) do not add up. Can this be cleared up?

Answer: Mr. Ametov said he would provide revised tables.

6. To date, separate pension programmes have existed for soldiers (responsibility of the union republics), military officers (in defense budget), collective farmers (law of 1964), and employees and state farmworkers.

Questions: (a) To what extent does the pension reform pull all of these groups? (b) Which remain separate and how are they to be financed? (c) Do the estimates provided to Mr. Kopits in September include these? (d) Are figures available for average military pensions (soldiers and officers) and average pay for these? (e) Are similar data available for kolhkoz workers?

Answer: It has been the clear intention of the overall reform of pensions to bring the population under more uniform pension provisions. The "Law on Pensions" passed in May indeed brings the collective farmworkers into the same programme as employees and state farmworkers. The "Law on Pension Security for Military" was approved by the Supreme Soviet in May of this year at the same time as the "Law on Pensions." Military pensions are to be financed from general revenues.

7. The average replacement rate of state pensioners, including working, non-working and the disabled from World War II, has been declining since the early 1980s. Based on data provided during our mission in August, the following replacement rates, defined as the ratio of the average pension to the average wage, are obtained for 1989 and 1990:

Year	Working pensioners	Disabled WW-II pensioners	Non-working pensioners	All pensioners
1989	0.419	0.195	0.405	0.408
1990	0.392	0.415	0.387	0.392

Question: These are of course based on the basic marginal statutory replacement rate of 50%. Given the fact that the pension reform increases the replacement rate to 55%, the average will increase as well. (a) What is the rate at which the average will settle, and by what year? (b) What are the average wage rates that underlie the table you provided Mr. Kopits in September?

Answer: When he provides the revised simulations of the medium-term outlook for social security, Mr. Ametov will also provide the data needed to calculate average wages and, hence, average replacement rates.

8. Insofar as the pension reform will increase benefits, this is likely to lead to a rise in the rate of retirement among persons who have reached the age of retirement.

Question: Can some indication be provided of the extent to which the government believes this might happen? Do the figures provided to Mr. Kopits during his second trip reflect any presumed increase in the rate of retirement?

Answer: The pension programme on the one hand increases incentives to retire via the higher benefits, but at the same time eliminates the ceiling on the earnings that a pensioners can retain by remaining employed. Thus, no one knows the degree to which these will offset each other.

9. In the past, the number of contributing workers as a proportion of the total labour force has been under 90%. Based on the data for 1989 and 1990 that were provided in August, the figures are as shown in the table below:

	1989	1990
Labour force (LF)	137,900	138,702
Covered workforce (CW)	120,100	118,900
Ratio of CW to LF	0.87	0.86

Questions: (a) To what extent is it reasonable to assume that this ratio will remain constant over the future? (b) If not, to what extent do you expect it to approach 1 ? (c) Can you provide the labour force projections on which the projected surpluses were made? (d) What unemployment rates were assumed in the medium-term simulations?

Answer: It seems reasonable to Mr. Ametov to assume that the ratio will remain stable. He said that he would provide either average wages and/or the number of workers on which the medium-term simulations are based. Lastly, the simulations make no assumptions about unemployment rates.

10. Strictly speaking, the Soviet social security scheme is a pay-as-you-go (PAYG) one; the fact that potential surpluses are projected derives from the immediate introduction of the high contribution rate juxtaposed against a phase-in of benefit increases.

Question: Has the government made estimates of the contribution rate (i.e. payroll tax rate) that would be required simply for pay-as-you-go financing? Have separate estimates been made for each component of social security (pensions, temporary disability, maternity & childbirth, and family allowances)?

Answer: The 26% rate noted earlier is just sufficient, according to their estimates, to yield a small (Rb 1 billion) surplus. Separate estimates have not been made for each category, however.

11. Are estimates available of the replacement rate that is likely to apply in the determination of temporary disability payments? Is it reasonable to assume that the range of 77.3% (1990) to 79.8% (1989) will apply in the future? What are the projected number of days of absenteeism per 100 workers for 1991?

Answer: Mr. Ametov's initial response was that he was glad to no longer have the responsibility for making temporary disability estimates, which will presumably be made in the future by the social security fund staff. He indicated that the replacement rates are likely to rise somewhat, as legislation recently enacted provides for an increase from 50% to 60% of wages, regardless of tenure. Mr. Ametov suggested that the average number of days of sick leave (which appear low to us by international standards) had been falling in recent years.

Question: Can estimates be made available of the number of working and non-working mothers? Are there any estimates of the numbers of beneficiaries of universal child care allowances?

Answer: Mr. Ametov said he would try to get these data, although he could not promise anything.

12. In the tables that were provided in August, there is a source of financing entitled "withdrawals from trust funds." This is to amount to roughly Rb 500 million in 1990. Is this included in the entry in the state budget called "social insurance taxes" ?

<u>Answer</u>: Yes, the use of trust fund resources to finance expenditures has traditionally been classified as social insurance taxes in the state budget.[1]

13. In the state social security budget tables, what are the sources of the receipts entitled "Funds from Union Budget" -- which are apparently "earmarked" to <u>pensions</u> and support for raising children? Where do these sources appear on the state budget?

<u>Answer</u>: In the past, contributions were not earmarked; contributions were included in general revenues, and all social expenditures came from the general budget.

14. In reconciling the figures related to the social security budget and the state budget, there are discrepancies on the revenue and expenditure sides. According to the social security budget, expenditures for 1990 are expected to be Rb 69.4 billion, whereas the sum of expenditures of the budget of state social insurance (Rb 29.0 billion) and social security on account of national social insurance (Rb 41.2 billion) equals Rb 71.0 billion. Likewise, revenues in the state budget are Rb 44.8 billion, while social security data show Rb 43.7 billion.

(a) What is the source of the difference? (b) What are the differences between "budget of national social insurance" and "social security on account of national social insurance?" (c) To what precisely do the Rb 5.6 billion called "other" under social security expenditures in the state budget refer?

<u>Answer</u>: There were subsequent revisions to the table he provided in August, and he would try to get these to me. The differences on the revenue side come from the addition of Rb 0.5 billion in receipts from the sale of tickets to sanitaria, and an Rb 0.5 billion surplus in the trust fund to the state budget. On the expenditure side, the Rb 1.3 discrepancy is the reserve of the budget committee for activities planned for the current year but not yet begun. The Rb 5.6 billion include (i) military pensions for compulsory service, (ii) expenditures on rest homes for the elderly, and (iii) grants to organizations providing assistance to disabled, and (iv) costs of operating local social security offices. These are included in the state budget but not in the social security table because they are paid out of the budgets of the republics. Also in the state budget but not in the social security tables are grants for social insurance to kohlkozes, and support for single mothers & large families. From 1991, these will be in the pension fund and social security fund, respectively.

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[1] Note that in the IMF presentation of the budget, this item should thus be reclassified as "financing."

15. Mr. Pushkin indicated that as of October 1 this year, pension spending for veterans of WW-II have been increased by Rb 1.5 billion.

(a) Where do these show up in the state budget? (b) Does this imply that such spending will be Rb 6 billion higher than would otherwise have been the case? (c) Are they already included in the tables you gave me in August?

Answer: Mr. Pushkin will have to say where the spending is classified. Yes, this is a quarterly rate of increase, so that next year's additional spending for these pensions would be, other things equal, Rb 6 billion.

16. It appears that many of the benefits recently adopted will be means-tested rather than universal. To which benefits does this apply, and how does this affect the replacement rates?

Answer: Mr. Ametov was unaware of any means-testing proposals.

17. The Russian Republic has just enacted a pension programme of its own. Can you tell us about it and how you think it will affect prospects for the union-wide scheme passed in May by the Supreme Soviet?

Answer: Mr. Ametov said that the additional benefits provided for by the Russian pension programme (which passed on a first reading, but may not pass on the second one), would increase pension outlays by Rb 5-7 billion. The benefit increases arise from an increase in the minimum pension to Rb 100 per month (instead of Rb 80) which is not fully compensated by a reduction in the ceiling. He also indicated that the pension would be based on the last 24 months of wages, as opposed to the high (consecutive) 5 from the past 15 years. He does not think that any surpluses in the Russian system, were they to arise, would be transferred to the Pension Fund of the USSR, and that this would effectively kill the chances for implementation of the reform enacted in May. Lastly, when asked if there were any union republics which could not be "self-supporting", he indicated that only 4 (although he said he wasn't sure which) would run deficits.

Current and Projected State Spending on Social Security and Social Insurance
(billions of rubles)

Category	1990	1991
Benefits for single mothers and poor families	2.1	2.2
-- for single mothers	0.8	0.8
-- for children in poor families	1.3	1.4
Grants to institutions & other social security measures	1.5	2.0
Pensions, including those of collective farmers	65.6	88.0
Benefits for raising children to age 1 and a half	5.6	5.6
Benefits for raising children from age 1.5 to age 6	0.8	10.0
Sick pay, maternity, childbirth, burials and outlays for sanitaria stays	16.3	22.0
Benefits to single mothers & one time benefits for birth of a child	-	0.3
Total	91.9	130.1

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Fiscal Meeting No. F.4
Held at the Ministry of Finance
on Thursday, October 18, 1990 at 2:00 p.m.

Soviet representatives	IMF representatives
Mr. Petrov, Budget Department	Mr. Kopits Mr. Wolf* Ms. Cheasty

The meeting was devoted to clarifying various conceptual and data issues regarding the relationship between the budget and the enterprise sector.

1. Budgetary financing of investment

Mr. Petrov said that "budgetary financing of state investment" (Finansy SSSR (1987-88), p. 193) referred to total financing of investment--except for a small amount of capital repair--by the state budget which included: (1) transfers to self-financing enterprises and state organs for investment (so-called Article 24 financing); (2) financing of investment by budgetary institutions (Article 16); and (3) possibly financing of investment connected with deep-well geological drilling. It was the last item that he thought possibly accounted for the fact that the Finansy SSSR figure (which incidentally Mr. Petrov said included all military construction) was regularly several billion rubles higher than the figure in the budget for "expenditures on the national economy: capital expenditures." 1/ He promised to deliver to the staff, later in the mission, a table that would break out "budgetary financing of state investment" among the three categories, for the period 1985-89 (Table 1).

1/ "The expenditures on the national economy" category in general excludes budgetary investment expenditure on military construction, housing, schools, hospitals and certain other outlays, such as those related to science and research and development.

2. Payments of state enterprises and organizations to the budget out of profits

Mr. Petrov explained the breakdown of "payments of state enterprises and organizations to the budget out of profits." 1/

a. Payments against productive basic funds and working capital

These payments, which were to disappear with the advent of the uniform profit tax rate on January 1, 1991, had represented the most universal form of profit tax under the system of "full self-accounting" of enterprises which had been introduced in firms belonging to five ministries in 1987, to an additional twenty ministries in 1988, and to all enterprises by 1989. The payments were established as a fixed rate against the value of fixed assets (or production basic funds (osnovnye fondy)) and working capital of enterprises. The rates were differentiated across enterprises, however, with a maximum rate of 6 percent but lower rates for enterprises with low profitability.

b. Payments for labor resources

These payments would also cease as of January 1, 1991, with the revenues directed to finance infrastructural investment in connection with the employment of state enterprises henceforth to be collected as part of the 23 percentage points (of the total 45 percent) profit tax to be levied by the republican and local governments. This tax had been levied on the basis of individual wages and paid by enterprises, with a basic wage of less than rub 80 a month being exempt and a progressive rate structure applied to higher wages with a maximum rate of 13 percent.

c. Residual profit payments

These payments (vznosy svobodnogo ostatka pribyli) represented the remittance to the budget of "excess" (presumably above-plan) profits earned by those enterprises not yet subject to full self-financing. Because increasingly more enterprises had become self-financing in recent years, revenues from this tax had fallen sharply (from rub 47.1 billion in 1985 to rub 4.8 billion in 1989) and would presumably soon disappear altogether.

d. Deductions from profits (incomes) and other payments

These payments, which were more than twice as high in 1987-89 than in 1985, were said by Mr. Petrov to refer to the taxation of enterprises operating under "special conditions." Examples given were the taxation of "excessive" profits earned by Ukrainian sugar beet processors and defense

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1/ See the budgetary tables; also Narkhoz (1988), p. 624 and Table 2 of Memorandum for Files on the financial position of enterprises of September 11, 1990.

industries which registered very high profitability by producing civilian goods with inexpensive military labor).

3. Other budgetary transfers to state enterprises

Other than capital transfers (section 1), Mr. Petrov could think of only one other category of budgetary transfer to state enterprises and other self-accounting organizations that was more than negligible. This was the category of "operational expenditures" under the heading of "expenditures on the national economy," which amounted to rub 12.7 billion in 1988 and rub 8.0 billion in 1989 and which were "mainly" made to self-financing enterprises and other entities. These consisted of allocations for a wide range of specific activities considered to be in the interest of the union, including geological prospecting, the use of herbicides and pesticides in agriculture, and pest and fire control in forestry. The list of such activities is determined by the Council of Ministers.

Mr. Petrov noted that most, but not all of the "expenditures on the national economy" in the budget were directed to self-financing entities; remainder was allocated largely to budgetary institutions.

4. Behavior of net indirect taxes in 1980-85

Asked why the share of net indirect taxes (turnover taxes less price subsidies) in NMP fell so sharply between 1980 and 1985--from 14.8 percent to 6.9 percent 1/--Mr. Petrov cited two main factors. First, wholesale prices were raised in general in 1982 and given the continued fixity of official retail prices, turnover taxes correspondingly declined. Second, following the May 1983 plenary session of the Central Committee, agricultural procurement prices were raised which contributed to a sharp increase in food subsidies. The decision to raise procurement prices was due to rising agricultural costs of production on account of higher wages and prices for agricultural machinery.

5. Rising shares of enterprise profits in GDP in 1988-89

Mr. Petrov did not have a ready answer for why the share of gross operating surplus of enterprises in GDP had risen by over 4 percentage points of GDP between 1987 and 1989 2/ despite an increase in the share of socialized wages in GDP by 1.5 percentage points over the same period. 3/ He admitted that possibly inflation and the growth of nominal output could have been understated, due to the introduction of bogus new products by enterprises to justify price increases.

1/ See Table R.17 of the background paper on the domestic economy.

2/ Table R.27.

3/ Gross operating surplus rose by a cumulative 25 percent in this period while GDP, in current prices, increased by 12 percent.

6. Enterprise profit and loss figures

Mr. Petrov was unable to reconcile the figures he had provided the August mission on net enterprise profits (i.e., after subtracting losses) and those provided by Goskomstat in Finansy SSSR. 1/ He thought the difference might be attributable to the fact that the Ministry of Finance tables excluded the profits of collective farms (and cooperatives), but closer inspection of the data and consulting Narkhoz (1988) did not bear out this explanation. He said that the Ministry's figures in any event constituted the basis for the payment of various profit-related taxes.

The "losses" recorded in the Ministry of Finance table were, according to Mr. Petrov, "gross" in the sense of being the total losses of loss-making enterprises before their subsidization--which he noted was virtually complete--by the relevant branch ministries. To the extent these losses are not covered by profit redistributions by the branch ministries, they were written-off against the "basic funds" of these enterprises.

Mr. Petrov considered that the "loss" figures in the Ministry of Finance table were significantly smaller than those in the Finansy SSSR tables (rub 4 billion against rub 25 billion in 1989) due to the fact that the former did not include the losses of the collective farms--which he thought were substantial--nor the losses associated with major disasters such as the Chernobyl accident.

7. Enterprise "funds" and the branch ministries

a. Enterprise "funds"

The Ministry of Finance still sets norms for the allocation of enterprise profits and depreciation charges to the various enterprise funds, the most notable of which were typically the fund for production and scientific and technical development, the material incentive fund and the fund for social-cultural measures and housing. Because it sets the norms, the Ministry is interested in the allocation of monies into these "funds," but not particularly in the expenditures from them. The budget estimate for these allocations in 1990 was rub 218 billion. 2/

Asked what accounted for the difference between the deductions from enterprise funds for material incentives (1988: rub 55 billion, excluding collective farms) and recorded premia paid out of after-tax profits (1988: rub 17.5 billion) 3/ Mr. Petrov noted that a long list of other payments

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1/ Table R.26.

2/ Observe that this is much less than the allocation of rub 334 billion in 1989 (Table R.26); Mr. Petrov's figure may have excluded the allocations of collective farms, but it still looks small.

3/ See Memorandum for Files of September 11, 1990 on the financial position of enterprises.

were made out of these funds, including housing loans, catering for night shift work, and so forth.

Mr. Petrov promised to supply the mission a schematic table of the allocation of after-tax profits (Table 2).

b. "Centralized funds"

Historically, the state enterprises had to pay over a certain share of their depreciation charges and after-tax profits to their respective branch ministries. Since 1962 branch ministries had been allowed to redistribute the working capital of enterprises among their subordinate firms and in effect manipulated the enterprises' funds at will--often based on the personal connections between the ministerial and enterprise personnel--as some 15 percent of the reserves in such funds were completely at the disposal of the ministries. The Law on State Enterprises, which went into effect on January 1, 1988, ended the more arbitrary redistributions, enterprises no longer had to turn over a share of their depreciation charge to their branch ministries, and the allocation of after-tax profits to the ministries fell sharply. Nonetheless, allocations to the ministries continued, into so-called "centralized funds," and the losses of loss-making enterprises continued to be covered through allocations to these companies from the "centralized" funds for the development of production, science and technology and to a lesser extent, from the other two major centralized funds. According to Mr. Petrov, such losses had fallen to only rub 4 billion by 1989 (1985: rub 13.2 billion).

Mr. Petrov thought that the Ministry's accounts for these funds did not in general add up--in the sense of the changes in the stock in those funds equalling the difference between allocations to and expenditures from the funds--chiefly due to the shifting of monies from one fund to another. 1/ He did not consider that the change in the ownership status of enterprises (e.g., to cooperatives) had much of an effect in this regard.

As of January 1, 1991, the branch ministries would no longer be able to establish such centralized funds. Asked whether it was not intended to abolish most branch ministries in 1991, Mr. Petrov said he did not know, but that it was necessary to proceed with the budget as if they would still exist in 1991. If it were decided to abolish the branch ministries in the interim, the budget item that provided for them--which, incidentally amounted to no more than rub 990 million, including wage payments--would be eliminated and transferred to the functional ministries. Mr. Petrov did not directly answer the question of what would be the cost to the budget of taking over the burden of supporting loss-making enterprises in the event that the branch ministries were to disappear.

1/ It was unclear why such shifts would still not have been recorded in the flows. Incidentally, Mr. Petrov noted that no data were available on the "centralized" funds for 1986.

The main effect of abolishing the centralized funds, he thought, would be to increase the liquidity of the profit-making enterprises.

8. The 1991 budget

Incidental discussion of the 1991 budget preparation process yielded the comment by Mr. Petrov that it was difficult to elaborate a budget without a quantified price policy. The goal was to restrain the deficit to 2-3 percent of GDP, but Mr. Petrov thought that this was an unrealistic goal. He observed that to halve the 1990 budget deficit of rub 60 billion would necessitate, for example, a complete cutback in budgetary financing of investment, which would run counter to the Parliament's directive to avoid cutting social programs and related investment. Likewise, it was difficult to conceive of achieving actual budgetary savings from a cut in defense expenditures, since there would be a need to spend large sums on the conversion program. Also assumed was continued investment in new state enterprises, to which rub 13.5 billion was allocated in 1990. He thought it was unrealistic to imagine the economy moving to a full-fledged market system overnight.

Table 1. U.S.S.R.: Expenditure of the State Budget on Capital Investment, 1985-89

(In billions of rubles)

	1985	1986	1987	1988	1989
State enterprises and organizations					
Self-accounting	55.9	59.1	63.4	69.0	61.5
Budgetary	14.4	14.7	16.6	16.7	17.1
Subtotal	70.3	73.8	80.0	85.7	78.6
Collective farms	1.7	1.7	1.8	1.4	0.4
Total	72.0	75.5	81.8	87.1	79.0

Table 2. U.S.S.R.: Illustrative Example of the Distribution of Profits of Self-Accounting and Self-Financing Enterprises (Prior to January 1, 1991)

(In rubles)

1.	Profits	1,000
2.	Payments to budget for use of production funds	150
3.	Payments to budget for labor resources	30
4.	Interest payments on bank loans	40
5.	Accounting profits (1-2-3-4)	780
6.	Normative payment to the budget from accounting profits (28 percent)	218
7.	Profits remaining "in the economy" (with the enterprise) (5-6)	562
8.	Transfer to centralized fund for the development of production, science and technology	100
9.	Pure profit (chistaia pribyl') (=7-8; also =10a+10b+10c)	462
10.	Allocations of pure profit to:	
	a. Fund for material stimulation	90
	b. Fund for social development	120
	c. Fund for development of production, science and technology	252

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Fiscal Meeting No. F-6
Held at Gosplan
Monday, October 22, 1990 at 9:30 a.m.

Soviet representatives

Mr. Regakin
Mr. Ogorokov
Mr. Stepanov
Mr. Dybzavina
Mr. Fomichev
Mr. Petrov
Mr. Salo
Mr. Ananiev
Mr. Elistratov
Mr. Martanov
Mr. Xolmogorov

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Kopits
Mr. Wolf
Ms. Christensen
Mr. DeMilner
Ms. Cheasty*

OECD representative

Mr. Hagemann

Prospects for 1991

This meeting covered the economic outlook for 1991. Another minute has been written, covering all but the fiscal aspects of the meeting. This note confines itself to budget issues.

The state budget in 1991

Among the emergency measures in the first stage of the program envisaged in the President's Guidelines is a sharp cut in the budget deficit, to 2 1/2 - 3 percent of GDP, from its 1990 level of 6.3 percent of GDP (according to the USSR presentation). Mr. Petrov agreed with Mrs. Ter-Minassian that several problems stood in the way of achieving such a deficit target.

1. Enterprise tax reform, implying a fall in the effective tax rate, may be expected to cost the budget rub 40 billion.

2. While wholesale prices are to rise definitely and immediately, the pace of retail price increase is to be gradual and appears not to be envisaged at all for the main commodities that are currently subsidized. Thus subsidies will have to rise, and turnover tax will fall. The cost to the budget of the increased subsidies is estimated at rub 50 billion, of which rub 10 billion is on account of the increases in procurement prices that became effective on October 1, 1990 (i.e. one quarter earlier than the other intermediate price adjustments). Foregone turnover tax is estimated at rub 30 billion.

3. The reform of pensions and extension of social assistance, including unemployment benefits, is likely to have budgetary costs. 1/

4. Increases in interest rates may be expected to have an effect on government debt service.

Added to last year's rub 60 billion deficit, the first two issues alone (tax and price reform) imply that the 1991 deficit, without policy change, will amount to rub 180 billion.

Recognising the inconsistency, technicians have begun to shape policies to bring down the deficit.

1. A major policy will be a sharp cut in budget-financed investment. Investment will be shifted to enterprises, who can finance it from bank credit. The banking sector will be in a better position to oversee it and assess its potential rate of return. A cut of rub 15 to rub 17 billion in state budget investment is envisaged (though officials cautioned that from now on they could speak only for the Union budget, and republics might prefer a higher investment budget).

2. Enterprise performance is expected to improve radically in 1991, so that subsidies to loss-makers can be cut by 80-90 percent. These subsidies at present amount to rub 5-6 billion.

3. Costs of administrative personnel are to be cut by around 30 percent, with a saving of up to rub 2 billion. The reform of the structure of government has been going on for some years. Now, some more ministries will be eliminated, and the personnel of branch ministries will be cut back (perhaps transferred to their subordinate enterprises).

4. Expenditure on science will shift from applied research to basic rub & D. This should allow for some saving.

5. Defence expenditure will be cut in accordance with international treaties. The benchmark figure for cuts is 1988. By the end of 1991, procurement has to be 19.5 percent lower than 1988, and the draft budget has been prepared consistent with this target. However, all of the reform programs have envisaged even more drastic cuts: Shatalin wanted defence expenditure to be cut by 20 percent overall; and the President's Program wants defence to be cut by rub 5 billion in nominal terms, compared with 1990. Ryzkhov has now asked Gosplan and other ministries to prepare cuts of rub 5-7 billion.

1/ To some extent, the budget costs of the pension reform show up indirectly, because the new wholesale prices were constructed at least in part to incorporate the increase in payroll tax exacted from enterprises to finance the reforms in social programs, with the idea that, thus, enterprises could pass on the tax. Had the wholesale prices been reflected in increased retail prices, the public would have financed its own social programs. As it is, however, the budget in effect finances the whole of the expanded social schemes.

6. State financial assistance to other countries is to be cut by the maximum. The target is that loans should not be greater than the repayment flow. This would allow a cut of around 70 percent in concessional aid.

7. The authorities are going to re-examine tax preferences in areas such as banking, research, charities, etc. Cuts in these preferences, however, would be difficult to implement, because the new tax laws, so recently adopted, would be difficult to amend.

On the broader issue of price liberalization, no decision has yet been made, nor on any accompanying policies, such as income compensation to the population affected by withdrawal of subsidies. If prices were liberalized, the incomes arising from the higher prices would have to be distributed between the state and the people. Officials were at present studying a sales tax that would capture revenue from free prices. What was most likely was that prices would be liberalized stage by stage, starting with luxury items and non-essential consumption goods, for which price hikes would not need to be compensated.

The planned stabilization funds (which in the President's Program are to be set up both at the Union and republics' levels) should not be a drain on the budget, because they are to be financed by destatization of property and perhaps by new contributions from enterprises. Together, the funds should not amount to more than rub 10 billion.

Mrs. Ter-Minassian noted that, on a deficit that looked as if it might reach rub 180 billion, savings of, at most, rub 40 billion had been identified. Such a deficit, equivalent to 14-15 percent of GDP, would most definitely create a large jump in prices. Hence, the conclusion was inescapable that, if the President's Program deficit target was to be achieved, drastic action on prices and the turnover tax would be required, to cut at least 100 billion from the budget. Gosplan officials agreed that, as things stood, the target deficit could not be met.

INTERNATIONAL MONETARY FUND

Minutes of Fiscal Sector Meeting No. F-7
Held at Goskomstat
Monday, October 22, 1990 at 3:00 p.m.

Goskomstat Representatives	OECD Representative
Mr. Guriev Mr. Isupov Mrs. Manykina	R. Hagemann

The principal purpose of this short meeting was to collect from authorities population data which I had requested by phone during the previous week. As promised, Mrs. Manykina provided me with total fertility rates and population by age groups for the Soviet Union as well for each union republic. Unexpectedly, I was also given population projections (to 2016) for each republic and the union.

I took the opportunity to discuss very briefly some social statistics. Mr. Guriev said that the Soviet Union's approach to the measurement of poverty is based primarily on the minimum consumer budget. The latter is a mix of normative and observed measurement. The normative component is the food budget, the cost of which is estimated for various locations based on state prices and Health Ministry standards for nutritional requirements. While this varies between republics, the average for the union is estimated at Rb 42 per month. A poverty line is then drawn at the level of income at which the absolute food expenditure is equal to that in the minimum budget. Based on the available data, Mr. Guriev indicated that this income level is around Rb 100-120 per month. On the basis of this, about 43 million people would be considered to be in poverty. Two thirds are thought to be in the middle asian republics and Azerbaijan. However, the estimates are distorted by the fact that many persons have to purchase food from collective farms, where there is greater availability than in state stores but where prices are higher. While the poverty line differs across the USSR, any compensation will be based on the determination of poverty lines using the same methodology in all republics. Also, an all-union minimum should be guaranteed.

INTERNATIONAL MONETARY FUND

Minutes of Fiscal Meeting No. F-8
Held at Gosplan
Wednesday, October 24, 1990 at 1:30 p.m.

Gosplan Representative	OECD Representative
Mr. Ananiev	Mr. Hagemann*

This meeting was aimed at obtaining information on Gosplan's estimates of the potential cost of unemployment compensation and social assistance in 1991. Unfortunately, because of the limited amount of time that was available, it was not possible to go into sufficient depth. There has been a follow-up by telephone via the Chief of Protocol at Gosplan, Mr. Zhelizniak, and hopefully the information will be available in a brief delay.

Unemployment compensation

Mr. Ananiev indicated that in 1990 there are approximately 2 million unemployed, according to Goskomstat. This refers mainly to women looking for part-time work and about 100,000 high school graduates who failed to enter university and who are looking for a job. The 2 million figure is a weak estimate, he said, as there exist no outlets in which job-seekers to register.

For 1991, Gosplan had two scenarios. The first, the so-called "shock therapy" scenario, would result in 40 million unemployed. In the second, which corresponds to the Gorbachev "guidelines," there would be 6 to 8 million unemployed. But this refers to the labour turnover -- the flow each month. Over the year, as many as 70 million (8 times 12) will have been unemployed for a short while. He said that Gosplan expected several policies to "help relieve the problem," such as the law on pension (i.e. increased retirement rates), and the various increased payments to single mothers and poor families with children. In other words, they hope to alleviate the problem by reducing the size of the labour force.

Mr. Ananiev said that they estimated the cost of unemployment compensation and retraining at Rb 5 billion in 1991, of which 50% would be for retraining, Rb 300 million would be earmarked for the creation of public works jobs, and the remainder would be for direct cash assistance. I indicated to him that this figure seemed too low, but that this may be because the projected number (ie the stock) of unemployed seemed low.

I also asked what the replacement rate would be. Mr. Ananiev said that there was considerable debate underway on this issue, and that it has not yet been settled by the Supreme Soviet. Goskomtrud prefers a 50% replacement of the tariff wage, while the trade union wants a 50% replacement of full compensation (including bonuses). The latter would raise the Gosplan estimate by 2 to 3 times.

As for financing, there are currently two proposals being debated. The first would have enterprises and organizations pay 1% of the wage fund, but the source would be profits (this is Goskomtrud's preference). The second, proposed by the trade union, would be 1% of state budget expenditure, but no specific source of financing was specified. I asked if it was fair to say that there was an implicit suggestion to use general revenue in this proposal, Mr. Ananiev agreed.

<u>Social assistance</u>

Mr. Ananiev said that work was still underway on draft legislation on indexation. According to the law, he said, all categories of the population are to be compensated for price increases. The population was being disaggregated into three categories:

(1) <u>low income</u> families, which are those in which income per capita is less than or equal to Rb 70 per month. This group would get 100% compensation.

(2) <u>middle income</u> families, in which family income is about Rb 260 per month (or, he said, about Rb 150 per capita per month), would get 70% compensation.

(3) <u>high income</u> families, in which per capita monthly income exceeds Rb 200, would get 30% compensation.

Mr. Ananiev said they estimated the cost at Rb 15 billion, on the basis of an 8-10% inflation rate. He said that there are approximately 40 million persons considered to have low income, and that about 35 million are considered to have average income. Mr. Ananiev said he would provide figures for each of the three groups.

INTERNATIONAL MONETARY FUND

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Held at Gosplan
Wednesday, October 24, 1990 at 1:30 p.m.

Gosplan Representative	OECD Representative
Mr. Ananiev	Mr. Hagemann*

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Unemployment compensation

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For 1991, Gosplan had two scenarios. The first, the so-called "shock therapy" scenario, would result in 40 million unemployed. In the second, which corresponds to the Gorbachev "guidelines," there would be 6 to 8 million unemployed. But this refers to the labour turnover -- the flow each month. Over the year, as many as 70 million (8 times 12) will have been unemployed for a short while. He said that Gosplan expected several policies to "help relieve the problem," such as the law on pension (i.e. increased retirement rates), and the various increased payments to single mothers and poor families with children. In other words, they hope to alleviate the problem by reducing the size of the labour force.

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As for financing, there are currently two proposals being debated. The first would have enterprises and organizations pay 1% of the wage fund, but the source would be profits (this is Goskomtrud's preference). The second, proposed by the trade union, would be 1% of state budget expenditure, but no specific source of financing was specified. I asked if it was fair to say that there was an implicit suggestion to use general revenue in this proposal, Mr. Ananiev agreed.

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(3) high income families, in which per capita monthly income exceeds Rb 200, would get 30% compensation.

Mr. Ananiev said they estimated the cost at Rb 15 billion, on the basis of an 8-10% inflation rate. He said that there are approximately 40 million persons considered to have low income, and that about 35 million are considered to have average income. Mr. Ananiev said he would provide figures for each of the three groups.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Fiscal Sector Meeting No. F.9
Held at the Ministry of Finance
Wednesday, October 24, 1990 at 2:00 p.m.

Soviet representatives	IMF representatives
Mr. Barchuk	Mr. Kopits
Mr. Pushkin	Ms. Cheasty*

Scenarios for 1991

The meeting concerned analysis of a discussion table (attached) prepared by the fiscal team showing options for 1991. The four columns of the table show the Ministry of Finance expected outturn for 1990 (on which the team's projections were based); some partial projections by the Ministry of Finance for 1991, together with the deficit (R 167 to R 187 billion--USSR presentation) the Ministry earlier said was implied by these projections; the team's scenario for 1991 that was based on the 1990 expected outturn but incorporated elements of the President's Guidelines; and a "policy-adjusted" scenario, that indicated, in the roughest of form, some measures that might be taken to reduce the large deficit implied by the President's Guidelines.

The team first cautioned that while its scenarios were based on Ministry of Finance data for 1990, there were still some questions outstanding about those figures. Mr. Barchuk confirmed that the unidentified "other revenue" was expected to be at least as high in 1991 as in 1990 (an exceptionally high year).

Column 3: the scenario under the President's Guidelines

The scenario incorporating elements of the President's Guidelines but making no effort to reduce the implied deficit, starts with an assumption of a year-on-year average 35 percent inflation rate--assumed necessary to absorb the inflationary overhang in the course of the year. Real output is assumed to fall by 5 percent. Wages are to be indexed by 70 percent of price increases, and pensions 100 percent. The nominal interest rate is to be held at 10 percent, consistent with a 15 percent rate on time deposits. Social assistance is to be offered to compensate for any removal of subsidies. Unemployment benefits are to be offered to all unemployed (assumed in the scenario to be 10 million--consistent with the Shatalin Plan's estimate).

The main message of the scenario is that the President's Guidelines (and the new Pension Law) grant generous social support without providing any financing (other than indirectly through the price rise implied by the subsidy cut). Thus, the budget is just as badly off as in the Ministry of Finance's base-line projection--the USSR presentation deficit in column 3 is R 160 billion. Since the price rise is assumed to follow from the subsidy cut, the fact that a budget based on that price rise generates such a large deficit (which would presumably have to be financed by credit, thus unleashing a further round of inflation) implies that the scenario in column 3 is inconsistent with its assumed macroeconomic context, and could not be realized.

a. Revenue. Wage indexing would raise individual income taxes. Enterprise profit taxes would grow with nominal GDP but be hurt by the assumed fall in the effective tax rate (from 49 percent to 37 percent between 1990 and 1991) and the imposition of the 20 percent tax on depreciation. (Surprisingly, the officials did not allow for the deduction of the depreciation tax beyond the underlying depreciation.) Though the 67 percent increase in tax revenue from cooperatives could be regarded as optimistic, the officials confirmed that they expected around that much. The projection's estimate of social insurance contributions--set at a 26 percent rate--happened to be the same as the authorities', because the Ministry of Finance projected a 24.7 percent increase in the wage fund, which the mission felt could only happen if there was 70 percent indexing. The effect of autonomous wage-push, said to be important, could be assumed to be offset by a rise in unemployment. (However,more precision about the meaning of the wage fund projection would be valuable.)

Projections of turnover tax and subsidies were a particularly weak element in column 3. The team agreed with the authorities that the budgetary impact of subsidy and turnover tax changes would depend crucially on the retail price level and the commodity composition of the changes. The mission's turnover tax projection was based on that of the Ministry of Finance (column 2), assuming that the Ministry had correctly taken compositional aspects of the wholesale price change into account, and simply relaxed the assumption of a fixed retail price level by the 35 percent retail price inflation rate. Revenue from foreign activity was taken directly from Ministry estimates, as was the new depreciation tax.

b. Expenditure. The team recognised that the authorities intended to cut investment, but felt that price increases, and the impact of the devaluation on the cost of capital imports, would mean that investment could not possibly fall in nominal terms. (Mr. Barchuk's personal opinion was that it might be even higher.) Direct subsidies were assumed cut in half, but this estimate should be refined by more information about the share of subsidies to loss making enterprises therein, and precision about intended cuts of that element.

The projection of price differential payments (R112 billion lower than that of the authorities) was greeted with disbelief--particularly given the assumed 35 percent price increase. Mr. Kopits explained that consistent with this average inflation rate (composed of an initial much higher retail price adjustment followed by asignificant deceleration in the rest of the year), the prices of subsidized and imported goods were assumed to rise at higher rates, and those of goods subject to turnover tax at a lower rate--i.e. a relative price adjustment. Specifically, the estimated R 68 billion assumes that all price subsidies are removed except for those on meat and dairy products, which were assumed to remain unchanged as a ratio of their own retail prices.

The defence calculation incorporated the 14.1 percent cut in procurement necessary to meet the 19.5 percent target cut by the end of 1991, indexed military wages by 70 percent and military pensions by 100 percent. Mr. Barchuk said he was wholly in agreement with the estimate. Projections for the pension plan and existing social programs were based on Ministry of Finance estimates, but assumed that benefits were 100 percent indexed (except for earnings-linked maternity leave and sick pay, which were indexed like wages). The new social assistance program assumed that around 100 million people (i.e. the means-tested population) received R 400 roubles a year, indexed by 100 percent of the 35 percent price increase--admittedly the weakest figure for a major expenditure category. Expenditure on foreign activity assumed that all trade and "industrial" subsidies (to Intourist, cruise shipping lines, etc.) disappeared, and that unilateral foreign aid (very small) was cut in half. Interest payments on domestic debt were calculated at the assumed 10 percent rate (approximately, with no cost of financing the 1991 deficit assumed to fall due during the year), except for interest on agricultural price subsidies, which is included in Gosbankas credit to enterprises, and was therefore assumed to bear a 15 percent rate.

Unemployment benefits were calculated as the minimum wage paid to 10 million people for half a year. (More precision about the relationship between the minimum wage and intended benefits would be valuable. The President's Guidelines appeared to imply that unemployed workers would receive at least the minimum wage, in which case our estimate (though high) might be conservative.) Expenditure for the stabilization fund was fully matched by the earmarked depreciation tax (i.e. ignoring the suggestion that the additional 11 percentage points of the social insurance contribution might be earmarked to the fund as well), and the outlays for Chernobyl and Aral were the authorities' figures.

<u>Column 4: scenario with policy options</u>

Column 4 builds on Column 3, but assumes certain important policy measures are taken. These are, in sum: a shift of the turnover tax to explicit ad valorem rates, at the 1990 effective rate; the extension of the turnover tax to imports (while removing the import tax); scrapping the depreciation tax; imposition of a dividend of 25 percent on after-tax profits of state enterprises; and a further halving of price subsidies on meat and dairy products. Taken together, these measures could ensure the virtual elimination of the deficit. However, the team cautioned again that its estimates were exremely preliminary, and the numbers could be taken only as the sketchiest of guidelines.

The same macroeconomic assumptions are used in column 4 as in column 3, notably, the 35 percent retail price increase. However, since, in this scenario, the government has no recourse to deficit financing, the plausibility of the assumed price increase is enhanced. (Again, the officials expressed reservations, noting that the further halving of subsidies would definitely require price rises in the order of 300 percent for staple foods with an important weight in the price index. Mr. Kopits defended the scenario as being composed of a large up-front jump in prices,followed by decline during the rest of the year, thus averaging inflation to 35 percent for the period as a whole.)

a. Revenue. Enterprise profit tax is slightly higher than in column 3, because this scenario assumes the depreciation tax is not imposed, thus raising profits. The turnover tax was calculated as the effective rate of 1990 (around 34 percent) on the base "MNP shares of industry and internal trade", excluding the turnover tax component of the base. (The authorities confirmed that this base, R 465 billion, was close to their measure of commodity trade turnover in current prices, R 420 billion.) Turnover tax on domestic trade would thus generate R 158 billion. 1/ To this amount was added turnover tax (of R 22 billion) on a base of manufacturing imports less exports (taken as R 44 billion in 1991, after devaluation), at an average rate of 50 percent, given the more highly taxed composition of goods.

The application of a turnover tax to imports would more or less require the elimination of the price differential revenue system on imports (the equivalent for external trade of the turnover tax price differential system on internal trade). This was a necessary first step in the harmonization of a broad based turnover tax, which would eventually contain much fewer rates, applied without discrimination on imports and domestic goods. High-yielding goods such as alcohol, cars and petroleum products could be subject to excises on top of the turnover tax.

The estimate of export tax used in the scenario had been based on the mission's balance of payments projections, notably for oil, assuming that, after the devaluation, oil receipts would be R 90 billion (given a price of $30 p.bbl). The authorities warned that this estimate would have to be revised downwards, as they expected large shortfalls in oil exports in 1991--to which the team agreed. The team also felt that, at least in the first year or so after the devaluation, export tax could be maintained, at its apparent present effective rate of 60 percent, on raw material exports for which no supply response to a price change can be expected for some time. For such goods, a devaluation implies a windfall gain,which may as well be captured by the government rather than going to traders.

The officials were particularly intrigued by the proposal of a dividend, which, Mr. Kopits reminded them, had been adopted with apparent success by other countries in the transition to a market economy. The team pointed out that in no country, East or West, was a firm free to dispose of more than half of its profits (specifically in the USSR: 55 percent or 63 percent, depending on whether the statutory or the effective tax rate is considered). The user of after-tax profits is the owner of the firm, and it would be foolish of the owner, just because he happens to be government, to forego his rights to the surplus of the firm. While a dividend payment should be based on risk-sharing, and therefore should not be fixed, it was likely that, for the USSR, where no market existed, that a rule-of-thumb dividend share would have to be adopted in the first instance--such as 25 percent of after-tax profits.

The authorities wondered about the political reaction to such a proposal, given the recent legislation governing the taxation of

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1/ There is probably a margin for higher tax here, as the same nominal growth assumptions were not used.

enterprises. The team explained that a dividend requirement should not be seen as a tax, but should be put in the context of a broader scheme to prepare state enterprises for destatization and privatization. The design of a framework where the enterprise was converted into a joint stock company, wholly owned by the government, which received a profit on its stocks, would (a) create the shares, and (b) give at least a preliminary indication of the value to be expected from these shares, would set the stage for sale of shares to the emerging private sector and to foreign investors. Needless to say, as the shares were taken over by non-government owners, budget revenue from the dividends would disappear--hopefully to be replaced by higher profits from a more buoyant private productive sector. In sum, the dividend proposal was likely to be successful if and only if it was envisaged as part of the necessary overall transformation to a private market. The Soviet officials indicated that they saw some merit in the proposal and would recommend this measure to their superiors in the Ministry.

b. Expenditure. The only explicit expenditure cut was the assumed further halving of food subsidies, to R 34 billion. However, some tightening on social assistance was implicit, given that the R 50 billion in income compensation was not adjusted to cover the extra subsidy reductions.

The subsidy cut brought the deficit down to more or less zero, while, without it it would have remained at R 30-40 billion--the target of the Presidential Guidelines. The immediate relation between the choice of subsidies and the deficit only highlighted the inescapable link between the financial policy set for 1991 and pricing policy.

25-Oct-90

USSR: State Budget Operations

(In billions of rubles)	MoF Est. 1990	MoF Proj. 1991	IMF Proj. 1991	Policy-adjusted 1991
Revenue	423	...	515	657
Income taxes on individuals	47	...	58	58
Enterprise profit tax	118	113	110	115
Cooperatives' income tax	6	...	10	10
Social insurance contributions	45	120	120	120
Turnover tax	123	80	108	180
Revenue from foreign activity 1/	52	...	63	90
o/w Export tax	16	...	42	80
o/w oil and gas	12	...	30	54
Import tax	33	11	15	0
Customs duty			6	10
Depreciation tax	--	--	13	--
Dividends	--	--	--	50
Other revenue 1/	34	...	34	34
Expenditure	498	...	686	652
Economy	196	...	160	126
o/w investment	42	29	42	42
subsidies (direct)	17	...	8	8
price differentials	96	180	68	34
Defence	71	71	84	84
Socio-cultural	164	...	322	322
o/w pensions	66	135	119	119
other exist. soc. programs	26	}	55	55
new social assistance	--	--	50	50
Expenditure on foreign activity 1/	19	...	13	13
Interest (internal)	6	...	30	30
Unemployment benefits	0	...	26	26
Stabilization fund(s)	0	...	13	13
Chernobyl + Aral	0	11	11	11
Other 1/	41	...	28	28
Overall balance	-74	...	-171	5
(In percent of GDP)	-7.8%	...	-13.9%	0.4%
Memorandum items:				
Overall balance (USSR pres.)	-58.9	-167/-187	c. -160	c. +20
GDP (current prices)	959	...	1230	1230

1/ Adjusted to remove financing items

To PI
cc: GL-done

INTERNATIONAL MONETARY FUND

USSR.: Staff Visit, October 17-26, 1990

Minutes of Monetary Meeting No. M.1
Held at Gosbank
Wednesday, October 24, 1990

Soviet representatives	IMF representatives
Mr. Mozhaiskov	Mrs. Ter-Minassian
Mr. Balagurov	Mr. Calvo
	Mr. Blejer*
	Mr. Flickenschild
	Mr. DeMilner

In response to a question by Mrs. Ter-Minassian on the prospective stance of monetary policy in 1991, Mr. Balagurov said that it was Gosbank's intention not to provide financing to the budget and to reduce credit to the economy. The tightening of credit policy would be supported by an increase interest rates to be implemented no later than January 1991. For next year in preparing the monetary plan, a decline of economic activity is assumed but from the presidential program it is not clear what will be the needed volume of credit to the economy. The precise quantification of credit targets will only be available in November.

Mrs. Ter-Minassian asked how much of the price increases of next year should be accommodated by monetary expansion. Mr. Balagurov mentioned that Gosbank has worked with two alternative programs of reform. On the assumptions of the government program, inflation would be 25-30 percent. It was difficult to predict how high inflation would be if there was extensive price liberalization.

Mrs. Ter-Minassian said that the presidential program will entail, in all likelihood, a large jump in retail prices. The question is: what would be appropriate degree of monetary tightness, given the existing excess liquidity in the system? Mr. Balagurov said that a tight monetary policy is required but pressures will certainly arise. There is a huge stock of inventories in the economy (rub 500 billion) financed by own resources (one-third) and by bank credits and inter-enterprise credit. A tight monetary policy could help reduce the hoarding. The interest rates on credit to finance inventories rose from 6 to 15 percent in the last two years without results. So it is necessary to have a tight monetary policy which would have to be implemented by direct credit ceilings and limits on refinancing. In Mr. Balagurov's view interest rate policies alone will not be effective. Regarding the suggested freezing of enterprise deposits, it was considered a few years ago. After 1986 enterprises started accumulating resources and deposits. The Ministry of Finance wants to use these resources which enterprises are not fully using. The Gosbank does not support this approach given the different situation of different enterprises and because it will increase the need for credit. It is better to create conditions for enterprises to use their excessive financial resources in acquiring State Bonds. Rumors about freezing enterprise deposits reduce confidence in the State (and increase demand for inventories and made interest rate policies less efficient). Mr. Balagurov said that interest rate increases should occur in stages. The first increase should be made administratively, and should follow prices closely. Deposit rates should increase to the level of inflation expected now. Later perhaps deposits of the population should be indexed. But Gosbank's room for maneuver in this respect is bound by government declaration that the deposits of the population should not suffer from the price increases. Regarding the cost of indexation, Mr. Balagurov said that the initial cost will be borne by the Government but after that by a higher interest on credit to the economy. In principle, the higher cost of deposits will have to be passed to the banking system and ultimately to the enterprises.

Mr. Balagurov regarded the stock problem of the monetary overhang less important than the flow problem of the monetary impact of large budget deficits. Fifty percent of credit resources are currently directed to the budget.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. 1
Held at Goskomstat,
October 17, 1990, at 11:00 a.m.

Soviet representatives	IMF representatives
Mr. Nevzorov, Deputy Chairman	Mr. Calvo
Mr. Ostrovskiy	Mr. Flickenschild
	Mr. Wolf
	Ms. Christensen*

Mr. Wolf presented a draft of the background chapter on the domestic economy and its statistical appendix to the Soviet representatives and requested comments by the following week. The meeting focused on developments during the first nine months of 1990 and projections for the year (a paper on the 1990 projections was given to the staff and was used in this summary to supplement items covered in the discussion). The discussion covered (1) recent economic trends; (2) macroeconomic developments; (3) sectoral developments; (4) other developments; and (5) statistical issues.

1. Recent economic trends

Economic activity had continued to slow down during 1990 and the situation by mid-1990 was much worse than at the beginning of the year. Contractual obligations within the country were frequently no longer fulfilled, partly because of the increasing conflicts between the union and the republics. Industrial production was adversely affected by lack of work force discipline and strikes. Barter agreements between republics had become much more prominent. There was no improvement in sight in the foreseeable future. Recent shortages of goods had affected mainly inputs for the textile and tire industries as well as medical supplies. The tobacco shortage had stabilized in Moscow due to the introduction of a rationing system and increased supplies from abroad. There was severe shortage of sugar because sugar production had stopped in Ukraine and no shipments were taking place outside the Republic. The bread situation was improving in Moscow, but noodles were in short supply. There were still supplies of meat although only of poor quality. Over the next three months, it might become necessary to ration food to secure the supply for the low-income segments of the population.

2. Macroeconomic developments

For 1990 as a whole, production was projected to decline: GDP by 2 percent; productivity by 2 percent; industrial production by 1.5 percent; construction by 5 percent; transportation by 4 percent; and housing construction by 4 percent. For the first eight months of 1990 the deficit of the state budget amounted to rub 14.8 billion. Because of necessary additional expenditures which had been decided on but which would be carried out only in the last quarter of the year, the planned deficit for 1990 (rub 60 billion) would be somewhat exceeded. Domestic debt of the budget was projected at rub 500 billion on September 1, 1990 or 3 1/2 times the 1985 level. Credit for investment which amounted to rub 364 billion on September 1, 1990, was likely to reach rub 396 billion by December 31. Money incomes of the population during January-September amounted to rub 461 billion and had risen by 14.4 percent compared with the same period of 1989 against a plan target of 7.1 percent. Outlays for consumer goods and services rose by 13.7 percent during the first nine months. The incomes of the population exceeded consumption and payments to the financial system by households by rub 46.7 billion over the same period. For the year as a whole, it was expected that incomes would rise by 14.5 percent, or by rub 80 billion to rub 640 billion. Savings deposits of the population with the Savings Bank would likely reach rub 370 billion. the increase in currency in circulation had been targeted at rub 10 billion for 1990, whereas the actual rise already amounted to rub 19.3 billion during the first nine months. Retail trade was projected to rise by rub 55 billion to rub 460 billion in 1990 (13.7 percent).

From January to September 1990 consumer prices rose by 3.7 percent (goods: 3.8 percent; services: 3 percent). State prices (accounting for 93 percent of goods sold) rose by 3.6 percent; cooperative/contract prices (2.4 percent of goods) by 6 percent; and collective farm prices (2.6 percent of goods) by 24 percent.

In foreign trade, the deterioration in the domestic economy had reduced the export potential. In addition, the changed social-political situations in the East European countries had negatively affected economic relations. Exports were projected at rub 65 billion representing a decline of 5-6 percent compared with 1989; and the decline might be even larger. Exports to the CMEA were expected to fall by almost 12 percent, and those to capitalist countries to increase by 6 or more percent. Imports were projected to increase by 3.5 percent to rub 74 billion reflecting mainly increases in imports of consumer goods, equipment for the textiles and food processing industries, chemicals, and medical supplies from non-CMEA countries. Grain imports of 40 million tons had already taken place (mostly from the United States and Canada but also from Argentina and Australia).

The commodity structure of exports was improving only slowly. The share of machinery and equipment would rise from 16.4 percent in 1989 to 19 percent in 1990, but the share of energy raw materials was also increasing, due to oil price movements, from 51.7 percent to 54.5 percent. The share of consumer goods in imports would increase from 31 percent to 35 percent and machinery and equipment from 39 percent to 41 percent on account of stepped-up purchases of equipment for the light and food industries. Technical assistance to foreign countries, in the form of construction projects, would amount to rub 3.2 billion in 1990, or 11 percent less than in 1989.

3. Sectoral developments

Industry: Overall production was projected to decline in 1990 by 1.5 percent. Production of consumer goods (group B) was likely to increase (4 percent), while the output of means of production (group A) was expected to fall by 3 percent. Production of appliances and other nonfood goods would rise by perhaps 17 percent, primarily reflecting military conversion. Industrial production of agricultural equipment and of medical instruments also rose significantly because of military conversion (e.g., food processing by 28 percent). By contrast, production of foodstuffs, wood products, and machine tools would remain almost unchanged and that of light industry would decline by 2 percent because of shortages of raw materials and labor.

The growing problems in the production of group A were likely to act as a future restraining factor for the growth in consumer goods production. The most alarming development was the projected decline in both oil and coal production of about 5 percent. Moreover, the prospects were for a continued decline. Metallurgical output was expected to fall by 1 percent for rolled products and 3 percent for steel pipes. Production of many basic chemicals was down by 3-8 percent from 1989, which in turn was affecting the output of various synthetic chemical products. In the machine-building sector, output of various types of transportation equipment (e.g., railway passenger cars, tractors) would decline, while other products such as automobiles would be produced at the same level as in 1989. Various other types of machinery, on the other hand, including agro-processing, light industrial and medical equipment, were registering large increases in output, again due to the military conversion program.

Agriculture: The grain harvest was projected at 240 million tons in 1990 against 225 million tons in 1989 (the initial projection of 300 million tons had proven exaggerated). After processing, the grain output would be 212 million tons or 15 million tons higher than in 1989. The average yield was expected to have risen by 5.3 percent.

Other projections included:

	1990 In millions of tons	Comparison to 1989
Vegetables	29	28.7
Fruits/berries	10	9.7
Sugar beets	87	97.4
Sunflower seeds	6.5	7.1
Potatoes	70	70.2
Tobacco	215	239
Cotton	8.6	8.6
Meat (all categories)	20.3	20.1
Milk	110.7	108.5
Eggs	83 (bil. eggs)	85
Corn	...	...
Cattle breeding	...	....

The slight increase in meat output was mainly due to the production of the "individual" sector. Gross agricultural production was estimated to rise by about 2 percent to rub 229 billion, with plant production up 4 percent and annual production down by about 1 percent.

Construction: Capital construction was projected at rub 169 billion (rub 15 billion less than in the Plan and rub 1 billion less than in 1989). 1/ By end-1990, unfinished new construction was expected to amount to rub 196 billion (an increase by rub 15 billion relative to end-1989). "Above-norm" unfinished construction would reach rub 56 billion, or rub 21 billion more than a year earlier. Housing construction was likely to amount to 125 million square meters in 1990 (1989: 129). Construction of schools, hospitals and other communal buildings was also expected to fall.

Transportation: Transportation was expected generally to decline by 4 percent in 1990, in large part due to the fall in output in the energy and mining branches (transport by railways by 2.7 percent; by pipelines by 0.7 percent; by sea by 4.6 percent; by inland waterways by 4.2 percent; log automotive transport by 6 percent and by air by 1.7 percent). The difficulties in road transport had been aggravated by the blockades in the Caucasus.

4. Other developments

The number of individuals employed by cooperatives exceeded 5.5 million on September 1. 2/ Cooperatives now account for 12 percent of households services and 7 percent of capital construction, but only about 1 percent of industrial output and 0.6 percent of retail trade. It is expected that at the end of 1990 there will be about 220,000 cooperatives which will employ some 6 million people, or 4 percent of total employment. 3/

At the end of the year, some 2,000 enterprises will be involved in leasing, accounting for output of approximately rub 40 billion or 4 percent of all those working in those branches. 4/ Some 1.5 million workers are employed by these enterprises, accounting for around 4 percent of all those working those branches (5 percent in construction). 5/

Privatization is only in its initial stages, but in agriculture it is most advanced in the Baltic republics and in Georgia. Some 30,000 private farms had been organized as of July 1, 1990.

1/ It is not immediately clear what concept of investment was meant here.

2/ Including, apparently, people holding more than one job.

3/ This suggests a very high employment figure, however, of about 150 million persons.

4/ Gross output must be meant here.

5/ Further information is provided on leasing activities by sector in the papers given to the staff.

5. Statistical information

It was confirmed that all gold exports were included in the statistics for total exports published by Goskomstat. There were no statistics available with the Goskomstat on foreign direct investment abroad but Mr. Seltsovsky of MVES might have an estimate.

The Soviet representatives promised to provide the following information on October 22:

(1) aggregate data for exports of diamonds/platinum/precious stones;

(2) trade data for 1990 (and comparable data for 1989) for CMEA exports and imports, by individual CMEA countries, as well as USSR exports of crude oil, oil products, and natural gas (value and volume) to each of these countries.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.2
Held at Gosplan
on Monday October 22 at 11:00 a.m. and
Tuesday, October 23, at 11:15 a.m.

Soviet representatives

Mr. Bezroukov
Mr. Stepanov

IMF representatives 1/

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Kopits
Mr. Wolf*
Mr. DeMilner
Ms. Christensen
Ms. Cheasty

OECD representatives 1/

Mr. Shafer
Mr. Hagemann

The meeting was devoted to a discussion of the "main guidelines" for reform, the role of the planning system in 1991 and the macroeconomic forecasts for 1991 prepared by Gosplan.

1. Main guidelines for reform

Mr. Bezroukov began by noting that the Supreme Soviet had adopted the President's "guidelines" for stability and restructuring the economy, and that he welcomed the President's ability to find a formula that could accommodate virtually all views. The guidelines were general, and were intended to leave the individual republics considerable scope for developing their own programs for transition to the market on the basis of local conditions. None of the constituent republics had objected in principle to the guidelines.

1/ Some of these representatives were not in attendance at the second session.

The main guidelines dealt with such issues as the development of jointly agreed--between union and republics--monetary and fiscal policies aimed at strengthening the ruble; adoption of a consumer price policy throughout the union with respect to a list of key commodities, with the republics free to decide on the precise scope of price controls; unified union customs legislation to ensure protection of the all-union market; development of a joint foreign economic strategy; and adoption of universal rules with respect to product standards, patents, etc.

There had been major agreement on the respect for the full financial and economic responsibility of producers, irrespective of ownership form. A market environment was to be developed and competition emphasized--in part through the establishment of an autonomous anti-monopoly office. An independent social support system was also to be developed.

Mr. Bezroukov outlined the guidelines in terms of three major stages. The first, 1/ which had already begun, was to consist of a program of emergency measures designed inter alia to establish a reformed financial and monetary system, significantly reduce the budget deficit, and control the rate of growth of money. Measures were to be taken to balance the incomes and expenditures of the population and to further develop the market for consumer goods. Stable links among enterprises were to be preserved, through the end of 1991; Mr. Bezroukov cited the recent presidential decree in this connection.

New wholesale and agricultural procurement price lists were to be introduced for the basis of 1991 contracts, but enterprises were also to be given a freer hand with respect to the negotiation of so-called contract prices at the wholesale level. The price of energy would be raised, in stages, the state would continue to set the prices of a number of basic goods but the prices of other, non-essential products at the retail level would be fixed.

There was to be a phased introduction of destatization and privatization, A Fund for State Property would be established to manage this process, which was expected to be particularly evident in the area of services, retail trade and public catering. Issues surrounding the transfer of ownership of property from the union to the republican level would be resolved in stages.

This first stage was also to involve the stabilization of foreign economic relations. This would be done through strengthening the basis for exports and the adoption of legislation, including that which would establish a centralized fund for the allocation of foreign exchange in 1991 among the republics to ensure a coordinated policy on imports. An "Inter-Republican Currency Committee" was to be established, composed of the prime ministers of the republics and Messrs. Ryzhkov and Sitaryan.

1/ This stage would appear to correspond to the first two spelled out in the guidelines.

The second stage was to be devoted mainly to the establishment of a market system. Housing and labor markets would be developed, and the system for setting wages would be significantly changed. Further reforms would also be pursued in the financial sector. With respect to the allocation of intermediates, Gossnab would be gradually transformed into a kind of large wholesale organization that would facilitate flexible trading links among enterprises rather than tieing them down to rigid links. Further resources would be devoted to channelling increased consumer goods to the population through such means as catalog sales.

By the onset of Stage 3, which would begin around mid-1992, they would hope to have stabilized the financial and consumer markets, to have developed a competitive market structure, and to have proceeded with significant destatization in agriculture, food processing, and the production and sale of consumer goods and services. The goal would be to have created the conditions for the internal convertibility of the ruble, which Mr. Bezroukov defined as ensuring that a "certain amount" of foreign currency could be freely purchased (presumably by residents) for rubles. These, then were the main objectives for the next 18-24 months.

2. The role of planning in 1991

Mr. Bezroukov observed that Gosplan had presented two basic documents to the Government in connection with 1991. One was a forecast of economic activity in the union as a whole, containing no directives--as traditionally--but only scenarios. The second document was a state plan that was limited to those areas of activity that had been delegated to the union. These areas had been enumerated by the Supreme Soviet in the spring, which had defined the nature of relations among the republics and had separated the functions of the union from those to be carried out by its constituent parts.

The following areas had been set aside for the union: (1) basic research and technological development; (2) national defense; (3) the unified fuel and energy systems (i.e., from extraction to processing and transportation); (4) major transportation systems (e.g., the railroads and pipelines); (5) nuclear power; (6) the space program and related research; (7) information and communication systems and (8) union emergency response systems; (e.g., to natural disasters). Mr. Bezroukov acknowledged that some of these areas--for example, energy--were somewhat contested by certain republics or even autonomous regions within republics insofar as jurisdiction was concerned, but such discussions would have to proceed in reasonable fashion. It was simply unrealistic, for instance, for certain autonomous regions to declare their economic sovereignty without taking into account their lack of experts, local production of spare parts and so forth.

The scope for state orders in 1991 was to be limited to the above areas that had been defined as being of all-union interest. 1/ Mr. Bezroukov estimated that in 1991 the following proportions of certain products would be sold outside the scope of state contracts (gasoline: 31 percent; coal: 73 percent; natural gas: 85 percent; rolled steel products: 14 percent; mineral fertilizers: 80 percent; polyethylene: 20 percent; synthetic fibers: 41 percent; and petroleum and petroleum products: 3.5 percent). He was unable to provide an estimate of the proportion of total output in 1990 and 1991 produced according to state orders.

Mr. Bezroukov proceeded to provide background on the development of the plan for 1991. The elaboration of the national plan had begun in the spring of 1990. From the very beginning of the process, Gosplan had departed from traditional procedures in the sense that the emphasis was on providing information to the republics and the enterprises on the likely conditions under which they might expect to operate in 1991, including the structure of wholesale prices, depreciation rates and so forth. Never before had Gosplan supplied such a comprehensive set of forecasts and information on economic indicators. At the same time, Gosplan had provided enterprises with so-called control figures, which set out non-compulsory norms for labor usage, output and other indicators.

It was decided, as noted earlier, that state orders should be confined mainly to supporting activities in the all-union interest, but it was also recognized that during the 1991 transitional period that various supply problems--for example, for consumer goods---would have to be faced and thus an elaborated variant of the 1991 plan was prepared to take these special problems into account. Thus, the agro-industrial complex, for instance, was also brought within the purview of state orders. Gosplan realized that the resulting plan would affect only a part, although a significant part, of the economy.

On the basis of the foregoing procedures, Gosplan had elaborated a forecast of economic outcomes for 1991, but there remained many uncertainties, deriving inter alia from the lack of full information provided by some republics, the growing difficulties in managing the economy, continuing ethnic tensions, uncertainties in foreign trade, and growing environment concerns, the latter reflected in what Mr. Bezroukov termed the "ecological war." The situation was also complicated by the growing expenditures envisaged for various social programs. The increase in such expenditures in 1991 was estimated at rub 45 billion, but this did not take into account a further rub 56-60 billion implied by the most recent proposed--but not yet enacted--legislation on social benefits. This compared with an originally planned increase, for the 13th Five-Year Plan period (1991-95), of some rub 57 billion.

1/ Mr. Bezroukov might have mentioned, as well, agriculture (see Minute No. R.3) and a large share of foreign trade (see Minute No. E.7).

Because of these and other difficulties in specifying the financial situation for 1991, and the fact that the reform program had not yet been decided on when the forecast was being developed, Gosplan had specified several alternative scenarios. The uncertainties with respect to inter-republican relations also complicated their task, but Mr. Bezroukov thought that there was growing recognition among the republics that coordinated policies, including with respect to their 1991 plans and budgets, were necessary. Indeed, the republics had suggested a more active role in all-union planning and the establishment, inter alia, of an interrepublican currency fund which would allocate access to foreign exchange on an agreed basis.

Mrs. Ter-Minassian asked how the autonomy of enterprises could be expected to evolve during the transition. Mr Bezroukov noted that considerable autonomy was already guaranteed by the Law on Enterprises. Nevertheless, during the transition, enterprises by necessity would be constrained in various ways, through the price lists elaborated by Goskomtsen, restrictions on liberalized prices and various other limitations. The main objects of such restrictions, however, were mainly basic fuels and raw materials and staple consumer goods. The continuing interest of state enterprises to hold on to the old relationships should also be noted. Thus enterprises still were quite interested in obtaining state orders because they--erroneously--believed that their receipt would ensure them of access to resources. In 1991, however, it was intended that enterprises would have to struggle more intensely than before for their survival.

Mrs. Ter-Minassian wondered what would be the main impetus to significant restructuring in 1991. Mr. Bezroukov said he was pessimistic about generating much of a supply response already in 1991; industrial output, he noted, was expected to remain essentially flat. At the same time, the role of Gosplan and other central agencies would begin to change,and enterprises would begin to learn how to adapt to market conditions as administrative pressures began to be relaxed. Mr. Bezroukov confirmed that the decree on maintaining "stable economic links" was intended to remain in force only through 1991, and in response to a question what would be the government's response if the economic situation was not significantly more stabilized by the end of 1991, he expressed optimism that the economy would already be improving by that point. He noted that the society had survived more difficult periods, and that the mood of the population was improving in the sense of recognizing that only through its own efforts could the situation fundamentally improve.

3. <u>Forecast for 1991</u>

Messrs. Bezroukov and Stepanov provided some basic projections for 1991 for several main economic aggregates (Table 1). Little in the way of an economic story was presented as background to these numbers, although the scenario presented presumably reflected the main assumptions incorporated in the presidential reform program.

The further fall in output in 1991 was predicated on the continuing decline in the "manageability" of the economy, which indeed Mr. Gorbachev hoped to brake with the recent decree regarding the maintenance of stable links. It was also assumed that inter-ethnic tensions--which had adversely affected output in 1989-90, would continue. Mr. Stepanov attempted to explain the projected sharper fall in GDP (-3.7 percent) than NMP (-1.5 percent) on the basis of the methodological problems in accounting for depreciation in comparable prices, but there was insufficient time to pursue the issue in adequate detail.

Although industrial output was assumed to remain flat in 1991, consumer goods output was expected to increase by 3-4 percent reflecting the shift of priorities from so-called Sector A (means of production) to Sector B (consumer goods). Accordingly, capital investment was to fall sharply, particularly in the so-called productive sphere, while investment in "socially-oriented" projects was to rise sharply.

It was hoped to start up various plants that had recently been closed down for environmental reasons, although this would require new investment in those facilities. The projections also assumed an increase in labor discipline and an end to the large output losses due to strikes which had occurred in recent years.

Mrs. Ter-Minassian asked if the mission could obtain a copy of the forecast document that Gosplan had already forwarded to the Council of Ministers. Mr. Bezroukov suggested the mission ask Mr. Sitaryan for a copy of this document.

Table 1. Gosplan Projections for 1991
(Percentage rate of growth) 1/

GDP	-3.7
NMP	-1.5
Of which:	
Industry	-0.5 to zero
Agriculture	3
Trade	-1
Transportation	-3.3
Construction	-13
National income utilized	-5
Of which:	
Personal consumption	2
Investment in productive sector	-20
Share of national income utilized devoted to the consumption fund and fixed investment in the nonproductive sphere	
1990	80
1991	87
Capital investment 2/	-15
Of which:	
In industry	-29
In socially-oriented areas	22

1/ Unless otherwise indicated.
2/ Presumably gross fixed investment.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.3
Held at Gosplan
on Monday, October 22, 1990 at 3:00 p.m.

Soviet representatives

Mr. Bezroukov
Mr. Stepanov
Mr. Petrov
Mr. Salo
Mr. Formichev
Mr. Elistratov

IMF representatives

Mrs. Ter-Minassian
Mr. Calvo
Mr. Blejer
Mr. Flickenschild
Mr. Kopits
Mr. Wolf*
Mr. DeMilner
Ms. Christensen
Ms. Cheasty

OECD representatives

Mr. Shafer
Mr. Hagemann

The meeting was devoted to a discussion of price policy for 1991, credit policy, the military conversion program, and developments in the agro-industrial complex in 1990 and its prospects for 1991.

1. Price policy

Mr. Formichev noted that in 1988-89 only about 5 percent of wholesale prices had been liberalized in the form of so-called contract prices. In formulating a policy for wholesale prices for 1991, it had originally been envisaged that some 25 to 30 percent of such prices might be liberalized. More recently, it had been decided to expand the proportion of liberalized wholesale prices to about 40 to 50 percent initially.

Three general wholesale price categories were envisaged. One group, consisting of fuels, raw materials, basic metallurgical goods, chemicals and forestry products would have largely administered prices, to be set in most instances by union-level agencies. A second group, consisting of medical and medical equipment prices, would also have closely controlled prices. A third group would consist mainly of processed and manufactured goods--including those in machine building, light industry and other consumer branches--for which the scope of wholesale price liberalization would be greatest. According to Mr. Formichev, the price setting agencies were just now determining the list of products that would have administered prices. Of the 40 to 50 percent of wholesale prices to be liberalized, some would be genuinely free, others would be subject to ceilings on the extent of permissible price increase, and still others would in effect be limited by rules restricting the rate of profitability which an enterprise could be allowed to achieve. The basic criteria for allowing a price to be really set free would be if it were a genuinely new product or if the product was not initially subject to significant market imbalance. Mr. Formichev acknowledged that the latter criterion in effect meant that whether the price would be fully liberalized would depend on the extent to which it was expected to rise when freed. It was intended, however, that the scope for genuinely free prices would be gradually expanded, although much could depend on what happened in the market in the course of 1991.

The list of wholesale prices which had been developed by Goskomstat for introduction in 1991 suggested an average increase of 60 to 62 percent, ranging from 20 to 30 percent for machine building products to 100 to 150 percent for various fuels and raw materials. Agricultural procurement prices were to be increased by about 30 percent on average.

As regards retail prices, Mr. Formichev noted that several views had earlier been put forward as to what the price strategy should be. The "more sensible" approach that appeared to have been adopted envisaged most prices remaining fixed, at least in the initial stage of the Presidential program. Some 70 to 75 percent of food prices would continue to be administered, while 25 to 30 percent would be freed in 1991. The proportion of nonfood prices to be liberalized would be larger. Even the freed prices, however, would in general be subject to certain regulations established by the state agencies, which would be aimed at ensuring a certain rate of profitability for producers, a specified markup for retailers, and a certain turnover tax. 1/

Mr. Formichev emphasized that work was still in progress on estimating the extent to which the retail rice level would rise in 1991. Goskomtsen and Gosplan had estimated that administered retail prices might rise on average in 1991 by 60 percent, while a small group of liberalized prices might increase by 100 to 200 percent on average. One or two months ago, the price specialists had estimated that retail prices on average might increase by some 40 to 60 percent in 1991. Mrs. Ter-Minassian pointed out that this latter estimate appeared low in light of the estimates for the component parts of the price index.

2. Credit policy

The foregoing estimates of price increases appeared to have been made independently of a projection for credit and money supply growth. Mr. Petrov noted the need to contain the growth of credit, but was unable to cite a target figure for the increase in credit. He said that interest rates on credits would be raised to a range of 6 percent (for credits up to one year) to 11 percent (over five years), but that credit would undoubtedly have to be quantitatively rationed and made available to only the more deserving borrowers. Asked whether such interest rate levels, in the light of the foregoing inflation estimates, would not encourage the buildup by

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1/ The meaning of the turnover tax provision was not entirely clear.

enterprises of stocks, Mr. Petrov acknowledged that such rates would probably not persist very long.

Interest rates on deposits were to be raised to the 2-8 percent range, while the staff noted--again in light of previous inflation estimates--would be strongly negative in real terms. Mr. Petrov agreed, but reminded the staff that the rates on credits and deposits would be some two to three times higher than the present effective rates, and therefore could be viewed as a first step toward more restrictive financial policies. He thought that deposit rates would also be raised again after a short period. Mr. Bezroukov noted that the interest rates mentioned were those that had been planned as long ago as April 1990; the rates in 1991 would almost certainly be higher than those mentioned, given the inflation forecast.

3. Military conversion

Mr. Salo noted that military procurement spending was planned to decline in 1991, with the level being 19.5 percent (in constant prices) below that attained in 1988. Such spending in 1990 was 10 per cent below the 1988 level. The military conversion process was to lead to a further increase of 8.6 percent in production of civilian goods by the defense industry in 1991, for a cumulative increase, since 1988, of 29.8 percent. Defense plants were estimated to have produced some 25 percent of all (presumably non-food) consumer goods in 1990, and the percentage would be higher in 1991. While the production of civilian goods had accounted for 42 percent of these enterprises' output in 1988, this proportion was to rise to 52.5 percent in 1991.

Several priority areas had been determined for conversion, including civilian aircraft, marine equipment, medical equipment, food processing technology and equipment, consumer electronics, communications equipment, and environment-oriented equipment and technology. Asked to what extent market incentives were being used to induce the conversion process, Mr. Salo noted that the military production of these enterprises was still taking place under state orders. As for their civilian production, the center knew the capacities of these industries and was partially using state orders to encourage civilian goods production along the foregoing lines. So-called target funds were also being used--drawing on centralized funds--to aid in the conversion effort and to support the wage payments of affected employees during the conversion process. Goods produced under state orders would be sold at administered prices. If components had to be purchased at market prices, the enterprises would be compensated accordingly. It would be incorrect to assume, however, that all the civilian goods sold as a result of the conversion process would be marketed at administered prices. Indeed, a governmental decree was expected shortly permitting "non-essential" consumer goods to be freely priced by the defense industry.

A State Fund for Conversion had been established, but it was yet to be funded. Mr. Salo thought perhaps some rub 2.5 billion of savings on military construction might be directed toward this Fund. Two other funds had also been established, to cover expenditures related to the Chernobyl and Aral Sea clean-ups respectively. The full budgetary impact of the conversion program was not yet clear, but it might include such expenditures as compensating enterprises for loses incurred on unfinished production of military goods. Mr. Salo said that it typically took 18 to 24 months for a given conversion program to become viable.

4. The agro-industrial complex

Mr. Elistratov said he agreed generally with the agricultural output projections for 1990 that had been presented by Goskomstat to the staff at an earlier meeting. 1/ The grain harvest was some 20 million tons above average and the sugarbeet harvest, while 10 million tons lower than in 1989, actually was yielding a higher sugar content. The main problems concerned plant production that was relatively labor intensive, given the erratic performance of many agricultural enterprises during the harvest. The acreage devoted to relatively labor intensive crops was being reduced next year.

As for 1991, overall agricultural production was expected to remain essentially unchanged from 1990. Output of raw cotton was expected to fall by 100,000 tons and sugarbeet production, due to reduced acreage devoted to plantings, could fall by 2-2.5 million tons, but in each case the decline would be small in percentage terms. The problem would continue to lie in distribution, in particular the intention of various republics to withhold supplies from major cities such as Moscow and Leningrad.

"Central administration" of many agricultural commodities would be retained in 1991 in the form of so-called union funds for distribution. Eight food product groups--including grain, meat and meat products, milk and other dairy products, vegetable oil, sugar, food for infants, and fish and fish products--would be covered by these funds, along with three agricultural raw materials. The union funds had existed for some time, but now the republics had taken a greater interest than in the past, and the funds would be jointly run by the union and republican governments.

Mr. Elistratov did not envisage any major changes in the volume or structure of agricultural production in 1991. All forms of ownership would be supported and there would be no restrictions on individual farmers, but as a practical matter the collective and state farms would continue to be the major producers of food products in 1991.

Asked if the increases in agricultural procurement prices were expected to stimulate output, Mr. Elistratov did not see them as having much effect. He did not directly answer whether an even faster rise in average retail prices in 1991 would discourage agricultural deliveries. 2/ Some 70 percent of food prices at the retail level would continue to be administered; food products delivered on the basis of state orders would be procured at administered prices, while the excess of deliveries above these orders could be sold at higher, negotiated prices.

1/ See Minute No. R.1

2/ He seems to have interpreted the question as asking what would happen if retail food prices rose more rapidly than procurement prices.

Mr. Elistratov considered that only 30 percent of agricultural activities had reasonably well-developed infrastructure, in terms of roads, storage and processing facilities. It was believed that investment in agriculture would rise in 1991, but a much greater share of this investment would be undertaken on the basis of the enterprises' own funds, and in accordance with their own priorities. State orders would predominate in agricultural production, however, and the state would continue to allocate construction materials to agricultural enterprises.

Food shortages were foreseen, particularly in the major industrial centers, which explained the use of the centralized distribution measures noted earlier. Mr. Bezroukov characterized these shortages in terms of a "virtual blockade" of Moscow and Leningrad in respect of food deliveries. Organized crime was heavily involved in this diversion of food supplies, and increased efforts must be taken to fight it. A decree had recently been passed to outlaw such abuses. Asked if possible commodity aid provided from abroad would also encounter distribution difficulties, Mr. Elistratov merely noted that if imports were to continue at the 1990 level, no additional distribution difficulties were envisaged. Mr. Bezroukov stressed the importance of keeping imports outside the reach of organized crime.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.4
Held at Goskomstat
on Tuesday, October 23, 1990 at 4:00 p.m.

Soviet representatives	IMF representatives
Mr. Nevzorov, Deputy Chairman	Mr. Wolf*
Mr. Ryabushkin	Ms. Christensen
Mr. Ostrovskiy	Mr. Renfield
Ms. Manykina	
Mr. Kalatylkin	

The meeting was devoted to additional information on economic developments in the first nine months of 1990 and projections for the year as a whole. 1/ Further information of this nature was also promised for a meeting to be held on October 26. A number of tables that had previously been requested by the staff were provided, including the information on foreign trade asked for at an earlier meeting.

1. Investment

Figures for the first nine months and projections were to be available by the Friday meeting.

2. Prices

The rate of inflation, both the measured open rate and the rate including estimated repressed inflation, was accelerating. The measured retail price index, which is meant to include hidden but not repressed inflation, was up by 2.7 percent (year on year) in the first half, 3.8 percent in the first nine months, and was projected to rise by 4.8 percent for the year as a whole. The acceleration was attributed mainly to the spreading use of contract prices and stepped up increases in prices on collective farm markets. If estimated repressed inflation was included, the corresponding inflation rates would be 7.5, 9.3 and 12 percent. Estimates of wholesale price increases would be provided on Friday.

3. Employment

In the first nine months of 1989, total employment was estimated to have fallen by 0.8 million individuals, or 0.8 percent. If the trend continued for the year as a whole, which Mrs. Manykina expected, employment would decline for the first time in recent Soviet economic history. Employment in the state sector was down by 1.8 million, or 1.5 percent,

1/ Also see Minute No. R.1.

while the cooperative sector recorded an increase in employment of 1.2 million, or 46 percent. The increase in cooperative employment was expected to slow in the fourth quarter, however, as the number of cooperatives was expected to grow more slowly due to certain limits being placed on simple retrading activities and the closing of some cooperatives due to the complaints of the citizenry about price gouging, particularly in public catering activities.

Ms. Manykina explained that the measurement of unemployment was very difficult, in part because, until enactment of the Law on Unemployment, the concept could not even officially be used. As yet, there was no system for registering unemployment. Ms. Manykina approached the issue from the standpoint of asking how many of those in the work force deemed capable of working were not employed. These included housewives, students and other groups. In 1989, this group numbered 8 million in total, of which 5-6 million were mainly housewives with small children, who could have been provided jobs had they been available close by to their homes. It was believed that many of these individuals would register with the labor exchanges as unemployed when it became feasible, although they were hardly unemployed in the usual sense. It was this figure, she thought, that had been misused by the Shatalin group in estimating the extent of unemployment at the beginning of 1990. She was more inclined toward an estimate of 2 million unemployed, although she noted that various experts had suggested that unemployment could rise to 5-10 million in the next two years under a reform program. Also to be taken into account, however, was the existence of 3 million vacancies at the present time, and the probability that the service sector--under conditions of reform--would absorb significant numbers of people.

4. <u>National accounts</u>

Mr. Ryabushkin noted that his forecasts of the main macroeconomic aggregates were based on developments known as of October 1, 1990. He expected that the tendencies then observed were likely to worsen in the fourth quarter. GDP was expected to fall for the year as a whole by 2 percent, with NMP declining by 4 percent. He expected gross output in agriculture to grow by not more than 2 percent but value added in that sector to remain flat in 1990. Gross output in industry would decline by 1.5 percent, with value added falling somewhat more sharply. The valuta trade balance would be in deficit by rub 10 billion (see section 5), and its further deterioration in 1990 would contribute roughly one percentage point to the decline in NMP.

He was not yet in a position to forecast the growth of real expenditure (i.e., national income utilized), but his preliminary guess was that it might decline by about 3 percent; in other words, by one percentage point less than NMP due to the rising trade deficit. He would not have an estimate of real consumption growth until November, but he considered that it would be positive in 1990 at roughly the same level as in 1989. 1/ Net fixed investment was considered to have fallen once again in 1990. Mr. Ryabushkin also hoped to have some information on stockbuilding by the October 26 meeting.

5. Household incomes and expenditures

Mr. Ryabushkin hoped to have some estimates on the growth of wages and the average monthly wage by the next meeting.

6. Enterprise financial position

Mr. Ryabushkin promised to provide a more or less precise profit estimate 2/ for the first eight or nine months of 1990 by the October 26 meeting. His estimate was that nominal profits had fallen in this period, which would mark a clear reversal from earlier years.

7. Foreign trade

The Goskomstat representatives provided Ms. Christensen with a number of tables that had been requested in this area at the earlier meetings. 3/ Mr. Nevzorov noted that the aggregate trade forecast had already been revised since the initial meeting. Valuta exports were now expected to reach rub 63 billion for the year as a whole, down 8-9 percent from 1989 and with exports to CMEA countries some 12 percent lower and exports to "capitalist countries" 6 percent higher. Exports to the CMEA in the first nine months of 1990 had totalled rub 23.1 billion. Valuta imports were now projected at rub 73 billion, suggesting a trade deficit of rub 10 billion (earlier meeting: rub 9 billion). CMEA imports were expected to decline by 4-5 percent while imports from the West would be up by 2 percent. Imports from CMEA amounted to rub 29 billion in the first three quarters.

Mr. Nevzorov said that on September 20 the price for crude oil exports (presumably to the non-CMEA area) was rub 145 per ton (about US$32/barrel), diesel oil sold at rub 159/ton and the price of mazut had recovered sharply to 84 percent of its (average?) 1989 level. He thought that the effective oil price would be a bit higher in the fourth quarter.

He also confirmed that exports of gold were supposed to have been included in recorded merchandise exports (i.e., red book exports) in the past, but the MVES and Goskomstat until now had been unsuccessful in obtaining such data from Vneshekonombank. A new agreement had been reached for its inclusion, and he thought it would indeed be included in the future. Goskomstat knew that large quantities of gold had been sold in July 1990, but it did not know the precise amounts.

1/ It was left until the October 26 meeting to address the problems associated with the estimated growth rates of the expenditure components in 1989.

2/ Comparable to the profit figure used in Table R.26 of the background paper in the domestic economy.

3/ See Minute No. R.1.

8. <u>Corrections</u>

Mr. Nevzorov also provided the staff with a few corrections to the document containing statistics on 1990 developments and projections which had been made available at the first meeting (Table 1).

Table 1. USSR: Corrections to Earlier Projections by Goskomstat 1/

(Percentage change from 1989, unless otherwise indicated)

Labor productivity	-3.5 percent
Capital construction	-3 percent
Transport	-1.3 percent
Housing construction	-3 percent
Budget deficit (January-July)	rub 14.8 billion
Credit for investment (October 1)	rub 360 billion
Grain output (1990)	220 million tons
(Growth over 1989)	(23 million tons)
Yield	+3.5 centners per hectare 2/
Sugar beets (1990)	90 million tons
Capital construction (1990)	rub 165 billion
Unfinished construction (end-1990)	rub 200 billion
Increase in unfinished construction (1990)	rub 20 billion
Above-norm unfinished construction (end-1990)	rub 60 billion
Increase in above-norm unfinished construction (1990)	rub 25 billion
Share of machinery and equipment in exports	No change from 1989
Share of energy and raw materials in exports	54.0 percent in 1990

1/ See Minute No. R.1.
2/ Not 5.3 percent higher.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.5
Held at Goskomtsen
Wednesday, October 24, 1990 at 11:00 a.m.

Soviet representatives

Mr. Ulanov
Mr. Ikhilchik

IMF representative

Mr. Wolf*

OECD representative

Mr. Shafer

The meeting was devoted to a discussion of the changes in the price system and the price policies envisaged for 1991.

1. Wholesale (producer) prices

Mr. Ulanov--who had to excuse himself soon after the discussion began to participate in a high level meeting held to finalize the outline of the new system of wholesale prices to be elaborated in a document to be signed that very day by the Prime Minister--said that the philosophy underlying the price program was to establish, prior to the transition to a market system, a systematic basis for the restucturing of prices. It was important from the outset to provide producers with correct signals on the costs of their inputs as well as on the final demand for their products. In effect, the intention was to provide enterprises with price signals that were not very different from what would be provided by a free market.

Mr. Ikhilchik elaborated by noting the intention to establish broadly uniform profit rates for enterprises, where profitability was defined essentially as a percentage mark-up over costs. These normative profit rates would differ somewhat across sectors and branches (e.g., for contractual price setting, 25-30 percent in industry, 35 percent in transportation and 25 percent in construction).

The attempt to restructure prices on this basis had been complicated by recent events. By the end of September 1990, new price lists for the purpose of signing contracts for 1991 deliveries had been received by enterprises. It was intended at that time to expand gradually, over a period of 2-3 years, the list of products for which negotiated, or contract prices, could be established. The so-called 500-day program, however, had found a mainly administered restructuring of wholesale prices to be unacceptable, and proposed a more active policy of expanding the scope of contract prices. Moreover, it proposed that the prices of basic fuels and raw materials be fixed, but only on the basis of negotiations among the republics. The problem was that in this uncertain environment of conflicting approaches, the enterprises had no basis on which to negotiate their 1991 contracts, and these had to be concluded before the end of 1990.

The recent Presidential decree had, in Mr. Ikhilchik's view, found the way to break the impasse. On the one hand, it provided for an expansion of the scope for contract prices over that envisaged by the earlier Government program. On the other hand, these contract prices would have to relate to the prices embodied in the price lists already distributed to the enterprises.

Asked why the wholesale price increases embodied in the price lists were so large, Mr. Ikhilchik acknowledged that a number of months ago when the measures were first considered the size of the increases was somewhat smaller. Conditions in the extraction industries had continued to deteriorate, however, and larger price rises were now deemed necessary. The new wholesale prices (e.g., rub 70 per ton for crude petroleum and rub 50 per thousand cubic meters of natural gas) were viewed as giving enterprises in these branches barely sufficient profits to maintain their current level of operations, but were still inadequate to provide sufficient internally generated cash flow for their expansion--therefore, they would still require budgetary support for investment. The wholesale price of coal was to be increased by 80 percent, but even this price rise had turned out to be quite modest in light of the rapid growth in wages in that branch in the wake of the strikes, concessions to unions in the form of extended holidays, and various expenditures needed to improve working conditions. Even with the price increase, the coal industry would still have to receive subsidies. A similar situation prevailed in the lumber industry, where wholesale prices were to rise by 70 percent.

Moreover, according to Mr. Ikhilchik, new expenditures were necessary in many of these primary industries to expand exploration and to fund environmental protection activities. In the past, most of these expenditures had been covered by the budget. Expenditures on socially-oriented programs were also growing; it was estimated that enterprises had the funds to cover only 50 percent of such expenditures, and the recently approved hike in pension contributions would only aggravate the situation.

With the very large wholesale price increases in the extraction industries, and higher procurement prices for agricultural raw materials, a significant general rise in wholesale prices throughout industry was inevitable. Mr. Ikhilchik noted that all these calculations had been made at the existing exchange rate, with the costs of imported inputs being valued at that rate. With a higher exchange rate and with trade with

Eastern Europe moving to world market prices, recalculations might be necessary at some point.

Asked whether the price calculations had also been based on assumed unchanged input coefficients, and thus would not put pressure on enterprises to economize in input use, Mr. Ikhilchik suggested that indeed conservation of inputs had been a major consideration. Although average costs of production were the benchmark, the norms took into account an assumed decline in these average costs; hence those firms which continued to be relatively inefficient would be put under pressure to reduce material costs or go into bankruptcy. In designing the new relative price structure, it had been assumed that tens of enterprises might go bankrupt, at least in industries in which there was competition. Quite frankly, this policy could not be held to rigidly in those industries that had only one or a few producers. As an example, he noted the production of excavators. One producer, in the Far East, sold virtually all its output in that region yet was relatively inefficient due to the need to pay high wages and being faced with relatively high capital costs. It could not be allowed to go out of business even though its costs were much higher than those of a similar enterprise in Leningrad.

Mr. Ikhilchik estimated that by the end of 1991, some 45 percent of wholesale prices might be set on a contractual basis (1990: about 10 percent), while 55 percent would continue to be set administratively. The latter would be raised at the beginning of the year and generally held fixed for the duration of 1991. The administered prices would apply mainly to fuels and basic raw materials, basic intermediates and some products of the machine building industry. He estimated that the average rate of increase of administered wholesale prices in 1991 would be about 50 percent.

The contract prices would be subject to one limitation, according to Mr. Ikhilchik, namely the permissible rate of profitability (percent markup over costs). Asked if this might not discourage efficient producers from stepping up production to increase profits, he noted a provision in the law that as long as a contract price for an "old" product did not differ from the list wholesale price for that product, the profitability rate restriction would not come into play. In effect then, this constituted a second alternative limitation on contract price increases. If a product were deemed "new," however, there would be no reference price and the producer would apparently have complete flexibility in price setting for the first two years. 1/ Mr. Ikhilchik considered that possibly by the end of 1994 that the proportion of wholesale prices set on a contractual basis might be as high as 80 percent.

Within 1991, most of the contractual pricing would probably be phased in during the first quarter. Mr. Ikhilchik estimated that the rate of increase of contractual wholesale prices would be less than 50 percent

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1/ It was not entirely clear, however, whether the producer would be completely free of the profitability norm restraint.

within 1991, but that the extent of increase would vary significantly across products and industries, and would of course depend on the overall demand management stance. Regarding the latter, he did not cite a specific set of policies, but only noted the assumption of the price authorities that considerable emphasis would be placed on cutting budgetary expenditures.

Uniform principles would be established on an all-union level for setting profitability norms and calculating the expenditures that enter into the formulae. Administered prices would be determined at the union level (presumably by Goskomtsen) for the major fuels, railroad and road transport tariffs, communication tariffs, the prices of standard defense products, and the prices of certain products relating to the maintenance of minimum living standards, including basic cotton fabrics, simple footwear, and vodka. The republics, on the other hand, would have an expanded scope of authority for price setting, and would set the prices for, inter alia, all construction materials, some chemicals, forestry products, a major portion of machine building products, and many products of the food and light industries. The republics would also not be precluded from changing various prices at the retail level in special circumstances (e.g., the price of vodka sold in the evening hours).

As for products delivered under state orders, Mr. Ikhilchik said that they need not be sold at administered wholesale prices. But if a product produced under state order were sold at an administered wholesale price, it was his view that all output of that product should be so priced, except in the case (as an example, he cited trucks sold by KAMAZ, now a joint stock company) in which a small number of items might be produced above and beyond the amount specified in the state order, in which case contract pricing might apply. Although only some 200 million tons of total coal output of over 700 million tons was to be produced under state orders, it was thought necessary to apply the administrative price to all sales.

For those products for which administered prices would be set at the union level, these prices should apply to all republics and inter-republican trade except possibly for small reserves that could be sold locally at prices established by the republics themselves. For those products for which the republics were granted price-setting authority--an example being timber--Mr. Ikhilchik acknowledged that they would be allowed to set different prices on the same product depending on the destination (i.e., within or outside the Republic) and that this could lead to problems.

Mr. Ikhilchik expected that as long as demand was adequately constrained in 1991, the increase in the relative price of fuels, raw materials and other intermediates could be expected to reduce shortages of these products and induce enterprises to economize on their usage. He was uncertain whether petroleum could be considered a deficit good at the present time, although he did view motor fuel as being in excess demand, a fact that had contributed to problems with the 1990 harvest.

2. Agricultural procurement prices

The decision to raise the procurement price for grain at the time of the 1990 harvest had been announced in a government decree in May 1990; thus, Mr. Ikhilchik said that suggestions that the price hike had been moved forward due to farmers holding back on grain deliveries were unfounded. On the other hand, the decision of the RSFSR to raise the procurement price for meat on September 15 and the similar decision by the rest of the Union on October 1 was indeed motivated by the fear that meat supplies would be withheld pending implementation of the previously announced price hike that was initially scheduled for January 1, 1991.

The average agricultural procurement price hike in 1991, including the already effective price increases for deliveries of grain and meat, would amount to a 32 percent increase over the 1989 level. The main motives behind the increases had been to offset the growing costs of the state and collective farms, including the increase in social security contributions, and to wean the weaker collective farms away from direct subsidies from the budget. Mr. Ikhilchik was not inclined to think that a major supply response had been expected from the increase in procurement prices.

3. Retail prices

Mr. Ikhilchik said that the situation regarding retail prices remained unclear. The intention was to free some 5-15 percent of prices on non-essential goods by the end of 1990, and that the list of liberalized products would be regularly expanded in 1991 although the rate of expansion would depend on the state of the markets as determined by the financial situation. Much depended also on the extent to which the population was willing to direct its purchasing power towards the liberalized products. He considered that it would be catastrophic to free 70 or 80 percent of prices now. If this were done, prices would rise several times and it would be necessary to compensate incomes. Larger-scale measures (unspecified) would be taken later as the situation clarified itself. Throughout this period there would be three categories of retail prices--genuinely free, free but controlled, and administered.

Asked about the effect on budgetary price subsidies of failing to raise the prices of the staple foodstuffs, Mr.Ikhilchik admitted that this was one of the most delicate issues. A one-time revision of these prices was viewed at this point as out of the question. The official price of meat in 1991, for example, would be rub 2 per kilo compared to a unit production cost of rub 9 billion. One possibility of partially relieving the budget of the subsidy burden, in his view, would be to introduce ration cards and sell those quantities above the rationed amounts at market prices. This was already being tried for tobacco, where a ration of up to 8 packs (?) per month was sold at 44 kopeks a unit and amounts greater than that at rub 1 per unit. It was envisaged that the republican authorities could take such decisions. The Estonian Government, for example, had already administratively increased the prices of meat and butter. The union would not officially delegate such responsibilities, but it would probably choose to accept such local decisions.

By the end of 1991, Mr. Ikhilchik envisaged that something less than 50 percent of retail prices would be either genuinely free or liberalized with restrictions--the percentage again depending on the overall financial situation. The restrictions on liberalized retail prices would mainly take the form of supervision of the profit margins of the trading organizations. For this group of products, increases in wholesale prices would essentially be allowed to be passed through to the retail level.

Asked for his estimate for the average rate of increase of retail prices in 1991, Mr. Ikhilchik said that if a large revision in administered prices was not carried out on a broad basis, but if the policy of gradually eliminating price controls was followed such that 70-80 percent of prices were liberalized, the rate of retail price inflation could be about 53 percent as mentioned in the Shatalin program. Realistically, however, 70-80 percent of all retail prices would not be freed by end-1991, and the rate of price increase should be somewhat less but not as low as one-half the foregoing rate. The financial situation, wage policy and the political situation were obviously key factors in this connection.

Mr. Ikhilchik said that reducing excess purchasing power of the population and reducing price subsidies were both goals of the price program. It was hoped that raising the prices of non-essential goods would lead to increased supplies and higher turnover taxes.

Asked whether he thought that enterprises profits were falling in 1990--as had been estimated by Goskomstat in an earlier meeting--Mr. Ikhilchik suggested that the profits of industrial enterprises had indeed been falling but that profits in other sectors (transportation, construction and agriculture) had been rising. He expected restructuring in 1991 to occur not so much because of the expected change in the relative prices of final products, but because the higher relative price of material inputs would lead enterprises in material-intensive industries to economize on inputs which would free them for use in those branches producing consumer goods. He was also willing to admit, however, that an increase in the prices of consumer goods relative to those of machinery could also stimulate some restructuring. Although acknowledging that higher prices for non-essentials such as jewelry could create a kind of wealth effect, he tended to downplay this factor as having much of a micro or macroeconomic influence.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.6
Held at Gosplan
Wednesday, October 24, 1990 at 2:15 p.m.

Soviet representatives	IMF representative
Mr. Stepanov	Mr. Wolf*
Mr. Ananiev	
	OECD representative
	Mr. Shafer

The meeting was devoted to a brief discussion of the possible effects of the Presidential program on unemployment in 1991.

Mr. Ananiev estimated 1990 average unemployment at 2 million and unemployment in 1991 under the Gorbachev program at 6 to 8 million people. The figure was not expected to be higher because the program gave weight to preventing the widespread dissolution of enterprises and minimizing disruption on the labor market. Of the possible unemployed, Mr. Ananiev estimated that 4 million would collect unemployment insurance and the rest--some 50 percent of the unemployed--would be engaged in public works projects.

Mr. Ananiev said it was too early to attempt to predict the profile of unemployment during 1991, and whether the rate of growth in the number of unemployed would still be growing at the end of 1991 and into 1992. He noted that the budgetary situation would not permit a "large army of the unemployed," and that it was possible that many enterprises in effect would hang on to more workers than efficiency dictated. He did not elaborate on what incentives enterprises would have to continue to operate with an underemployed work force.

The greatest fall in employment was expected in heavy industry, including the extractive and metallurgical branches, and construction. Employment in light industry, by contrast, could be expected to increase. An increase in unemployment was not expected in agriculture, due to already existing labor shortages in that sector and the attractiveness of entering into farming for many people under the new conditions. One proposal was that the unemployed be offered land to start their own farming activities. Due to the expected increase in the relative prices of energy and raw materials, it was expected that the large, relatively materials intensive enterprises would be more heavily affected than smaller, more flexible firms.

The staff pointed out that if unemployment were to rise by 4-6 million in 1991, and most of this were concentrated in industry, this would imply an employment decline in state industrial enterprises of some 10 to 12 percent, whereas Mr. Stepanov in an earlier meeting had projected essentially no change in industrial value added in 1991. 1/ The two forecasts seemed to present different pictures regarding the degree of restructuring expected in industry, or was it more a matter of industrial enterprises having new incentives to shed labor? If the latter, this would imply a substantial increase in the average wage in industry.

Mr. Ananiev responded that the planned system of taxation of "excess" wage fund increases--described to the staff in August--might be expected to encourage labor shedding. The growth in the average wage might nevertheless, in his opinion, be limited by the high individual wage tax that would kick in at a salary of rub 750 per month, although he agreed with the staff that this figure represented a relatively high average wage and might not be a significant limiting factor. In any event, the staff suggested that under such circumstances an increase in the average wage should probably not be discouraged for incentive reasons.

Mr. Ananiev considered that the growth in unemployment would likely be concentrated in the relatively heavy industrialized areas of the RSFSR, Belorussia and the Ukraine; he estimated that about 70 percent of unemployment would be in these republics. In Central Asia the structural changes could be expected to occur more slowly. The relative regional immobility of labor would also play a role; job opportunities in the Far East were likely to expand, but the demand for labor there would be focused on special categories. Significant unemployment of union government members was not anticipated, as these individuals usually had little difficulty in finding jobs in enterprises or in the republican or local governments.

Another factor, however, was "forced" regional emigration. Some 600,000 people were estimated to be subject to this phenomenon in 1991, particularly Russians living in Central Asia and the Caucasus and ethnic groups fleeing politically unstable regions of the RSFSR. A draft law on refugees was being elaborated to deal with this growing problem. Contrary to some views, it was not expected that Russians would emigrate in large numbers from the Baltic republics, due to the economic attractiveness of that region. In principle, the estimate of 6-8 million unemployed in 1991 would include these refugees, although many of them might be quite employable.

1/ See Minute No. R.2.

INTERNATIONAL MONETARY FUND

USSR: Staff Visit, October 17-26, 1990

Minutes of Real Sector Meeting No. R.7
Held at the Goskomstat on
Friday, October 26, 1990 at 2:00 p.m.

Soviet representatives

Mr. Nevzorov, Deputy Chairman
Mr. Ostrovskiy
Mr. Ryabushkin
Mr. Kalatylkin
Ms. Manykina
Mr. Sokolin
Mr. Poltaturev

IMF representative

Mr. Wolf*

The meeting was devoted to a discussion of various aspects of the draft background papers on the domestic economy and statistical issues regarding the real sector, some further estimates regarding the 1990 outturn, as well as to the clarification of a number of outstanding statistical issues.

1. Goskomstat comments on background papers

Both background papers had been translated into Russian and reviewed by the Goskomstat staff. As regards the background paper on developments in the domestic economy through 1989, both Mr. Nevzorov and Mr. Kirichenko--Chairman of Goskomstat--had read it and were broadly in agreement with the story presented therein. The only substantive comments related to some of the narrower statistical issues, which are discussed in section 3.

The Goskomstat representatives had some comments regarding the text of the background paper on statistical issues, but these were few and mainly focused on specific issues of interpretation. They found the paper to be a generally accurate and fair description of the problems associated with Soviet statistics. They suggested some alternative wording--in Russian--for several passages which, on first glance and discussion, appeared to be reasonable amendments. One substantive issue on which the Goskomstat representatives demurred was the estimate of the Chairman of the KGB--cited in the statistical background paper--of the size of the shadow economy. Goskomstat estimated it to be one half the size quoted in the paper, in other words, about R 70 billion (about 7.5 percent of 1989 GDP).

Regarding the apparent discrepancy between the amount for depreciation recorded in the national accounts and the estimates provided for gross and net fixed investment, respectively, Mr. Ryabushkin provided a reconciliation--in Russian--which is summarized in English in Table 3.

Mr. Nevzorov expressed a keen interest in seeing the final version(s) of the background paper(s) on the Soviet economy, and considered that they would provide Soviet economists a useful tool by which to understand better the "approach" taken by western economists. Mr. Ryabushkin also emphasized the wish of Goskomstat to maintain a dialogue to track the financial flows of enterprises, an area that had been long neglected by Soviet economists (also see section 3). Mr. Nevzorov expressed the intention, once the Fund's Soviet Task Force had wound down, to place the East European III division of the European Department on its regular mailing list for statistical publications.

2. Further prognoses for 1990

Messrs. Ryabushkin and Kalatylkin provided further estimates for 1990 for various macroeconomic aggregates (Table 1) and for different categories of investment (Table 2), respectively. Of note in this connection are projections that national income utilized would fall by 2.6 percent in comparable prices in 1990, with consumption rising by 3.1 percent and accumulation falling by some 20 percent (Table 1). Stockbuilding 1/ was expected to fall by 18 percent in real terms, despite a further substantial increase in unfinished construction (Table 2). Money incomes of the population were expected to rise by almost 15 percent, with wages in state enterprises growing by 10 percent and wages paid by cooperatives by over 45 percent. Mr. Ryabushkin personally estimated that profits of the enterprise sector would decline, in nominal terms, by a little under 2 percent in 1990. Gross fixed investment was expected to decline by about 3 percent in comparable prices and investments actually brought into operation to fall by around 4 percent. A copy of Goskomstat's 34-page report (in Russian) on the first nine months of 1990 was also provided to the mission.

3. Statistical issues

a. National accounts

The Goskomstat representatives acknowledged that the figures earlier provided to the Fund for national income utilized and consumption in 1989--in comparable prices--were partially incorrect. Specifically, national income utilized (NIU) had grown by 7.6 percent in current prices but only by 3.4 percent in comparable prices. The growth in the consumption fund was 8.3 percent in current prices but only 5.1 percent in comparable prices. This new information would facilitate the completion of Table R.14 in the draft background paper.

It was confirmed that the figures for NMP, NIU and their components in current prices for 1989 as presented in Goskomstat table RSF38 were the revised numbers, and superseded those reported in Osnovnye pokazateli...

1/ Actually, the more general category, termed "change in material circulating means," which includes the change in unfinished construction.

(1990). Mr. Sokolin revised all the component numbers therein by hand during the meeting and also revised the derivation of GDP in 1989 (Table 1 of the statistical issues paper); GDP for 1989 was now estimated at R 940 billion.

There was considerable discussion of the alternative and very different estimates of the contribution of stockbuilding to NMP in both 1987 and 1988 (see Table R.14) but with no immediate result. Mr. Ryabushkin promised to examine this issue in greater detail and to fax to Washington any comments he might have in this regard.

Insofar as the breakdown of NMP by income recipient was concerned (Table R.17), Mr. Ryabushkin noted that wages paid to cooperative workers were now broken out separately (see the handwritten revisions referred to above), and amounted to 2.0 percent of NMP in 1989. He was unable to present a complete breakdown of the "other" elements of surplus product in NMP, but was under the impression that it largely reflected net price equalization taxes collected by the budget and, beginning in 1989, the profits of cooperatives. Mr. Ryabushkin said that the exclusion of some 4 million workers in defense-related activities from the employment totals in past years had not meant that NMP and GDP were not recorded in full. The change in unfinished construction was fully recorded, in the national accounts, under the "change in material circulating means" (i.e., stockbuilding) and within this category was allocated exclusively to the construction sector. The changes in financial arrangements between contractors and the enterprises contracting construction in the second half of the 1980s did not affect the allocation of the change in unfinished construction within the national accounts.

The table showing the detailed breakdown of accumulation in current prices, since 1985 (RSB12), was updated through 1989 by hand by the Goskomstat representatives during the meeting and a number of revisions were made to the components for earlier years.

b. Investment

Messrs. Kalatylkin, Sokolin, and Ryabushkin commented at some length on the gross and net fixed investment growth rates in Table R.2 of the background paper. They noted that net fixed investment--as recorded in the accounts for NIU--did not just refer to investment undertaken in the material sphere. The apparent contradiction between the still rapid growth in gross fixed investment in the second half of the 1980s and the sharp decline in net fixed investment beginning in 1988 could be reconciled by noting that (a) the latter concept referred to investment put into operation ("vvod v deistvie"), which had been relatively flat in recent years, and (b) depreciation had been growing fairly rapidly.

c. Employment

Ms. Manykina confirmed that the unpublished table on total employment--first given to the August mission--had been revised for each year to reflect the addition of the 4 million defense workers previously excluded from the employment numbers. Thus the growth rates for employment incorporated into Table R.1 of the background paper were correct. These employment figures referred to average rather than year-end employment levels.

As to possible double-counting of employment--particularly in the cooperative and "personal subsidiary employment" spheres--Ms. Manykina confirmed that there was no double-counting and that individuals were simply allocated to one category or another depending on what was judged to be their main place of employment.

d. Financial position of enterprises

Considerable discussion took place of the reasons for the large residuals--particularly in 1985 and 1988--in the enterprise sources and uses of funds statements derived by the Fund staff (Tables R.26-R.27). Messrs. Ryabushkin, Sokolin, and Poltaturev were quite interested in the form of presentation and agreed to consider the issue further and possibly to fax comments to Washington in this regard in coming weeks.

The Goskomstat representatives were also not readily able to explain why the gross operating surplus of enterprises as a share of NMP (GDP) had grown in the second half of the 1980s at the same time as the wage share had also grown (Tables R.17 and R.27). This issue, too, they intended to examine. Mr. Sokolin thought that the particularly large increase in the share of financial profits in GDP might be attributable to some double-counting in the measure of financial profits (i.e., the Finansy SSSR figure). The Goskomstat representatives were unwilling to accept, off hand, the argument that possibly the conumdrum could be explained by an underestimation by Goskomstat of the growth of NMP (GDP) in current prices, possibly due to an underestimation of second economy activities which, however, might still show up in the reported financial profits of enterprises. The mission was provided a copy of the new publication Finanzy SSSR 1989, which contained 1989 figures for profits and the end-year stock of "material circulating means". Also provided was a figure for 1989 depreciation charges of enterprises from Narkhoz (1989). This publication is still in page proofs but was due to be published soon and a copy would be sent to the Fund.

e. Inter-republican trade

The 1989 estimates of inter-republican trade (Table R.33) were not yet available, but Mr. Ryabushkin thought they could be faxed to the Fund sometime in November.

Table 1. U.S.S.R.: Goskomstat Estimates of Various Macroeconomic Aggregates, 1990 (and 1989 Actual)

(In billions of rubles)

	In Current Prices			In Constant Prices (of 1989)	
	1989	1990	Percent change	1990	Percent change
National income utilized	666.0	703.5	5.6	648.9	-2.6
Consumption fund	504.2	556.2	10.4	520.0	3.1
Accumulation	161.8	147.0	-9.2	128.9	-20.3
Of which:					
Change in material circulating means	(38.9)	(38.4)	(-1.2)	(31.8)	(-18.2)
Money incomes of the population	558.0	640.0	14.7		
Of which:					
Remuneration of labor	(406.8)	(455.4)	circa 12		
Of which:					
Wages	347.1	381.0	circa 10		
Other from state units	12.7	13.9	circa 10		
Wages from cooperatives	18.8	27.5	circa 46		
From collective farms	28.2	33.0	17.0		
Profits	281 1/	276	-1.8		

1/ Compares with rub 290.1 billion in Finansy SSSR (1989), p. 25.

Table 2. U.S.S.R.: Goskomstat Estimates of Capital Investment, 1990 (and 1988, 1989 Outturn)

(In billions of rubles; comparable prices)

	1988	1989	Jan.-Sept. 1990	1990 Expected
Gross fixed capital investment	218.2	228.5	...	221.5
Of which:				
State enterprises and organizations	192.9 1/	200.8 1/	...	192.0
State capital investment	188.6 1/	198.5 1/	124.0	192.0
Of which:				
- centralized	(114.0)	(97.5)	(55.1)	(76.0)
- from own funds of enterprises and organizations	(74.6)	(101.0)	(68.9)	(116.0)
Capital investment put into operation 2/	192.5	197.4	...	...
Of which:				
State enterprises and organizations	168.3	172.3	...	165 3/
Stock of unfinished construction (end-year) 4/	160.7	183.3	...	200 3/7

1/ The difference between these lines for 1988 and 1989 is not made clear by the footnote in Russian to the original table.

2/ "Vvod v deistvie osnovnykh fondov."

3/ From the Goskomstat document "Ob otsenke itogov ekonomischeskogo i sotsial'nogo rasvitia SSSR v 1990 godu," and assumed to be a comparable figure to those for 1988 and 1989.

4/ In prices of the year in which the investment was made.

Table 3. U.S.S.R.: Goskomstat Reconciliation of Net Fixed Investment (NIU Accounts) with Gross Fixed Investment and Amortization (GDP Accounts), 1989 1/

(In billions of rubles, in current prices)

1.	Net fixed investment from NIU table ("accumulation of basic funds")	89.8
2.	Less change in livestock heads	3.2
3.	Adjusted net fixed investment (1-2)	86.6
4.	Depreciation - renovation only	111.6 2/
5.	Increase in unfinished construction	22.8
6.	Undepreciated value of retired capital assets	5.1
7.	Write-off of halted unfinished construction	5.5
8.	Budgetary (article 12) and other small-scale investments (e.g., in small equipment) not included in "gross fixed investments"	5.3
9.	Gross fixed investment (= lines 3 + 4 + 5 + 6 + 7 - 8)	226.3 3/

1/ Based on attached Goskomstat commentary in Russian.

2/ The difference between this amount and total depreciation in the GDP accounts is accounted for by capital repairs of rub 62.4 billion.

3/ It is unclear why this figure differs from that in Table 2 by rub 2.2 billion.

FORM NO. 75
(6–83)

THE WORLD BANK/IFC

ROUTING SLIP	DATE: October 18, 1990

NAME	ROOM NO.
Messrs. Paul Isenman,	
Costa Michalopoulos	H12-085
John Holsen	S9039
Stephen Mink	S9040

	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:

Attached for tomorrow's meeting at 5:00 p.m. in Paul's office.

FROM:	ROOM NO.:	EXTENSION:
Geoff Lamb	S13-119	32544

RECEIVED
90 OCT 19 AM 7:44
PRDDR

Technical Assistance Program for the Soviet Union (TAPSU)

Business Plan - CY 1991

A. Background
- Joint Study of the Soviet Economy (JSSE)
- Soviet Request for Technical Assistance
- Conable Visit to Moscow

B. Work Program
- Country Considerations
- Bank Members' Considerations

C. Business Plan
- Base Case
- Membership Case (i.e. assuming early Soviet membership
- Work Program and Budget Details
- Assumptions for Manpower Allocation
- Country Economic Report (following up to Joint Study of Soviet Economy - JSSE)
- Economic and Sector Reports
- Investement Strategies
- Institutional Reforms
  - Training
  - Role of EDI
- Assumption for Dollar Allocations
- Program Budget

Appendices

Executive Summary of JSSE

Speical Study of China

Legal and Policy Bsis for Foreign/Soviet Joint Ventures

Graph 1: EMENA Resources by Work Program Category

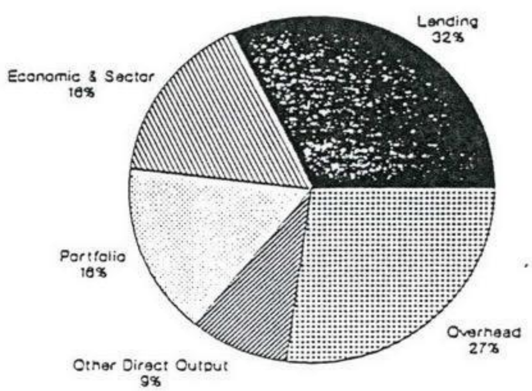
Graph 2: EMENA Dollar Budget

Graph 3: Soviet TA Budget in Context of EMENA Work Program

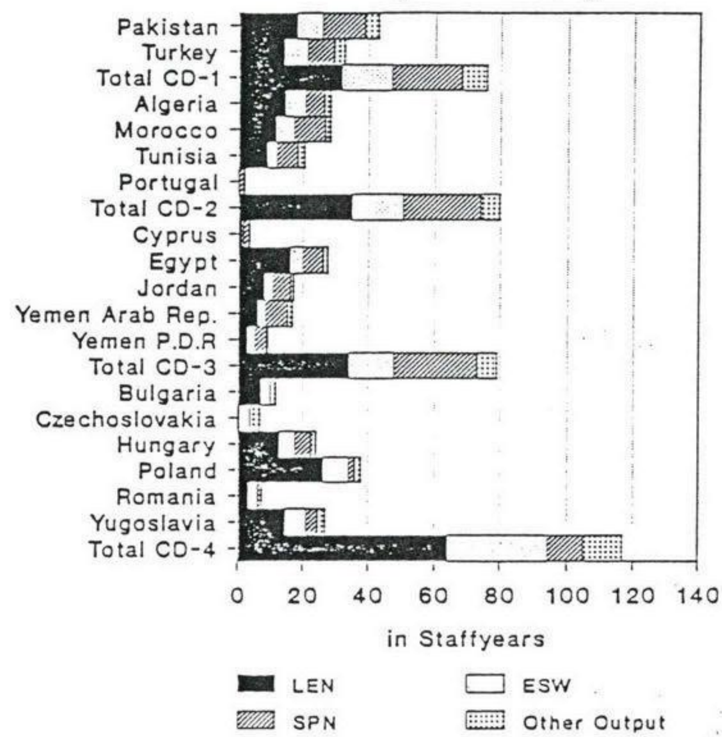
FY91 CAM - Programmed Resources

Total Resources: 505 SYs

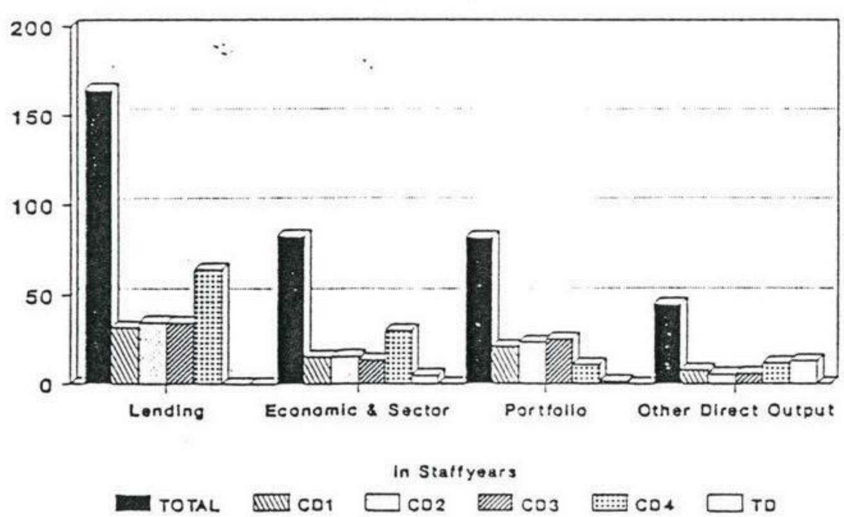
by Work Program Category



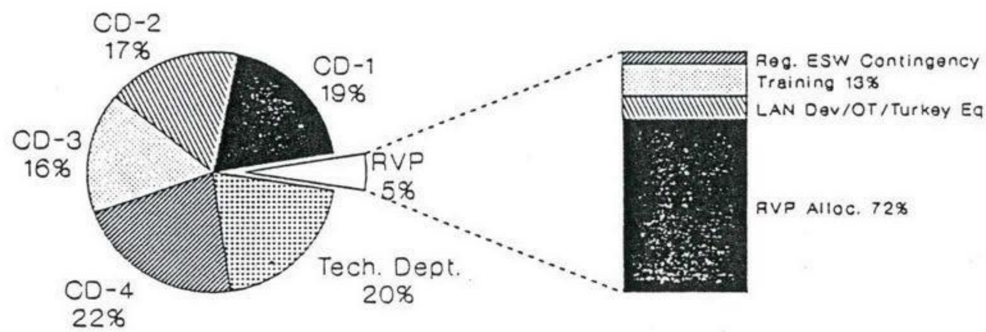
by Country

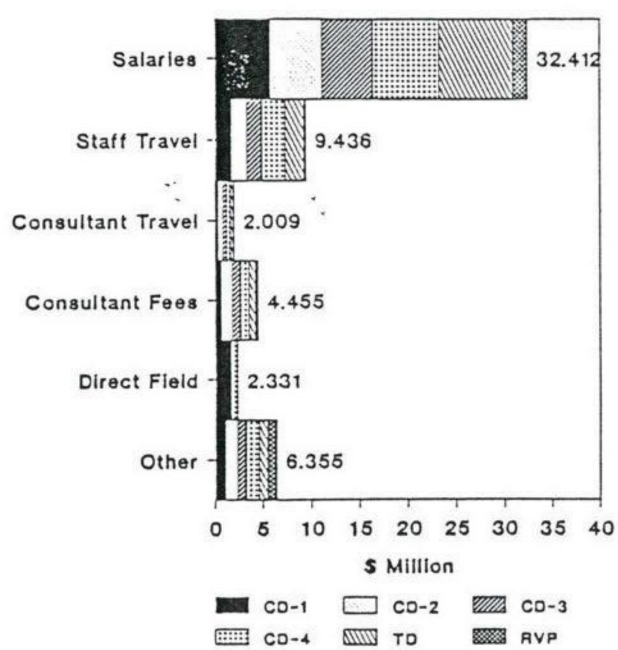


by Work Category and Department



FY91 Dollar Budget
Total Requested: 57.000 ($m)
(excl. FY91 Price Increases)





The World Bank/IFC/MIGA
OFFICE MEMORANDUM

To be revised

DATE:

TO: Paul Isenman (PAUL ISENMAN)

FROM: Stephen Mink, DECVP (STEPHEN MINK)

EXT.: 33696

SUBJECT: Communications with IMF on Bank TA to USSR

As noted during last Friday's meeting, we owe David Robinson and the Fund some information on our proposals for TA to the USSR.

One possibility is the attached. This is essentially the Bock/Lamb aide memoire, minus that document's introduction (paras. 1-2) and discussion of modalities, next steps, and budget (paras. 19-21). If something shorter is preferable, I will hack away some more.

CC: John A. Holsen (JOHN A. HOLSEN)
CC: Costas Michalopoulos (COSTAS MICHALOPOULOS)

WORLD BANK TECHNICAL ASSISTANCE PROGRAM FOR THE SOVIET UNION

This memorandum outlines a possible World Bank Technical Assistance Program for the Soviet Union (TAPSU). The program of advice and technical assistance is comparable in many respects to that provided by the Bank to member countries, new or long established, which wish to undertake major economic reform programs.

The scale and coverage of potential collaboration are set out in deliberately broad terms in this memorandum, to indicate what assistance might be made available if there is agreement in principle between the Bank and relevant authorities in the Soviet Union. However, the actual scope of any program ultimately agreed will have to be carefully defined after further discussion within and between the Bank and the Soviet authorities, and will need to take account, in particular, of the findings of the Joint Study of the Soviet Economy currently underway. At this stage, the Bank has only very limited knowledge of the Soviet government's priorities for technical assistance. In a country as large and diverse as the USSR, moreover, it may be desirable for some assistance under this program to be provided through appropriate channels to other governmental levels, the republics in particular. Bearing in mind these and other issues yet to be determined, this memorandum outlines areas of possible collaboration between the World Bank and the Soviet Union.

The content of this potential program has been the subject of consultation with the IMF to ensure broad coverage of the range of key issues for economy-wide reform. There would also be collaboration in the implementation of the two institutions' proposed technical assistance programs.

Program Outline

The scope and content of technical assistance from the World Bank must be determined by decisions on economic reform to be taken by the Soviet authorities. Soviet economic policy debates have defined three broad challenges: to design and implement fundamental policy and institutional changes to transform the economic system; to develop the new institutions and economic practices which will allow an efficient market economy to flourish; and to increase the efficiency of investments and production in key sectors -- at Union and republic level, and in public and private sectors -- to support the transition to the new system. As Soviet decision-makers address these challenges and the difficult problems of consistency and sequencing which they entail, the Bank has experience and capacity to help at all three levels.

In summary, it is envisaged that the Bank would offer expertise to work alongside Soviet counterparts and provide advice and assistance in the following tasks:

- short-run actions to raise efficiency and production;

- detailed design and sequencing of economy-wide policy reforms, especially in the areas of trade, finance and prices;

- design and implementation of key institutional changes, especially in the financial system and in restructuring and privatization of the productive and service sectors;

- design of sector-specific policy changes, and identification and assessment of sectoral investment priorities;

- training for Soviet cadres in a range of skills critical to a successful transition to a market economy; and

- coordination of external assistance.

These are discussed in further detail below.

System reform. Soviet policy-makers are currently grappling with how to effect a transition towards a market economy, while also establishing macroeconomic stability and fiscal and monetary discipline. Bank advice and technical assistance here would focus on the detailed content and sequencing of reforms, drawing on experience in other countries undertaking extensive structural adjustment, including some -- like Poland, Yugoslavia and Hungary -- in transition to market economy. Crucial areas of Bank assistance are likely to include timing and design of reforms in external trade, price structure and the financial system, and the linkage of these reforms to fiscal and macroeconomic policy objectives.

Short-run actions. While the primary objective of economic reform must be implementation of an appropriate, comprehensive combination of policies, a pragmatic response to Soviet needs must also deal with the key issues of supply response. These include the need to halt deterioration in the economic situation and expand the production and supply of key consumer goods -- both food and manufactures; measures to correct the most obvious waste in the use of valuable resources, especially energy and materials; the provision of social protection for those most immediately affected by the reforms; and improvements in the foreign trade and foreign investment environment (drawing inter alia on the expertise of the International Finance Corporation and MIGA, the Multilateral Investment Guarantee Agency).

Institutional change. Bank advice and assistance would address specific priority areas of institutional change. In the financial sector, for example, the Bank has assisted a number of countries to restructure the financial system, establish sound commercial banking and investment financing institutions, rationalize the public sector's direct involvement in finance, and strengthen its supervisory and regulatory capacity. This is likely to be an important area of work in the Soviet case too. The Bank has also given extensive assistance to countries wishing to reduce the State's direct role in production through encouragement of private investment and divestiture of state holdings. The Bank would draw on this experience to assist Soviet decisions to increase private ownership and investment through privatization and related legal, regulatory and capital market reforms, with the primary objective of promoting efficiency and competition and mobilizing private domestic and foreign savings. The International Finance Corporation has relevant experience, particularly of capital market institutions such as stock markets, to complement the Bank's policy and institutional expertise. The Bank would also offer help in strengthening the management of state enterprises, rationalizing the legal framework for a market economy, and re-orienting administrative institutions from their former control function to one of promotion and regulation.

Sectoral policies and investments. The Bank's effort would focus on establishing sectoral policies and investment strategies consistent with overall reform objectives. Bank teams would also assist the Soviet authorities to assess major investments and establish sectoral investment priorities.

In agriculture, a sector vital to economic reform, World Bank technical assistance would provide expertise on overall sectoral policies, and in particular address agricultural pricing, the creation of marketing institutions and channels appropriate to a much greater role for private production, and improvements in crop storage and transportation.

In industry, the broad business environment is the key -- and this will be determined by the comprehensiveness and depth of the policy reforms and changes in the financial system, ownership and regulation referred to earlier. Beyond assistance in setting this basic framework, Bank technical assistance would probably concentrate on improvements in a limited number of subsectors.

For infrastructure, assistance could be provided in long-range investment planning and assessment, pricing and efficiency improvements, and developing private sector financing of infrastructure projects. Energy, where the Bank has wide experience in the investment, pricing and efficiency issues particular to this vital sector, may be an important focus of the assistance program.

A critical dimension cutting across several sectors is likely to be environmental policy and rehabilitation, where the

Bank has a rapidly growing portfolio of experience to draw on.

In the social sectors, the Bank has been extensively involved in the design of public expenditures to promote cost-effective and equitable service delivery, in health and educational services especially. Restructuring of the housing sector -- including ownership and financing -- is a possible important area of potential assistance as well. A critical aspect of social policy is the design of social safety nets to provide transitional help for those adversely affected during the course of reform -- including displaced workers, the elderly, and vulnerable families. Beyond this short-term requirement, assistance may be needed in designing and setting up effective and fiscally sustainable institutions for financing health care and social security in the new economy.

Training. The Bank's Economic Development Institute (EDI) can work with Soviet institutions to mount policy seminars and help to design training by Soviet institutions for officials and managers assuming new responsibilities in economic management, privatization, industrial and agricultural development, and other fields. EDI could also provide thorough training in the techniques of investment analysis and project appraisal. Most of these programs would be done in the Soviet Union and managed by Soviet institutions: their scale, language of instruction and design will need to be worked out in detail.

Coordination. The Bank has considerable experience in the coordination and management of external financial and technical assistance programs provided by diverse sources. This expertise could be provided to help the Soviet Government establish administrative arrangements to manage external resources cost-effectively. This function may become particularly important as the range of external entities providing assistance to the Soviet Union increases.