

Confidential Filing

Correspondence with and about  
George Soros

FOREIGN POLICY

September 1987

Referred to	Date	Referred to	Date	Referred to	Date	Referred to	Date
8/9/87							
PREM 19/2687							

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MP  
PRIME MINISTER

ASSISTANCE TO POLAND

I attach the latest version of George Soros' plan for economic assistance to Poland, which you may find of interest. It is the so-called 'big bang' approach advocated by the American economist called Sachs and applied with considerable success - but in very different circumstances - to Bolivia. To the layman, quite a lot in it looks unrealistic but it is certainly bold.

Soros is going to Poland at the end of next week and has asked whether he could see you on the way through London. I have said that this simply will not be practicable with all your other commitments, and am trying to arrange for a Foreign Office or Treasury Minister to meet him. I shall also be seeing him myself.

CDP

Charles Powell

8 September 1989



Reak

10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

8 September 1989

See steps,

POLAND: GEORGE SOROS

George Soros has sent me the latest version of his plan for economic reform in Poland. It is the 'big bang' approach about which the Economist (I think it was) wrote last week. Soros tells me that he is full of admiration for the lead given by the Prime Minister on Poland and would very much like to see her to discuss his latest plan, when he is en route to Poland in the middle of next week.

I shall be showing the Prime Minister the paper (she has seen earlier ones), but I don't think its going to be possible for her to see him. It would be helpful to know whether Mr Waldegrave or another Minister would be willing to do so on 13 September. I have undertaken to get back to Mr Soros by this evening.

I am copying this letter and enclosure to John Gieve (HM Treasury) and to Neil Thornton (Department of Trade and Industry).

Your sincerely,  
  
Charles Powell

J.S. Wall, Esq.,  
Foreign and Commonwealth Office.

TELECOPIER COVER SHEET

SOROS FUND MANAGEMENT  
888 SEVENTH AVENUE, SUITE 3300  
NEW YORK, NEW YORK 10106

TELEPHONE (212) 262-6300  
TELEX 428289 SOROSFD  
FAX (212) 245-5154 (GENERAL)  
245-6302 (TRADING)

PLEASE DELIVER THE FOLLOWING PAGES TO:

NAME: Mr. Charles Powell

COMPANY: Prime Minister's Personal Office

FAX NO.: (44-1) 222-8141

FROM: George Soros

IF YOU DO NOT RECEIVE ALL PAGES CLEARLY, PLEASE CONTACT US AS  
SOON AS POSSIBLE.

NUMBER OF PAGES (INCLUDING COVER SHEET): 6

FAX MACHINE OPERATOR: K. Valen

DATE: Sept. 7, 1989

SENDER'S INSTRUCTIONS/MESSAGE:

A PLAN FOR POLAND

There is no precedent for the successful conversion of a centrally planned economy to a market-oriented one. The present situation in Poland offers a unique opportunity to accomplish such a transformation. If successful, it would have an impact that goes far beyond the borders of Poland. It is not too much to say that it would change the course of history.

A radical, comprehensive program is more likely to succeed than the gradual, step-by-step approach usually favored by the IMF. Painful measures that would be accepted today may run into greater resistance in the future; and the more far-reaching the plan, the more likely it is to engender enthusiasm both in Poland and abroad, the Soviet Union included.

The main argument against a radical approach is the lack of preparation and the lack of qualified personnel. I believe that both shortcomings could be overcome with assistance from the West. A "big bang" could be prepared before the end of this year. Emergency help, especially food, could be obtained for the transition period.

A comprehensive reform program would have three major components:

- A) monetary stabilization;
- B) internal economic reorganization;
- C) external assistance.

A) Monetary Stabilization

This would be arranged with the assistance of the IMF but it would resemble the German currency reform of 1948 rather than a typical IMF program. Most price controls would be removed at once and a new, fully convertible currency introduced. Certain key commodities (bread, fuel) may remain controlled to provide an anchor for the price structure but the subsidies would be removed. Domestic prices of tradeable goods would adjust to international levels, prices of non-tradeable goods would be governed by the level of in-

comes. Wages and social benefits would have to be fixed for an initial twelve-month period. Thereafter, wages would be subject to collective bargaining and social benefits would be indexed to the cost of living. The Polish National Bank would be given greater autonomy to assure proper control of the money supply and the budget deficit would be eliminated as part of internal reform.

As a result, the cost of living should remain stable after the initial adjustment period and may even fall if improved efficiency is translated into a rising currency rather than rising wages. Real wages can be kept at their current level to start with but living standards would suffer from high unemployment. Internal reforms coupled with external assistance should encourage new investment so that both employment and living standards would start to rise rapidly from the initial low point. Special measures would be needed to attract investment to areas of high unemployment and to improve labor mobility. To this end, rents must be raised to realistic levels and housing privatized over a relatively short period of time. The introduction of realistic rents, the removal of subsidies, the reduction in international debt service, and the elimination of operating losses in State-owned enterprises should swing the State budget into surplus, allowing a reduction in taxation.

#### B) Internal Reform

The entire public sector would be converted into corporations guided by the profit motive. The major part of the equity capital would perforce remain in public hands since there is not enough private capital available, but both foreign and domestic private investment would be encouraged. Public shareholdings would be distributed into a large enough number of institutional hands to allow stock and bond markets to be established. Institutions would include profit sharing and pension funds, as well as newly created investment banks and trust funds for servicing the foreign debt.

To attract much needed foreign participation, the government would select certain enterprises and/or ministries and specify the percentage of foreign ownership allowed. Investment banks from abroad, as well as newly formed investment banks at home, would then be invited to take charge of these enterprises and/or ministries and arrange for their transfer into private hands. Insofar as they realize a

price above a guaranteed minimum established by a bidding process, they would participate in the profit. This would maximize the price received by Poland.

The conversion of the entire Polish industry to the profit motive could be accomplished over a period of, say, 3-5 years. The process would be guided by the National Property Trust envisaged by the Roundtable Agreement, relying on the assistance of foreign experts. Since most of the enterprises would be left in the hands of present management to start with, foreign experts could be helpful to Parliament in exercising control. It would be desirable to establish an expiration date for the National Property Trust.

c) External Debt Reorganization and Assistance

i) Commercial Bank Debt

Trade debt will be serviced in full. Medium term debt will continue to receive interest, but commercial banks will be asked to give a 3-5 year option to Poland to repurchase the loans at 40% of par; in addition, they will be asked to re-lend to Poland 100% of the interest they receive in the first year, 66% in the second year, and 33% in the third year, subject to the same conditions. Poland will have an incentive to exercise the option starting in the second year because the effective interest rate, calculated on the repurchase price, is very high. It will use any funds raised from the sale of assets for this purpose and, if it makes progress in attracting a capital inflow by maintaining high domestic interest rates, it should be able to refinance the entire amount quite soon. The bankers will have to be persuaded to accept these terms by the Paris Club governments.

ii) Paris Club Debt

There would be a three-year moratorium on payments. Ideally, interest would be forgiven during the moratorium period but, if this is not acceptable to the Paris Club because it would establish a precedent, interest could be capitalized. In that case, a commitment must be obtained now which would limit future obligations. Otherwise, the currency could not be stabilized because of the overhang of accumulated debt. The export credit agencies would re-open their windows

during the moratorium period and Poland would fully service all new obligations.

iii) New Money

Poland could receive, say, \$700 million a year for the next three years from the IMF and World Bank under existing facilities. In addition several countries (Germany in particular) have indicated willingness to provide bilateral credits. Together with private investment from abroad and the mobilization of Polish savings, this should be sufficient to make the currency stabilization scheme possible and to impart an upward momentum to the economy.

iv) Trade

- (a) The European Common Market would admit goods manufactured by EC subsidiaries in Poland free of duty. After the moratorium period, an excise duty may be charged which would be used to service the Paris Club debt. A similar concession may be made to all Polish enterprises, provided the Polish trade surplus is kept within certain bounds. The excise duty could be on a sliding scale, depending on the trade surplus. Some such arrangement is indispensable to create jobs for people displaced from loss-making enterprises.
- (b) Similar agreements may be concluded with the U.S., Scandinavia, Austria, Switzerland.
- (c) Trade with the USSR would have to be renegotiated. I know too little about it to formulate a concrete proposal, but the new arrangement should encourage Polish exports to the Soviet Union while allowing termination of uneconomic contracts.

v) Management Assistance

Management assistance from the West is required on a massive scale. Under the guidance and supervision of the National Property Trust, individual Polish enterprises may be matched up with individual Western enterprises. The Western enterprises would receive an incentive payment based on profit improvement. The Liquidating Agency itself would need an international staff -- Poles living abroad could be mobilized. The costs must be borne by Poland.



This plan is subject to modification in every detail as long as the guiding principle -- a radical transformation of the Polish economy -- prevails.

George Soros  
September 6, 1989

cyBG

# SOROS fund

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George Soros  
September 6, 1989

SOROS  
fund

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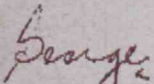
June 9, 1989

Mr. Charles Powell  
Prime Minister's Personal Office  
10 Downing Street  
London WC1  
England

Dear Charles:

The informal Round Table discussion of my plan for Poland will take place in Warsaw on June 19th. I shall be in London on June 15 and 16 and would be happy to discuss the situation and to hear about Jaruzelski's visit. As you know, I would welcome an opportunity to meet with Margaret Thatcher, if possible.

Sincerely,

  
George Soros

GS:asg

# SOROS fund

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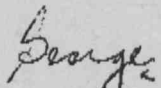
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Sincerely,

  
George Soros

GS:asg

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Have you  
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cc Ro  
HMT.

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

7 June 1989

Thank you for your letter of 23 May. This crossed with mine of two days earlier, in which I explained our view that a meeting of Western policy makers to discuss your ideas for Poland would be premature.

The letter you have received from Mr. Wroblewski surely underlines the need to allow events to unfold rather than to try to force their pace. There are the negotiations within the International Financial Institutions, to which my earlier letter refers. In addition, the Round Table agreements will produce important legislative changes within Poland which will affect your proposals. Mr. Wroblewski referred to the laws before Parliament to set up a National Property Fund and settle the principles for the sale of shares in state enterprises. As he emphasised, worker councils could have a large role to play in this process.

Another area of current uncertainty is the relationship with the commercial banks. Some are considering projects to convert some debt into equity in Polish companies. Clearly if this trend develops, it will converge with some of the ideas you are promoting. It would certainly seem more sensible for private banks to take a stake in Polish enterprises rather than for creditor governments to do so.

I may have some better ideas after we have seen General Jaruzelski at the weekend. But with all the current uncertainty, the best course seems to me to go on refining your proposals and discussing them with the Polish Government and with Solidarity.

(C. D. POWELL)

Mr. George Soros

95

NFCF RB-6  
CR



Foreign and Commonwealth Office

London SW1A 2AH

6 June 1989

Dear Charles,

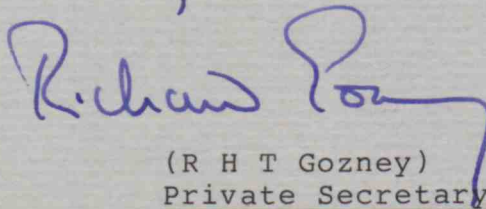
Soros Plan

Thank you for your letter of 24 May, following Mr Soros' further letter to you of 23 May, asking for advice on his proposal for a meeting at policy-making level to discuss his scheme for economic assistance for Poland. You had already replied on this point in your letter of 21 May, which he will by now have received.

Mr Soros also sent a copy of a letter from the Polish Minister of Finance, Wroblewski. While welcoming the plan, this helpfully indicated that there was much in it that had to be worked out in detail to take account of post-Round Table legislation. It also pointed out that some of the ideas coincided with what the Poles are already seeking, eg the conversion of commercial bank debt into equity. Mr Soros could therefore be reasonably advised to continue his discussions with the Polish experts from both the Government and Solidarity sides on those aspects of the plan which they can between them move forward. On the broader question of official debt, however, the appropriate place for discussion will continue to be in the Paris Club and the IMF, as your earlier letter made clear.

/ I enclose a draft letter from you to Mr Soros. I am copying this letter to Johnathan Taylor (HM Treasury).

Yours ever,

  
(R H T Gozney)  
Private Secretary

C D Powell Esq  
10 Downing Street

DSR 11 (Revised Sept 85)

DRAFT: minute/letter/teleletter/despatch/note

TYPE: Draft/Final 1 +

FROM:

Reference

Charles Powell  
DEPARTMENT:

TEL. NO:

POJAAM

BUILDING:

ROOM NO:

Your Reference

SECURITY CLASSIFICATION

- Top Secret
- Secret
- Confidential
- Restricted
- Unclassified

TO:  
George Soros Esq

Copies to:

*KKIAGY*

*e*

SUBJECT:

PRIVACY MARKING

..... In Confidence

CAVEAT .....

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Enclosures flag(s) .....

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SECURITY CLASSIFICATION

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Secret

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PRIVACY MARKING

.....  
In Confidence

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Against this background of uncertainty at both the domestic and international levels, the best advice I think I can give, for the time being, is that you continue your discussions with the Polish Government and Solidarity to refine and <sup>e</sup>velop your proposals on those matters which lie outside the remit of the Paris Club and IMF.

cdm

George SOROS  
7/6



T.G.  
EAM

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

24 May 1989

**POLAND**

I enclose further correspondence from George Soros which has crossed with my letter to him. I should be grateful for advice and a draft reply.

I am copying this letter and enclosure to Jonathan Taylor (HM Treasury).

CHARLES POWELL

R H T Gozney Esq  
Foreign and Commonwealth Office

A handwritten signature in blue ink, appearing to be 'M' or similar, located in the bottom right corner of the page.

SOROS  
fund

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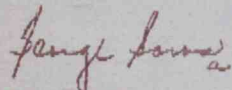
Dear Charles:

I attach the reply I received from the Polish Government today. As you can see, they are ready to take part in discussions under the aegis of the Batory Foundation and suggest a date between June 4 and June 15. The economic advisers to Solidarity have already expressed their enthusiastic support for the plan and indicated that they would be willing to modify the provisions for employee self-management in the "Round Table" agreement.

I believe a meeting among the major Western participants at the policy-making level ought to precede any meeting of experts in Warsaw.

Please advise me how to proceed.

Sincerely,



George Soros

GS:asg

Att.

MINISTER FINANSÓW

Warszawa, May 23, 1989

Dear Mr. Soros :

I would like to inform you that we have studied with great care Your proposal of overcoming the economic crisis in Poland.

The proposal is convergent, in many respects, with the solutions which are being adopted by the Polish government. In particular this includes creation of capital market, sales of equity capital of the Polish companies to private, domestic as well as foreign, investors and use of debt to equity swaps. Our present works provide conditions for broader discussion of your proposal at the expert level.

Therefore, please do accept our readiness to take part in such a discussion between experts of both sides. It seems that there are no obstacles to arrange such a discussion under auspices of the Batory Foundation. I would suggest that a discussion may take place between June 4th - June 15th, 1989.

In my opinion it would be beneficial to consider at the very beginning some questions that might be essential for the final solutions and their feasibility. This refers to the following issues :

-- According to the legal regulations being in force, the transfer of control of an enterprise to any legal body as well as its transformation into a joint stock company or sale of its equity capital requires acceptance of its employees selfmanagement. It should be pointed that we have already experienced such cases, so such solutions might be adopted to limited extent, however, they require negotiations with the concerned enterprises. These solutions might be applicable on larger scale after the Parliament approval of necessary law. It would be possible after the

elections of the new Sejm if such a proposal would find the necessary support of the majority of political forces represented in the Parliament.

-- According to your proposal the establishment of the Agency would imply reaching an agreement with the Paris Club. This involves a question who and in what manner should undertake such at least initial negotiations. According to my experience, the policy of the Club is to avoid engagement in any nonconventional solutions lest to set a precedent. Moreover, the Club stresses that being only an organizer of the cooperation between the creditors it cannot get involved in any agreements going beyond its functions.

-- Next issue refers to the structure and the composition of the Agency. Whether the members in question are to be selected on the basis of personal confidence or by the decision of the representatives of the institutions. Is the participation of the representatives of the Polish government taken into account? How is the responsibility of the agency for the enterprises property to be regulated? Should the participants engage their own resources or is it possible to find a guaranteeing institution (if so, who could offer such a guarantee)?

-- To what extent the agency would be obliged to comply with the current decisions of the Government based on the existing law? To what extent the enterprises of the Agency would have to follow the national regulations being in force?

-- According to the former policy and the agreements of the "Round Table" considered attention is being attached in Poland to the workers participation in management decisions, i.e. in form of the workers selfmanagement. To what extent this idea of workers participation in decision making could be implemented in the

reprivatised enterprises?

-- An important element of your proposal is a three-year moratorium on the Paris Club debt. At present however the Paris Club maintains that no moratorium might be under discussion. Moreover, even in the case of moratorium declaring, the foreign exchange resources would not be increased. An important question, in this context, is who would be ready to provide new money for the first phase of implementation of your proposal. It is a key question because our domestic resources are not sufficient for starting such a process. When planning the implementation of the program it is necessary to decide the sequence of steps to be taken. Which sequence should be followed: Paris Club-Agency - IMF or IMF - Agency - Paris Club? Who in every particular case should be the main partner in negotiations?

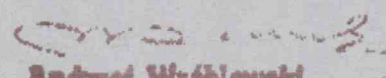
- In the whole proposal a great importance is being attached to the question of money stabilization. According to the proposal the zloty is to be pegged to the ECU. The question is how to arrange such a pegging and how to set the exchange rate.

The presented matters do not cover the whole subject. There are still many more detailed, but very important problems to be considered, e.g. a question of assets evaluation, rules governing the transfer of foreign investors profits, etc.

Having presented some of my remarks, I would be obliged if you could let us know your point of view on the questions being touched in this letter before the experts meeting.

Sincerely Yours,

Minister Finansów

Wp.   
Andrzej Wróblewski

SOROS  
fund

May 23, 1989

Mr. Charles Powell  
Prime Minister's Personal Office  
10 Downing Street  
London WC1  
England

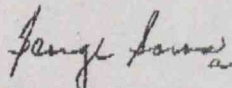
Dear Charles:

I attach the reply I received from the Polish Government today. As you can see, they are ready to take part in discussions under the aegis of the Batory Foundation and suggest a date between June 4 and June 15. The economic advisers to Solidarity have already expressed their enthusiastic support for the plan and indicated that they would be willing to modify the provisions for employee self-management in the "Round Table" agreement.

I believe a meeting among the major Western participants at the policy-making level ought to precede any meeting of experts in Warsaw.

Please advise me how to proceed.

Sincerely,



George Soros

GS:asg

Att.

M. NISIER FINANSÓW

Warszawa, May 23, 1989

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Sincerely Yours,

Minister Finansów

Wz   
Andrzej Wróblewski



FILE

KA-TAND

cc FCO  
PC

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

21 May 1989

Thank you both for the original paper on Poland and for the expanded version. I am sorry you have not had a prompter response. That does not indicate any lack of interest. We are conducting a major review of policy towards Poland and your ideas are being considered in that context. It is certainly common ground that a medium-term debt restructuring with IMF involvement will be needed and that a vital element in this will be to ensure a radical restructuring of the Polish economy to improve its efficiency. Your ideas have a clear role to play in that.

Equally we think the place to pursue them is in the context of the negotiations with the Paris Club and the IMF later in the year, and see an international meeting in London this month as premature. This is not bureaucratic foot-dragging: its a case of bringing together all the various proposals which are kicking around, e.g. the Brady plan for debt reduction, which have a bearing on your plans.

I hope you will see this as a strong declaration of interest - which it is - even if you feel that we are not pressing on fast enough.

(C. D. POWELL)

Mr. George Soros

KK



Foreign and Commonwealth Office

London SW1A 2AH

12 May 1989

Dear Charles,

Poland *at flap*

Thank you for your letter of 2 May enclosing the expanded version of the paper on Poland by George Soros. Whitehall Departments are studying the proposals, as part of a review of our policy towards Poland in response to your letter of 19 April. This exercise is expected to be completed very soon and we may then be able to provide some suggestions of how Soros' ideas could be tailored more closely to Polish realities as we see them.

Mr Soros proposed an international meeting in London later this month preparatory to an unofficial tripartite meeting in Warsaw. We think this would be premature: there are many other proposals under discussion in other fora which have a bearing on his plans, but will take more time to mature. The most important will be the tough negotiations ahead in the IMF and Paris Club. There are other relevant discussions, notably about the Brady Plan for debt reduction. A hastily arranged meeting, which attempted to force the pace of international discussions, could prove counter-productive.

The Foreign Secretary hopes you can convey this negative response to Mr Soros without creating the impression that we are wholly dismissive of his ideas. It is clear to everyone that a medium-term debt restructuring, with IMF involvement, will be needed and that a vital element in this will be to ensure a radical restructuring of the Polish economy to improve its efficiency. The sort of ideas Mr Soros is proposing could have a role to play but they would have to be pursued in the context of the negotiations with the Paris Club and the IMF later the year.

I am copying this letter to Jonathan Taylor (HM Treasury), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

*Yours ever,*

*Richard Gozney*

(R H T Gozney)  
Private Secretary

C D Powell Esq  
PS/10 Downing Street

MJA DNM



10 DOWNING STREET  
LONDON SW1A 2AA

From the Private Secretary

A 2 May 1989

POLAND

BF

George Soros has sent me the enclosed expanded version of his paper on Poland. As you will see, he is now anxious to pursue the idea of a preparatory meeting in London prior to an unofficial tripartite meeting in Warsaw. I should be grateful for advice on how to respond to this.

I am copying this letter and enclosure to Jonathan Taylor (HM Treasury), Neil Thornton (Department of Trade and Industry) and Trevor Woolley (Cabinet Office).

Charles Powell

Richard Gozney Esq  
Foreign and Commonwealth Office.

OTS,

TELESCOPIER TRANSMITTAL COVER SHEET  
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NUMBER OF PAGES 1 / 5 INCLUDING COVER SHEET

FAX MACHINE OPERATOR: Adrienne Gluckmann DATE: May 1, 1989

SENDER'S INSTRUCTIONS/MESSAGE:

Dear Mr. Powell:

The following is an expanded version of the Poland Paper.

George Soros

# SOROS fund

## A Plan to Solve the Economic Crisis in Poland

(Expanded Version)

A political solution in Poland cannot endure without economic assistance from the West. Indeed, both sides are entering into a social contract in the firm expectation of such assistance.

The fact that the Polish economy is so devastated creates an opportunity. A comprehensive restructuring scheme, which would be otherwise inconceivable because of existing structures and practices, becomes feasible.

There are three major tasks to be accomplished:

- a) restructuring of the international debt;
- b) monetary stabilization;
- c) internal economic reform.

The three tasks can be accomplished more effectively in combination than separately.

The central problem in internal economic reform involves the more effective use of capital. This is the main stumbling block in all reform attempts and it has not been overcome in China, Yugoslavia or Hungary (although the latest moves in Hungary look promising).

The problem is that the interests of capital are not properly represented. Communist systems treat capital as a free good and the function that in a capitalist system is performed by the owner is left unfulfilled. Economic reform has difficulty in dealing with the problem because the owners are missing. Even the managements of so-called independent enterprises are more responsive to political pressures, keeping employees satisfied and making barter deals with third parties, than concerned with maximizing the return on capital.

The problem could be resolved in conjunction with a debt reorganization scheme. The enterprises owned by the Polish state could be used in a kind of debt:equity conversion scheme. In the first instance they would be put in the hands of an independent Agency which would be charged with the task of selecting and supervising managements; reorganizing state enterprises into joint stock companies; and finding final owners for their capital. As part of the reorganization, the Agency may sell all or part of some companies to investors at home or abroad. When the reorganization is completed, a large part of the foreign debt would be exchanged for debt or equity of the reorganized entities.

#### The Liquidating Agency

The Agency would be established by agreement between the Polish government and the Paris Club, subject to the approval of the Polish Parliament, so that it would not infringe on Polish sovereignty. Its independence from domestic political pressures would be assured by the fact that the foreign lenders may not accept the eventual exchange offer if they are not satisfied with its work. The Agency may employ foreigners in an advisory capacity. It will have a limited life span, say three to five years. Since only a portion of its assets can be placed into private hands during this period, the Agency will have to make permanent arrangements for performing the ownership function. The creation of a capital market should be an essential part of these arrangements.

#### Monetary Stabilization

The establishment of the Agency would be combined with a monetary stabilization scheme arranged with the assistance of the IMF. It would take the form of a "big bang" in which price controls and subsidies are removed all at once and the zloty is tied to the ecu at a realistic exchange rate. It may involve giving the Polish National Bank a greater degree of autonomy to assure proper control of the money supply.

Domestic prices of tradeable goods would adjust to international levels with appropriate differentials for consumer goods which would be subject to import duties. Real wages need not fall but there would be a temporary reduction in living standards due to high unemployment caused by tight monetary policy and tough decisions taken by the Agency. But the radical reforms coupled with a settlement of the debt problem should encourage



new investment so that both employment and living standards would start to rise rapidly from the initial low point. Special measures would be needed to attract investment to areas of high unemployment or to improve labor mobility. To make the removal of subsidies socially acceptable, pensions and unemployment benefits would be fully indexed to the cost of living. The 80% indexation of wages agreed to in the social contract could also remain in force but, if the stabilization scheme is successful, the cost of living would remain stable after the initial adjustment. The removal of subsidies and the decisions taken by the Agency should swing the state budget into surplus, allowing a reduction in taxation.

### International Debt

#### i) Paris Club

There would be a three-year moratorium on Paris Club debt. After that time, if the Paris Club is satisfied with the performance of the Agency, it would exchange its debt for participating preferred shares or convertible bonds of entities established by the Agency. These entities may be operating companies, or investment companies holding shares in investment companies. The preferred dividend (or, in the case of convertible bonds, the coupon) would be fixed at a low rate, say 3-5%, payable in hard currency, but the lenders may participate in the improved performance of the companies in question. Participating preferred shares may represent a certain percentage (say, 30%) of each company's capital and the lenders may decide in which company they want to hold shares.

#### ii) Bank Debt

The commercial banks will continue to receive interest; but they will be asked to give a 3-5 year option to the Agency to repurchase the loans at 50% of par; in addition, they will be asked to relend to the Agency half the interest they receive, subject to the same conditions. The Agency will have an incentive to exercise the option as soon as possible because the effective interest rate, calculated on the repurchase price, is very high. It will use any funds raised from the sale of assets for this purpose and, if it makes progress in attracting foreign investors, it should be able to refinance the entire amount quite soon. The bankers will have to be persuaded to accept these terms by the Paris Club governments.

Under this scheme, Poland's interest payments will be reduced by about one billion dollars a year for the next three years. In addition, Poland should receive new credits from the World Bank and the IMF of, say, \$700,000 a year. Most importantly, one can expect significant private investment from abroad, not to mention the dollars coming out of Polish mattresses. These factors should be sufficient to create an upward momentum in the economy. After the expiration of the moratorium, interest payments will once again increase to roughly their present level but by that time the economy should be in a better position to cope with it. Moreover, Poland will be meeting its obligations in full, instead of being in default. The debt problem will have been resolved.

Every party will have to make concessions: the Western creditors, the Polish government and the Polish people. Without such concessions there is no way out of the present economic crisis; but, by putting the various elements together, a positive resolution becomes clearly visible. The importance of successful economic reform in Poland can hardly be exaggerated.

I have found considerable interest in this proposal both from the Polish and the Western sides. Both the Polish government and Solidarity have indicated that they would welcome an informal discussion under the aegis of the Stefan Batory Foundation in Warsaw. I suggest a preparatory meeting in London, prior to an unofficial tripartite meeting in Warsaw. The earliest possible date is May 16 in London and May 18 in Warsaw. Your urgent response is requested, via my New York office.

George Soros  
May 1, 1989

cc: Ambassador Robert Blackwill, Washington  
Dr. Horst Teltschik, Bonn  
Mr. Charles Powell, London  
M. Hubert Vedrine, Paris  
Mr. Gianni de Michelis, Rome  
Messrs. Secula and Wroblewski, Warsaw  
Mr. Bronislaw Geremek, Warsaw

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Mr. Charles Powell, London  
M. Hubert Vedrine, Paris  
Mr. Gianni De Michelis, Rome  
Messrs. Sec. and Wroblewski, Warsaw  
Mr. Bronislaw Komorowski, Warsaw

CFC



Foreign and Commonwealth Office

London SW1A 2AH

27 April 1989

CDD  
27/4.

Dear Charles,

International Economic Assistance to Poland

Thank you for your letter of 24 April. CFC

George Soros called on Patrick Wright on 25 April and explained his ideas in some detail. He had recently visited Poland and claimed to have had a positive response from Solidarity and the Government. (We know from a report from our Ambassador that the government's reaction was in fact fairly cautious.) Our impression is that Soros underestimates the difficulty of the problems presented by economic reform in Poland.

He said that his proposed agency (which he said would be Polish rather than foreign, as implied in his paper) would be responsible for restructuring Poland's 150 largest enterprises in the course of 3 years. We think that a much longer timeframe will be needed, and that Soros underestimates the difficulty of dealing with the problems of unemployment, retraining etc which would result. Moreover, the Poles might balk at the considerable loss of sovereignty which such a scheme would entail.

He also seemed to underestimate the difficulty the Poles would have in following a credible macroeconomic policy. He regarded cutting the budget deficit and stabilising the currency as essential to the success of his plan, but argued at the same time that living standards should not be depressed any further as, in his view, the IMF would insist.

We would not wish to pour too much cold water on his ideas. As you know he is an energetic and influential figure and may be able to devise ways of helping the Poles. But we are concerned that he may give the impression of being able to deliver debt relief and an easy ride with the IMF. We do not believe that he should involve himself with the IMF/Paris Club which are the concern of Governments.

We think that he should focus on the private sector and on seeking possible investors. If he can interest private banks in debt/equity swap arrangements we would certainly welcome this. It is very much in line with President Bush's statement of 13 April.

/Finally,



RESTRICTED



Finally, we see no difficulty about the informal meeting which he hopes to arrange in Warsaw in June or July, although we are doubtful about IMF participation. If the meeting takes place we should certainly like to send an observer from the Embassy in Warsaw.

I am copying this letter to Jonathan Taylor (HM Treasury).

Yours ever,

*Richard Gozney*

(R H T Gozney)  
Private Secretary

C D Powell Esq  
10 Downing Street

RESTRICTED

Poland : Pt 10

Int Situation

27.11  
AM. 9

FILE KATAUK



10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

SIR ROBIN BUTLER

Thank you for your note about Mr. Soros whom I know quite well. Indeed, I am having dinner with him tonight. Besides his other qualities, he is extremely persistent. On his present visit to London he has seen the Economic Secretary at the Treasury and Sir Patrick Wright at the Foreign Office. I am in more or less constant communication with him and have in the past shown the Prime Minister, as well as Departments, some of his papers. Their quality is uneven. Not all his ideas are by any means practical. He has been pressing me very hard for an appointment with the Prime Minister. But she has access to a very wide range of sources on developments in eastern Europe at present, and I do not think that Mr. Soros would add enough to make it a worthwhile investment of her time.

C. D. POWELL  
27 April 1989

ls

Ref. A089/1077

MR POWELL

---

Lord Lever telephoned me today about Mr George Soros, an American of Hungarian origin who is in London for two weeks. Lord Lever said that Mr Soros is a very intelligent and interesting man, who has made a great deal of money in America but retains a passionate interest in Eastern Europe and in promoting democracy there. He has used his money to found Trusts for this purpose in both Moscow and Hungary and is very well informed about what is going on in both places.

2. Lord Lever recommended Mr Soros as a man with whom the Prime Minister would find it interesting to talk about Eastern Europe. Would you let me know whether the Prime Minister would be interested in meeting Mr Soros during the next fortnight?

R.R.B.

ROBIN BUTLER

27 April 1989



bc PC

10 DOWNING STREET

LONDON SW1A 2AA

*From the Private Secretary*

24 April 1989

INTERNATIONAL ECONOMIC ASSISTANCE FOR POLAND

Thank you for your letter of 21 April commenting on the note from George Soros setting out his ideas for an international economic programme of assistance for Poland. Mr Soros subsequently telephoned me and I was able to make the points in your letter. He said that he had also seen the Economic Secretary and Treasury officials.

Soros claimed to have had quite a positive response from Polish officials to his ideas. He is now contemplating organising a round table discussion, involving Polish officials and representatives of Western donor governments, sometime in May in Warsaw. The purpose will be to discuss very informally how his ideas could be taken forward. He had put this to the Americans and was hoping for a positive response. He thought it would be very helpful if there could be some British participation. He emphasised that it would be entirely without obligation. I said that I would consult about this and be in touch with him (I shall in fact be at a dinner with him on 27 April). Might we in fact be ready to send someone from our Embassy in Warsaw, at least as an observer at such a meeting, if it happens?

I am copying this letter to Jonathan Taylor (HM Treasury).

C. D. POWELL

Richard Gozney, Esq.  
Foreign and Commonwealth Office

dg

End - Day  
17/12/89  
Winn

APC



Foreign and Commonwealth Office

London SW1A 2AH

21 April 1989

CSD

24/4.

Dear Charles,

International Economic Assistance for Poland

Your letter to me of 12 April enclosed a note from George Soros outlining his ideas for an international economic programme of assistance for Poland.

We very much agree with Soros' comment that the central problem of reform in Eastern European countries involves the effective use of capital and the problem of defining who owns fixed capital and property. It is a vexed question for Communist societies. The Hungarians are about to bring in legislation to establish in law that the State formally owns property and can dispose of it as it wishes, but, as Soros comments, other Eastern European countries have yet to address the issue.

But implementation of much of the programme would depend on a voluntary cession of sovereignty by the Poles investing the ownership and management of State enterprises in an "agency" involving foreign advisers, and in handing the conduct of monetary policy to foreign advisers. It seems to us politically unrealistic to imagine the Poles ceding sovereignty in these areas.

You will not be surprised that Mr Soros' ideas about the handling of Paris Club debt would cause a number of difficulties for us. We have repeatedly made it clear that debt and credit problems should be addressed only after the negotiation of an agreement between Poland and the IMF. This remains our policy (and it appears, that of most other Western creditors) despite the conclusion of the Round Table accords. Indeed we believe the latter provide some hope that a political consensus can be developed on which the Poles can agree forceful policies for economic reform and adjustment, which will have the support of the international community. Nonetheless we recognise that it will not be easy to secure a Poland/IMF agreement. The Polish economy is in a parlous state, and a weak IMF programme is in neither the Poles' nor our interests. It may be necessary to take measures to bring the IMF and Poland into a closer relationship leading to a full stand-by arrangement.

/Once



Once an IMF programme begins to be implemented, we are ready to consider debt rescheduling. We believe a three year repayment moratorium ought not to be necessary. Mr Soros' proposal that the Paris Club could in due course exchange its debt for equity in the state enterprise Agency is unlikely to find favour among governments which have not previously become involved in such mechanisms. We are sceptical also that many commercial banks would be prepared to convert some of their debts in Eastern Europe into equity shares (even after local legislation has advanced to the point that this would be possible) as they have already done in certain Latin American countries, although you will have noted that President Bush, in his statement on aid to Poland on 17 April, undertook to encourage business and private groups to "implement creative debt-equity, debt-nature and debt-charity projects".

I shall be replying separately to your letter of 19 April.

*Yours ever,*

*Richard Egan*

(R H T Gozney)  
Private Secretary

C D Powell Esq  
10 Downing Street

Poland - Relaters





UNCLASSIFIED

am.

NOTE OF A MEETING IN THE ECONOMIC SECRETARY'S ROOM, TREASURY CHAMBERS  
AT 4.30pm ON THURSDAY 20 APRIL

Those present:            Economic Secretary  
                                 Mr Mountfield  
  
                                 Mr Soros

#### MEETING WITH GEORGE SOROS

Mr Soros was grateful to the Economic Secretary for agreeing to meet him. He had just returned from Warsaw having previously visited Budapest and Moscow.

#### Poland

2. Mr Soros explained his ideas for international economic assistance for Poland. He believed a lasting political solution for the country could not be gained without first solving economic problems. Action was needed as in all Communist countries to tackle the problems of debt, monetary instability and the inefficient use of state capital. It was, Mr Soros believed, better to tackle these problems together rather than separately. His primary concern was the effective use of capital. He proposed that all state enterprises should be put in trust to be administered on behalf of shareholders by an independent Agency with representatives of foreign interests. There would also be a 3 year moratorium on Paris Club debt. After that, debt would be converted into preference shares in the Agency at a relatively low rate of return. The Agency could later use part of its income to repurchase its preference shares through an auction process.

3. Mr Soros claimed that as far as he could judge, Solidarity were enthusiastic about these proposals. They recognised Poland's problems and regarded Mr Soros' plans as a possible solution. The Polish Government had also proved more receptive than he had hoped. He was

UNCLASSIFIED

aware that he was likely to receive a much cooler reception from the UK and, he suspected, the US.

4. It would be important, Mr Soros explained, for the Government in Poland to relinquish its 'Nomenklatura' rights of nomination to the top management positions in the biggest companies. These would need to be forfeited for the Agency he proposed to operate. He recognised it would not be easy to achieve this, but it was essential to bring in new and properly trained management.

5. The Economic Secretary said that Mr Soros was no doubt correct in thinking people needed incentives to make capital work effectively. However he was doubtful as to how ready people in Poland would be to face up to the necessary solutions. Britain had faced problems of overmanning, for instance, in the 1970's. Once management of industries had improved, jobs had been shed. The same would happen in Poland.

6. Mr Mountfield added that Mr Soros' plan resembled a debt-equity swap, but by governments. It would be odd for Britain to pursue a policy of privatisation at home but to buy up nationalised industries in Poland. It would be easier for the banks to use their share of the debt for this purpose. The Economic Secretary said that if Poland could attract equity capital, this could be used to service debt. Mr Soros agreed that joint ventures with part foreign ownership would be helpful. He foresaw the Agency selling some of the more promising state industries to domestic buyers and holding the remainder as social capital. Administration of these remaining nationalised industries would need to be divided up otherwise he would just be creating another form of state ownership.

7. Mr Soros was under the misapprehension that the Paris Club had deliberately chosen to play a subordinate role compared with the commercial banks in rescheduling Polish debt. Mr Mountfield explained that this was accidental. The conventional Paris Club deal arranged in 1981 had been suspended on the imposition of martial law and the Paris Club had been forced to capitalise most of the interest accruing during the ensuing period. The banks by contrast had achieved an agreement with the Polish Government, and had continued to receive interest.

This had resulted in a switch in the relative shares of the stock of debt, as between banks and government, from 60:40 in 1981 to 40:60 now. The Paris Club wanted to increase the flow of funds to Government creditors and not, as Mr Soros proposed, agree to a further moratorium. It was for the banks (or other creditors, like USSR) to provide Poland with a breathing space if this could be negotiated.

8. Mr Soros said that concessions from the commercial banks alone would not be sufficient. Government creditors also needed to participate. Mr Mountfield noted that it would be difficult for the US to be seen to be more generous to Poland than, for example, to Mexico. They had not been prepared to contemplate write-down of Mexican debt to Paris Club governments.

9. Mr Soros asked whether there were any technical or constitutional obstacles to the Polish Club taking a stake in Polish industries. Mr Mountfield noted that the Paris Club collectively had never taken a loss. The individual agencies by statute had different rules. He knew of one which was debarred by statute from taking a loss; 5 or 6 others would have difficulties in doing so. Two had taken a small loss in the past on selling off or swapping some of their debt. The UK was not barred by law from accepting a loss but Ministers were not willing to do so at present. The Economic Secretary reminded Mr Soros that the Paris Club was not in the business of writing off debt. At most, debt was rescheduled on occasion.

10. Mr Soros said that he wished to see informal, round-table discussions on his proposals in Poland between Solidarity, the Government and foreign participants. His next step was a meeting with Sir Patrick Wright on 25 April. He hoped that a Government conference might be possible in May/June. Before that he would need to discuss with the West, and perhaps the Paris Club, what concessions they were prepared to make.

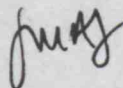
11. The Economic Secretary said that the Prime Minister recognised the importance of what had happened in Poland, and indeed she had been part of the process of making it happen. Nevertheless the Government did not believe in throwing money at problems. Structural reforms were

needed in Poland. Where a breathing space in debt repayment was necessary, Poland should look to the commercial banks to provide it.

Mexico

12. Mr Soros was interested in finding out more background to the Spring meetings. Why in particular was the Chancellor opposed to the Brady Plan for Mexico? The Economic Secretary said that the UK's position was clear. We did not believe that IFIs should prop up commercial banks. The banks should come to agreements with the debtor countries themselves. The banks were now in a position to take a hit if necessary. Britain did not maintain a root and branch opposition to all Brady's proposals in Mexico but sought a more selective response to different aspects of Mexican problems.

13. Mr Soros asked whether the issue of interest guarantees was still being disputed. The Economic Secretary said the issue was still under discussion and the UK were not alone in opposing interest guarantees. The split was roughly Europe on one side, the US and Japan on the other. Mr Mountfield added that the details of the proposals had still to be worked out.



S M A JAMES  
Private Secretary

cc: PS/Chancellor  
Mr Wicks  
Mr Lankester  
Mr Mountfield  
Mr H Evans  
Mr Bottrill  
Mr Powell - 10  
PS/Mr Waldegrave - FCO  
PS/Chief Executive - ECGD



FILE

KK

bc PC

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

12 April 1989

**INTERNATIONAL ECONOMIC ASSISTANCE  
FOR POLAND**

I enclose a note from George Soros about international economic assistance for Poland. It looks very unrealistic to me: in effect handing over the Polish economy to be run by a group of receivers. But I should be interested in any views, since I have to see Soros shortly.

I am copying this letter to Jonathan Taylor (HM Treasury).

(C. D. POWELL)

Richard Gozney, Esq.,  
Foreign and Commonwealth Office.

## International Economic Assistance for Poland

- 1) A political solution in Poland cannot endure without economic assistance from the West. Indeed, both sides are entering into a social contract in the firm expectation of such assistance.
- 2) The fact that the Polish economy is so devastated creates an opportunity. A comprehensive restructuring scheme, which would be otherwise inconceivable because of existing structures and practices, becomes feasible.
- 3) There are three major tasks to be accomplished:
  - a) restructuring of the international debt;
  - b) monetary stabilization;
  - c) internal economic reform.

The three tasks can be accomplished more effectively in combination than separately.

- 4) The central problem in internal economic reform involves the more effective use of capital. This is the main stumbling block in all reform attempts and it has not been overcome in China, Yugoslavia or Hungary (although the latest moves in Hungary look promising).

The problem is that the interests of capital are not properly represented. Communist systems treat capital as a free good and the function that in a capitalist system is performed by the owner is left unfulfilled. Economic reform has difficulty in dealing with the problem because the owners are missing. Even the managements of so-called independent enterprises are more responsive to political pressures, keeping employees satisfied and making barter deals with third parties, than concerned with maximizing the return on capital.

- 5) The problem could be resolved in conjunction with a debt reorganization scheme. The enterprises owned by the Polish state could be put in trust to serve as collateral for the reorganized debt. The trust could be administered by an independent Agency with the participation of foreign advisors. The Agency would be responsible for selecting and supervis-

ing managements, and it would be empowered to sell companies to investors at home or abroad.

- 6) I believe Poland would welcome such an arrangement because it would bring an expertise that is lacking and give the Agency a stature and independence that would be otherwise unattainable. Polish acceptance would, in turn, demonstrate their commitment to economic reform and justify Western participation.
- 7) Foreign advisors would also participate in running the central bank and controlling the domestic money supply. This would give the central bank the independence needed to carry out a successful monetary reform. Monetary reform would, in turn, be made possible by a reorganization of the international debt and a reduction in debt service payments.
- 8) The foreign advisors would be engaged as individuals, not as representatives of foreign governments. The two functions -- managing state capital and managing the money supply -- would be kept separate, much as the IMF and the World Bank are separate.
- 9) There would be a three-year moratorium on Paris Club debt. After that time, if the Paris Club is satisfied with the performance of the Agency, it would exchange the debt into preference shares of the Agency. Interest would be fixed at a relatively low rate, say 3 to 5%. In addition, the Agency could use part of its income, especially the part coming from the sale of assets, to repurchase its preference share through an auction process.
- 10) To flesh out this proposal, I suggest setting up an international task force with the participation of all interested parties. To keep the discussions informal, the task force could, if necessary, be sponsored jointly by the Rockefeller and Soros Foundations.

George Soros  
April 10, 1989

## International Economic Assistance for Poland

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George Soros  
April 10, 1989

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April 10, 1989

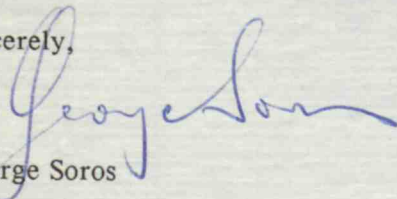
Mr. Charles Powell  
Prime Minister's Personal Office  
10 Downing Street  
London WC1  
England

Dear Mr. Powell:

I look forward to seeing you at Meriza Giori's on Thursday, April 27th. In the meantime I am sending you a short memorandum on Poland for your consideration.

I should love to meet with Mrs. Thatcher if she were available.

Sincerely,



George Soros

GS:asg

Enc.

## International Economic Assistance for Poland

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George Soros  
April 10, 1989

Tel: Oxford (0865) 513146  
Fax: Oxford (0865) 310750  
Tlx: 83295 NUCLOX G

CF

STEFAN BATORY TRUST  
3 Church Walk  
Oxford OX2 6LY  
(Reg. Charity No: 327797)

29th March, 1989.

Mr. Charles Powell,  
The Prime Minister's Private Secretary,  
10 Downing Street,  
London SW1A 2AA.

CDP 01R

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Dear Mr. Powell,

Encouraged by the progress of the round table talks in Poland and the likelihood that a new "social contract" will soon be concluded between the Government and the opposition, Mr. Soros has been giving some thought to the problem of the Polish debt. He has put down his ideas on paper at the request of Mr. David Rockefeller (whom he hopes to involve in the preparation of his plan) and has asked me to pass them on to the British and the Polish Government for comment.

Mr. Soros will be in London for the last week in April and most of May and may actually go to Poland to discuss his ideas. His address is:

in case there was need to contact him directly.

Yours sincerely,

Zbigniew Pelczynski

Enc.

TEMPORARILY RETAINED 5/8/2016

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RETAINED UNDER SECTION 3 (4)  
OF THE PUBLIC RECORDS ACT

**F A X**

March 24, 1989

To: Dr. Zbigniew A. Pelczynski

From: George Soros

David Rockefeller asked me to put my idea in writing. Here it is. You may pass it on to the Polish and British governments to get their response.

Best,

### International Economic Assistance for Poland

- 1) A political solution in Poland cannot endure without economic assistance from the West. Indeed, both sides are entering into a social contract in the firm expectation of such assistance.
- 2) The fact that the Polish economy is so devastated creates an opportunity. A comprehensive restructuring scheme, which would be otherwise inconceivable because of existing structures and practices, becomes feasible.
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- 5) The problem could be resolved in conjunction with a debt reorganization scheme. The enterprises owned by the Polish state could be put in trust to serve as collateral for the reorganized debt. The trust could be administered by an independent Agency with foreign participation. The Agency would be responsible for selecting and supervising manage-

- ments; it would be empowered to sell companies to investors at home or abroad, but sales to foreigners would be subject to a Polish veto.
- 6) I believe Poland would welcome such an arrangement because it would bring an expertise that is lacking and give the Agency a stature and independence that would be otherwise unattainable. Polish acceptance would, in turn, demonstrate their commitment to economic reform and justify Western participation.
  - 7) The Agency would also participate in running the central bank and controlling the domestic money supply. This would give the central bank the independence needed to carry out a successful monetary reform. Monetary reform would, in turn, be made possible by a reorganization of the international debt and a reduction in debt service payments.
  - 8) The foreign participants in the Agency would act as international civil servants. The two functions -- managing state capital and managing the money supply -- would be kept separate, much as the IMF and the World Bank are separate.
  - 9) Poland's international debt would be converted into long-term obligations of the Agency, preferably with some international guarantees in order to enhance their resale value. Part of the interest would be fixed and part tied to the performance of the Polish economy. In addition, the Agency could use part of its income, especially the part coming from the sale of assets, to repurchase its obligations in the open market.
  - 10) To flesh out this proposal, I suggest setting up an international task force with the participation of all interested parties. To keep the discussions informal, the task force could, if necessary, be sponsored jointly by the Rockefeller and Soros Foundations.

George Soros  
March 24, 1989





*file*

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

20 February, 1989.

*Dear Mr. Soros,*

Thank you for sending me the further papers reflecting the work of your Open Sector Task Force in the Soviet Union. I was most interested to read these, and have shown them to the Prime Minister. You may like to consider sending copies also to Sir Gordon White.

*Yours sincerely,  
C.D. Powell*

(C.D. Powell) -

Mr. George Soros



*File to  
pc PC*

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

20 February, 1989.

*Dear Sir,*

**THE SOVIET UNION: OPEN SECTOR TASK FORCE**

You may be interested in the enclosed papers which have been sent to me by Mr. George Soros.

*Yours sincerely,  
C.D. Powell*

(C.D. Powell)

Richard Gozney, Esq.  
Foreign and Commonwealth Office.

*to*

R17/2

SOROS ②

Rice Minister

fund

I continue to think that there are some really rather ingenious ideas here. If you agree, I will

February 9, 1989

send a copy to James Hansen / Gordon

Mr. Charles Powell  
Prime Minister's Personal Office  
10 Downing Street  
London, W.C. 1  
England

White. There is an increasing rapprochement between their

Dear Mr. Powell, ideas & those of Mr. Soros. (I think Gordon

I want to bring you up to date on the work of my Open Sector Task Force in the Soviet Union. I enclose two papers: my opening remarks and the interim report prepared by the co-chairmen of the task force. I regard the progress we have made as quite outstanding by Soviet standards but quite unsatisfactory by my own. We did have a productive meeting with Mr. B. P. Mozhin, Deputy Head of the Social-Economic Department of the Central Committee. I was unable to meet with Mr. Gorbachev, who was out of town, but I am trying to see him, if possible prior to his visit to Britain. I shall keep you posted.

White may now have talked to him)

Sincerely,

George Soros

GS:psw  
Enclosures

CSP  
1872

First Class.

I wish we could follow with it

## Opening Remarks on the Open Sector Project

Addressed to Participants of the Open Sector Task Force

by George Soros

at the State Foreign Economic Commission

Moscow, USSR

January 23, 1989

### I. The Open Sector and Special Economic Zones

I should like to set the context for our meetings.

Two disparate impulses have brought us together. One is to design a framework for integrating the Soviet economy into the world economy. That is my interest and the motivation of most Western participants sitting here today. The other is to design a structure for Special Economic Zones. That is Ivan D. Ivanov's task and probably the reason why many, but not all, Soviet participants are present. We must clarify the relationship between these two objectives, otherwise we risk working at cross-purposes.

The Open Sector is a broad concept. Special Economic Zones is a more narrow one. There is a natural tendency for us to treat these concepts as if they were opposed to each other, especially as we approach the subject from different directions: the Western experts

from the point of view of general systemic reform and the Soviets from the point of view of a specific administrative task. If we are not careful the two concepts could in fact become opposed to one another. This would be a mistake. The proper relationship between the two concepts is that the narrow concept should fit into the broader one. The creation of Special Economic Zones alone, without an Open Sector, may do more harm than good to the Soviet economy. On the other hand, if Special Economic Zones are integrated into an Open Sector, they can play a useful and perhaps even necessary role in domestic economic reform.

First, I'd like to give three reasons why the creation of Special Economic Zones taken in isolation may be harmful.

1) Special Economic Zones require investment in new infrastructure and the creation of new enterprises rather than the utilization of existing resources. One of the main faults of the present Soviet economic system is the wasteful use of resources. Setting up Special Economic Zones would merely aggravate this problem.

2) Special Economic Zones require the creation of new administrative and regulatory superstructure. As it is currently envisioned, each SEZ would have its own administration, rules and regulations. These additional layers of bureaucracy would create yet additional confusion and inefficiency. We all agree that the last thing the Soviet economy needs is more bureaucracy.

3) Special Economic Zones would have little impact on the domestic economy. It is difficult to see what tangible effect a Special Economic Zone in Nahodka, far from the heart of the Soviet economy, would have on domestic economic restructuring. SEZ's would, in effect, be a misallocation of precious new investment capital.

If the aim of Soviet reformers is to preserve the existing economic system and isolate it from pernicious foreign influences, then creating Special Economic Zones in isolation is indeed the correct recipe. But if their aim is to restructure the Soviet economy, then it is a mistake.

Special Economic Zones could play a useful role in economic reform, but only as part of a more general scheme - an Open Sector. We should therefore agree on the outlines of the Open Sector before we set about designing the specific features of Special Economic Zones.

## II. Defining the Open Sector

You have before you a paper, "The Open Sector Concept." It is as short and simple as possible. After discussion and modification, I hope that we could adopt it as a guideline for designing both the Open Sector and Special Economic Zones.

The paper has ten sections. Each has a distinct point.

1) The restructuring of the Soviet economy cannot be accomplished uniformly across the board. It would be advisable to create an Open Sector which serves as a catalyst for restructuring the rest of the economy.

2) The Open Sector cannot be an imitation of Chinese economic zones or any other foreign experiment. The conditions which made those experiments possible do not prevail in the Soviet Union.

3) This is the most difficult point because it is the most abstract and I am not sure that we have formulated it in the best possible way. Basically, it says that the Open Sector should be the home of all enterprises which operate on the profit principle wherever they are located, and the Open Sector should rely on the market mechanism to the greatest possible extent.

4) Since the professional skills required for the management of firms in a market environment (i.e. the Open Sector) are largely absent in the Soviet Union, they need to be imported from abroad. The importation of management skills should take precedence over the importation of equipment.

5) The importation of management skills and the creation of a market environment must be carefully coordinated. If not, foreign managements will learn to live in a Soviet environment instead of teaching Soviet enterprises to operate in a market environment.

6) The Open Sector needs a Planning Agency.

*An Urban Development Corporation*

7) To create a competitive environment the Open Sector must be concentrated along both geographical and industry lines. This is where Special Economic Zones come in. A critical mass of firms must operate in the Open Sector for it to be truly effective.

8) The creation of an Open Sector could first focus on certain industries such as the food processing, clothing and shoe industries. This could be accomplished by marrying off Soviet enterprises with foreign managements. The result would be a new type of joint venture (Type C) in which the foreign partner contributes only management and receives a small participation in profits.

9) This section sets out a timetable for developing the Open Sector.

10) This section returns to the need to create a Special Planning Agency for the Open Sector. I feel this has to be our first and most urgent recommendation. A new type of government agency is needed which is "soft on the inside, hard on the outside;" that is, it interferes as little as possible with the operation of individual enterprises within the Open



Sector but regulates the relationship of the Open Sector with the rest of the Soviet domestic economy and the outside world.

### III. Open Sector Participants

Joint ventures, cooperatives, and state enterprises which have been re-organized as profit-oriented units could operate in the Open Sector. Generally speaking we can anticipate three main types of foreign participation:

Type A: Natural resource-based and export-oriented ventures. There is plenty of capital available for this purpose and conversion of profits into foreign currency would not be a problem. Special Economic Zones in Nahodka and elsewhere would serve as supply bases for such enterprises.

Type B: Technology-based ventures directed primarily, but not exclusively, at the domestic market. Large-scale foreign capital investment is needed, but would not be readily available because of difficulties in converting profits from domestic sales. The difficulties could be overcome by tying Type A and Type B ventures together in specific deals and more generally in introducing an auction market for hard currency. It would be a mistake to confine Type B ventures to Special Economic Zones but if such Zones are established close to the consumer, Type B ventures may find it convenient to use them.

Type C: Foreign management participation in firms catering to the domestic consumer. For such ventures, very little foreign capital is needed, but foreign management must be given some profit participation and this must be paid in foreign currency. I believe that Western Europe would be willing to make credit available for this purpose.

#### IV. Concluding Comments

There is intense interest abroad in cooperating with the Soviet Union along these lines. Unfortunately, there is tremendous frustration among those who are currently trying to do business in the Soviet Union. It is therefore urgent to establish the ground rules of foreign participation in the Soviet economy and to create an overall strategy for the Open Sector.

Business and government leaders I have spoken with have expressed a great deal of enthusiasm for the Open Sector and are willing to act once the Soviet government has committed itself to a specific strategy.

I very much hope that we shall be able to produce an interim report on the Open Sector on the basis of which the Soviet government can move ahead. I believe the first step in this direction would be the creation of an Open Sector Planning Agency which could immediately set about creating the womb within which the embryo of a market economy could develop.

## Interim Report on the Open Sector Project

This is a progress report on the Open Sector Project. The basic goal of the project is to develop a strategy for establishing an Open Sector in the Soviet Union. An Open Sector economy composed of market-oriented firms (enterprises) would facilitate the process of economic reform in the Soviet Union and the integration of the USSR into the world economic system.

From January 22-27, 1989 Soviet and foreign experts met in Moscow to develop the framework for the Open Sector. Considerable progress was made towards developing this framework. In this report we summarize our preliminary conclusions and the issues that remain to be resolved

### Goals of the Open Sector

The aim of the Open Sector is to facilitate Soviet economic reforms, boost Soviet living standards and integrate the USSR into the world economy. More specifically, the Open Sector will:

- establish a market-oriented economic system
- expand the supply of high-quality consumer goods, food products and services
- increase the production and export of manufactured goods
- attract foreign capital
- develop managerial skills and increase labour productivity
- stimulate scientific research and technological development

### What is the Open Sector?

The Open Sector is a market economy. Its boundaries may be both geographical and functional. It could include, for example, some areas in the Far East, the Odessa Region, the Stavropol region as well as segments of the light and food industries. If the Open Sector is successful, its boundaries may expand and come to encompass the remainder of the Soviet economy.

The Open Sector will include the following participants:

- joint ventures
- cooperatives
- state enterprises reconstituted as "economic firms" which qualify for the Open Sector

Some of these entities will be export-oriented, others will be geared to the domestic economy. Initially many will operate with the help of foreign managers. Entities will be owned by private individuals, foreign investors, cooperatives and the state. Shares of the entities may be issued and traded which will broaden the Open Sector's ownership base.

The guiding principles of the Open Sector are cost-accounting and competition. Participating joint ventures, cooperatives and firms will compete for customers, labour, capital, foreign exchange and resources. They would be free to:

- set their own prices
- choose their own suppliers
- choose their own product lines
- set wages and salaries
- hire and fire employees

Freed from administrative interference, these entities will focus on maximizing the value of their capital. This emphasis on capital combined with competitive pressures would drive entities to produce high-quality goods at low cost. The absence of subsidies and threat of bankruptcy would further reinforce this tendency.

#### Managing the Open Sector

The creation and management of the Open Sector will be in the hands of the Open Sector Management Authority (OSMA) whose regulations will apply equally to all Open Sector entities wherever they may be. OSMA's principal task is to develop and sustain a competitive environment in which the Open Sector will operate. It would do this by:

- establishing the regulatory, tax and anti-trust framework for the Open Sector
- encouraging and facilitating the entry of new firms into the Open Sector
- enforcing legislation

- attracting foreign investors and management
- regulating economic ties with the remainder of the Soviet economy and with the world economy

### Issues To Be Resolved

A number of issues still need to be resolved in the coming months. The most important are:

- **Currency issues and the Open Sector.** Will successful operation of the Open Sector require a second currency or will the Soviet rouble plus a foreign exchange auction market be sufficient?
- **Relations between the Open Sector and the remainder of the Soviet economy.** What is the linkage between reform of the traditional system and the Open Sector? How can opportunities for arbitrage and speculation between the two systems be minimized?
- **Nature of OSMA's authority and operation.** How can the independence of OSMA be assured? Under what organ should OSMA operate? What should be the mix of representation (i.e. local population, foreign investors, and Soviet authorities) on OSMA's governing board?
- **Social issues and the Open Sector.** What voice will affected citizens have in joining and managing the Open Sector? What special forms of social security will be necessary for the Open Sector?
- **Agriculture and the Open Sector.** Should the Open Sector include agriculturally underdeveloped areas (i.e. Northwest RFSFR) or should it focus on more highly developed areas (i.e. South Ukraine, Stavropol)?
- **Light Industry and the Open Sector.** What segment of the consumer products industry should be given priority within the Open Sector?

### Implementing the Open Sector

The Open Sector will be introduced quickly and will, if successful, expand to encompass the rest of the economy by the end of the century. The foreign experts envisage the following stages of implementation. These will be discussed in the coming months.

### Preparatory Stage (January 1990)

- OSMA and legal and institutional framework are created.
- Open Sector is marketed to foreign investors. Existing bilateral commitments (i.e. American Trade Consortium) are honored and accommodated by OSMA.
- Designation of the Open Sector regions and industrial branches. Existing plans for Special Economic Zones and Development Areas are modified and incorporated into the Open Sector strategy.
- Selection of Open Sector firms. Number is sufficient to achieve to achieve critical mass.

### Initial Stage (1990-1992)

- Open Sector commences operation.
- Soviet economic reform continues. Budget deficit is brought under control. Rouble overhang is reduced. Overall financial discipline is enforced.
- Open Sector laws and regulations are modified.
- Joint ventures with foreign partners are established. Management contracts with foreign management are negotiated.

### Final Stage (2000)

- Soviet economic reform continues.
- Open Sector expands to encompass more regions, industries, and firms.

The above issues and timetable will be addressed and resolved by Soviet and foreign experts in meetings to be held from February through April. Presentation of the Open Sector proposal will formally take place at a public forum to be held in Moscow on May 15, 16 and 17. The forum will be attended by leading Soviet and Western policymakers and businessmen many of which have already expressed interest in the project.

- Ivan D. Ivanov and Ed A. Hewett

January 27, 1989

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etc



Foreign and Commonwealth Office

London SW1A 2AH

16 January 1989

Dear Charles,

CD Powell

Mr George Soros

I understand that you had an opportunity for a word with Mr Soros at a social occasion this week. He called on Sir Patrick Wright on 12 January. You may be interested to see the attached note of the discussion.

We shall include reference to Mr Soros's ideas in the briefing for the Prime Minister for her next meeting with Mr Gorbachev.

I am copying this letter, with enclosure, to Alex Allan at HM Treasury.

Yours ever,

Richard Gozney

(R H T Gozney)  
Private Secretary

C D Powell Esq  
PS/No 10 Downing Street

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NOTE FOR THE FILE

CALL ON THE PUS BY MR GEORGE SOROS, 12.00 NOON,  
THURSDAY 12 JANUARY 1989

Mr George Soros

PUS  
Mr Hemans

1. The PUS asked Mr Soros how much political support his proposal for an Open Sector in the Soviet Union had. Mr Soros said that this was the crucial question. The top leadership in the Soviet Union, in contrast to China, had no understanding of economics. Currently Soviet Prime Minister Ryzhkov was in charge of the discussion on the Soviet side, having taken over from Deputy Prime Minister Kamentsev who lacked sufficient understanding of the issues, as had Politburo member Yakovlev with whom Mr Soros had discussed the question. It was now vital that Mr Gorbachev should be brought in to the equation. The Soviet Ambassador in Washington, Dubinin, had been very supportive throughout and was trying to arrange for Mr Gorbachev to receive Mr Soros. He would be in Moscow on 23 January when all six working groups would convene, but he did not know whether he would be received. In response to a question Mr Soros said that the broad nature of the proposal was quite widely known amongst Soviet academics. Outside the Soviet Union he had contacted the Italian, German and British governments but had not made contact with the US Administration. The Americans were more likely to be critical, as they had been over credits to the Soviet Union. Europe would have a potentially more significant role.

2. Mr Soros went on to talk briefly about prospects for the Soviet economy. He was very pessimistic. The Soviet economy was "disintegrating before our very eyes". Time was of the essence. It was important to get Mr Gorbachev focussed on the Open Sector proposal quickly without waiting for the full rigmarole of working groups and so on. A planning body needed to be established with international civil servants working with Russians. Mr Soros hoped that when she met Mr Gorbachev the Prime Minister would be able to encourage the Open Sector concept. The PUS suggested that if Mr Gorbachev could be persuaded to endorse the proposal it should perhaps be his initiative to outline it to the Prime Minister and seek her encouragement. Mr Soros said he had already spoken to Mr Powell at No 10 Downing Street, who had told him that the Prime Minister had read his paper and was very interested in the proposal.





3. The PUS referred to Mr Soros's draft article on the Soviet Union and queried whether it was true to say that the Soviet Union was no longer interested in superpower status. Mr Soros said that he had rephrased this now. What he had meant to say was that the Soviet Union was indeed vitally interested in maintaining the same status as the United States, but was no longer willing to pay the price in terms of armaments and support for allies and adventures which had characterised its foreign policy in the past. However, and here Mr Soros acknowledged that he differed from the Prime Minister, he believed that Mr Gorbachev had a vision of a world governed by international organisations, primarily the United Nations. He also spoke enthusiastically in favour of taking Mr Gorbachev at face value when he spoke of "reasonable sufficiency" in armaments. This should also enable arms control negotiations to push ahead much faster.

S N P Hemans  
Soviet Department

12 January 1989



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File 1/16  
cc for  
TSY

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

12 January 1989

Thank you for your letter of 4 January. I subsequently received Mr. Soros' paper and had a good talk with him yesterday evening. I understand that he is also seeing Sir Peter Middleton and Sir Patrick Wright.

CHARLES POWELL

Dr. Zbigniew A. Pelczynski.

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Foreign and Commonwealth Office

London SW1A 2AH

10 January 1989

*Dear Charles,*

*Attaded*

Soviet Union: Soros and the Open Sector

Your letters of 4 and 5 January asked for early advice on our views of the Soros ideas and on whether it would be appropriate for you to see Mr Soros. I understand that you have now agreed to do so.

George Soros is a Hungarian exile who has turned himself from a more or less penniless waiter in London to a multi-millionaire. His financial skills are well-known and appreciated in the City. He is now particularly interested in the possibility of influencing the Soviet Union and Eastern Europe and has for example set up scholarships schemes for Hungarian, Polish and Soviet students to study in Britain. The FCO contribute to these and have a hand in the selection process. 9 Soviet Soros students started at Oxford last term.

Soros has very good contacts inside the Soviet Union, not least with Politburo member Yakovlev.

Last year these contacts led to an invitation to him to bring to Moscow a team of Western economists (including Dr Philip Hanson from Birmingham University) to discuss ways of reforming the Soviet economy and introducing market mechanisms and habits. The team visited Moscow last October and met many senior economic figures inside and outside the Soviet administration, including a 2½ hour meeting with the Soviet Prime Minister Ryzhkov. The fact of the visit was public but its origins and the ideas under discussion have remained confidential. We have been kept in touch with developments by Dr Hanson who has sent us copies of relevant papers.

The essence of Soros' idea is to establish a part of the Soviet economy, defined by both geographical and sectoral criteria, as an "open sector" operating on market lines and with direct links to the outside world. This sector would eventually expand to embrace the whole of the Soviet economy. The paper from Soros enclosed with his letter to you of 3 January is a summary of the latest version of this idea. He continues to make explicit that the ultimate object of the exercise is to create a market economy in the Soviet Union. It is not clear how far this aim is shared by the members of the Soviet leadership who have met Soros and his team, but they have not so far asked him to abandon it. Kamentsev is said to be particularly keen to see some form of Soros' ideas put into practice.

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The Soros proposals are indeed far-reaching but they have a lot of good economic sense in them. The latest paper is particularly clear for example about the pitfalls which have beset practical reforms of other communist economies (China, Hungary); that radical reform of the Soviet economy as a whole remains essential, including measures to bring the money supply under control and stop escalating inflation; and that reforms grafted on to the existing Soviet system simply will not work, so that in the short term the open sector can only work using imported foreign managers. However considerable question marks inevitably hang over the proposals:

- can the Soviet leadership really accept (and implement) the degree of market forces and dependence on foreign expertise envisaged?
- how would the interface with the rest of the Soviet economy work in practice, not least given the endless black market possibilities?
- would it be quite as easy as Soros suggests to enlist the help of Western companies, who may well doubt whether the Soviet Union can be a really large and profitable market for them, except in the long term?

What Soros seems to want from us at present is no more than general encouragement. He has been in touch with Sir Patrick Wright, in parallel with the letters you have received, via Mr David Walker, the Chairman of the Securities and Investments Board. Sir Patrick has discussed the Soros ideas with Mr Walker, and whom Soros might most appropriately see while in London. He is already due to call on Sir Peter Middleton at the Treasury and Mr Walker himself. Neither the Foreign Secretary nor Mr Waldegrave can fit in a call by Soros this week. Sir Patrick has therefore arranged a meeting himself at noon on 12 January. In these circumstances our view, with which Mr Walker agrees, is that there is no need to arrange further calls this time round, though we would see no objection if you particularly wish to see him yourself. We will keep you informed of further developments, not least in the context of briefing for the Prime Minister's talks with Mr Gorbachev, if and when his visit here is confirmed.

I attach a draft reply to Dr Pelczynski from you (Dr Pelczynski has also been in touch with us separately). It may need amendment in the light of your meeting tomorrow.

I am copying this letter to Alex Allan (Treasury).

*Yours ever,*  
*L Parker*  
(L Parker)  
Private Secretary

C D Powell Esq  
PS/No 10 Downing Street

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DSR 11 (Revised Sept 85)

DRAFT: minute/letter/teleletter/despatch/note

TYPE: Draft/Final 1 +

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Your Reference

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- Restricted
- Unclassified

TO:

Copies to:

Dr Zbigniew A Pelczynski  
 Pembroke College  
 OXFORD  
 OX1 1DW

LD3BFC

SUBJECT:

PRIVACY MARKING

..... In Confidence

Thank you for your letter of 4 January. I subsequently received a letter from Mr Soros' enclosing a paper setting out his ideas.

CAVEAT .....

~~As you are no doubt already aware, meetings have been arranged for Mr Soros with Sir Peter Middleton, Permanent Secretary at HM Treasury, and with Sir Patrick Wright, Permanent Under-Secretary at the Foreign Office. These will enable us to stay in close touch with Mr Soros's thinking as his ideas develop and his contacts with the Soviet authorities continue. You will know that we are following these developments with close and sympathetic interest.~~

I am asking the Treasury and Foreign Office to keep me informed about this fascinating initiative and we shall no doubt be in touch again in the future.

Enclosures flag(s) .....

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 good talk  
 with him  
 yesterday  
 evening.  
 I advised  
 that he is  
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en

Z. PELCZYNSKI

6/1

FILE MRM



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 January 1989

~~Henry~~ 10/1  
 No - could  
 you please  
 check.  
 Let's  
 tell him  
 tomorrow.  
 an  
 Charles  
 Have FIO  
 responded?  
 10/1

I wrote to you yesterday about a letter from Dr. Pelczynski, asking me to see Mr. George Soros next week.

The enclosed letter from Mr. Soros himself has now arrived, setting out his ideas. I should be grateful for early advice and a draft reply.

C. D. POWELL

Lyn Parker, Esq.,  
Foreign and Commonwealth Office

Z. PELCZYNSKI

6/1



fine  
DA

10 DOWNING STREET  
LONDON SW1A 2AA

*From the Private Secretary*

4 January 1989

I enclose a copy of a letter I have received from a Mr. Pelczynski. As you will see he suggests that I meet Mr. George Soros to discuss his ideas on the formation of an "Open Sector" in the Soviet Union. Since Mr. Soros is coming to London very shortly, I should be grateful for some early advice on our views of this concept and whether it would be appropriate to see Mr. Soros.

(C.D. POWELL)

Lyn Parker, Esq.,  
Foreign and Commonwealth Office.

MRM

THE SOROS FOUNDATION—SOVIET UNION

ANTONINA W. BOUIS  
EXECUTIVE DIRECTOR

January 3, 1989

Mr. Charles Powell  
Prime Minister's Personal Office  
10 Downing Street  
London, W.C.1  
England

Dear Sir:

I enclose some material on the "Open Sector Initiative" in the Soviet Union which I would very much like Prime Minister Thatcher to see. It is being sent at the suggestion of Dr. Zbigniew A. Pelczynski of Pembroke College, Oxford, who is writing to you separately.

Very truly yours,

*George Soros*

George Soros/ll.

enc.



REVISED  
December 30, 1988  
Opensec.5

THE OPEN SECTOR CONCEPT

(Guidelines to the Working Groups)

I.

The restructuring of the Soviet Economy cannot be accomplished uniformly across the board. To mention just two reasons:

- (1) as price controls are loosened, latent inflationary pressures become acute;
- (2) if all enterprises were allowed to hire and fire freely, unemployment would become an intractable problem.

But if these reforms are introduced gradually in relatively small segments of the economy, the problems can be kept to manageable proportions. For instance, selectively granting freedom to hire and fire would not create large-scale unemployment, and if the prices of products not previously available (e.g. computers) were left to the forces of supply and demand the result would not be inflation but a sense that one can buy something worthwhile with rubles. That is why it would be advisable to create an Open Sector which serves both as a demonstration model for *perestroika* and as a driving force for the rest of the economy.

The Open Sector is not a substitute for *perestroika* in the rest of the economy; on the contrary, it needs to be combined with certain reforms in the rest of the economy in order to create the appropriate connections between the two. Specifically, the money supply needs to be brought under control. These issues will be studied by Working Groups 2 and 4.

## II.

The Open Sector cannot be an imitation of the Chinese or any other foreign experiment because the conditions which made those experiments possible do not prevail in the Soviet Union. For instance, the Soviet Union does not have the labor cost advantages of China, nor does it have the overseas Chinese community or Hong Kong. The Open Sector concept has to be developed to meet the specific requirements of the Soviet Union. Moreover, the Chinese and Hungarian models of reform have certain problems which have not been resolved to this day. Rather than imitating those models, it is better to try and understand the problems and to devise a different model of development.

## III.

What is the Open Sector meant to accomplish?

It is generally agreed that the role of central planning needs to be diminished and decisions made by the participants given greater weight. What is less clearly understood is that the appropriate decision-making units do not exist: they need to be brought into existence. Given the opportunity, consumers and workers can be expected to look after their own interests; but within the present structure of economic management, nobody is properly motivated to look after the profits of the enterprise. That is why capital is used wastefully and investments do not earn an adequate return. This holds true even in Hungary and China where reform is quite advanced.

The method of assessing -- and rewarding -- management performance is all wrong. Soviet managers are preoccupied with meeting a variety of requirements; they should focus on the bottom line -- the return on capital employed. Under present conditions, it is only by increasing the return on capital that the productivity of labor can be improved.

It is necessary, therefore, to bring into existence enterprises that are professionally managed and operate on economic principles; that is to say, they are self-supporting and seek to maximize the return on capital employed. We shall refer to such enterprises as "firms", and the environment in which they operate as the "Open Sector".

The central task of the Open Sector is, then, to create an environment in which firms can function effectively. This has to be a market-oriented environment because in the absence of competition the return on capital employed gives a very misleading measurement of a firm's performance. A competitive environment will give firms the incentive to produce desired goods at the lowest cost.

#### IV.

Since the professional skills required for the management of firms in a market environment are largely absent, they need to be imported from abroad. Foreign managements must play a key role in the creation of an Open Sector, although their importance should diminish as the Open Sector becomes established. Assistance is needed especially for buying and selling in a competitive environment.

The importation of management skills should take precedence over the importation of equipment. Foreign equipment should be purchased only by firms run on economic principles, preferably with foreign management assistance, and not by ministries; otherwise the investment will be largely wasted, as it has been in the past. Foreign management participation will pay for itself in funds saved through reduced equipment imports and through more efficient use of imported equipment. This consideration should influence the way the recently negotiated Italian and German loans are utilized. This subject will be studied by Working Groups 5 and 6.

#### V.

The establishment of firms, the importation of management skills, and the creation of a market environment must be carefully coordinated. The flexible establishment of firms must come first, but the introduction of market prices must not lag far behind otherwise foreign managements will learn to live in a Soviet environment instead of teaching Soviet firms to operate in a market environment. During the transition period many prices will still be fixed, but firms must be aware that prices will be decontrolled in the near future so that they can prepare for it. On the other hand, premature introduction of market pricing or

even contract pricing can lead to inflation, as the recent experience of China has demonstrated.

## VI.

The Open Sector needs a Planning Agency which operates by offering economic incentives rather than by issuing specific orders. Its task is to create a market environment -- for instance, by bringing into existence competing firms. This requires direct intervention at first but, as the market environment grows stronger, the Planning Agency can operate increasingly through the market mechanism. The concept of such an Agency is totally new to the Soviet Union -- it is more akin to MITI in its early stages in Japan, or the Economic Planning Board in South Korea.

The need for such an Agency must be emphasized because economic reformers both in the Soviet Union and elsewhere tend to be opposed to central planning in all its forms. Without it, no Open Sector can survive. The Open Sector must interface both with the outside world and with the rest of the Soviet economy. Both relationships are subject to regulation. Unless a strong and efficient Agency is in charge of the Open Sector, it cannot develop and maintain the appropriate connections. This will be the subject matter of Working Groups 3 and 4.

## VII.

A competitive environment requires the participation of a sufficiently large number of firms. The fastest way to attain a critical mass is by concentrating the participants both geographically and along industry lines. Certain locations and certain industries should therefore be given priority. It is advisable to move concurrently along both geographical and industry lines.

There is much to be gained from geographical concentration, especially where foreign managements are involved: they would find it difficult to survive, let alone function, in isolation. It is therefore desirable to designate certain strategic locations as Special Zones. These could serve large regions which could be designated as Development Areas. For instance, the natural resources of Siberia could constitute a Development Area

and Special Zones could be established in Nahodkha and/or other locations.

It would be a grave mistake, however, to confine the Open Sector to certain geographic areas. The Open Sector should develop wherever firms are located and the location of firms should not be dictated by administrative convenience -- otherwise, the creation of Special Zones may do more harm than good. This issue will be studied by Working Group I.

#### VIII.

Even more important than the establishment of Special Zones and Development Areas is the decision to concentrate on certain industries because all the enterprises in an industry must be converted into firms before market pricing is introduced. In this respect, the decision to assign the German and Italian loans to specific industries -- the food processing, clothing and shoe industries -- could be very effective, provided that they are used for importing management first and plant and equipment afterwards. This issue is also within the purview of Working Group I.

In utilizing the Italian and German credits, one can envisage pairing off Soviet enterprises with foreign firms to create Soviet firms. The foreign firms would contribute only management, not capital, and would be rewarded by a small participation in the Soviet firm's profits. If the cooperation is successful, the investment of capital may follow. Thus, a joint venture, as it is currently understood, would be the last step in cooperation, not the first.

We believe that European industry would be eager to cooperate in this manner. It would involve much less risk than establishing joint ventures and it would allow them to gain experience in what they consider an enormous potential market.

The Soviet firms would benefit both from foreign management assistance and from having their own managements trained abroad. They would be induced to participate not only by the lure of foreign credit but also by the prospect that the entire industry in question will be converted to market pricing in the not too distant future.

If the program is successful, European governments would be willing to extend additional credit, so that the program could grow until it embraces practically the entire economy.

## IX.

The Open Sector is a dynamic concept. Its boundaries expand along both geographical and industrial lines, and within the Open Sector the market mechanism evolves over time. A plausible course of development is as follows:

### Preparatory Stage (to be completed by May 1989)

- The legal and institutional framework is established.
- Special Zones and Development Areas are designated.
- Industries are selected which will be developed with the help of foreign credit and foreign management.
- Firms are created. They can take various legal forms: cooperatives, joint ventures, stock companies without foreign participation, etc. In all cases, the firms are self-supporting and obtain their financing in the form of capital contributions or loans.
- The Planning Agency is established.

### Initial Stage (1989 - 1992)

- The Planning Agency begins to operate.
- Selected industries (food processing, clothing and shoes) are converted into firms and foreign management assistance is arranged. Joint ventures are established in Special Zones, Development Areas and elsewhere. The Planning Agency arranges deals along the lines of the American Trade Consortium, whereby export-oriented joint ventures are paired off with joint ventures producing for the domestic market. For instance, Korean conglomerates might build consumer electronics plants in the main centers of consumption, pulp and paper plants in Siberia, and cotton processing plants in the South. The hard currency for Korea's share in

the consumer electronics firm would come from the exports of pulp and cotton.

- Firms are free to hire and fire and negotiate some prices, including wages, but other prices remain subject to price control. If the controlled price is inadequate to cover the cost of production, a subsidy is paid but on a declining scale. Conversely, the State may impose excise taxes on certain items. In any case, it is agreed in advance that price controls will be lifted within a predetermined period of time, so that firms have a reason to prepare for a market environment. It is critical this schedule be realistic and strictly adhered to.
  
- A restricted auction market is introduced for hard currency in which both importing and exporting companies can participate. This resolves the problem of inter-company settlement for the American, Korean and other consortiums and allows foreign companies to set up subsidiaries in the Soviet Union producing for the domestic market.

Hard currency bought in the auction market is used for the importation of selected items not currently available in the Soviet Union -- computers, consumer electronics, etc. Import licenses may be tied to the establishment of manufacturing subsidiaries in the Soviet Union.

The exchange rate in the auctions is regulated by the Planning Agency by supplying or withholding hard currency. The exchange rate for hard currency would start out very high so that the imported products would be very expensive, but this would not be inflationary. On the contrary; to the extent that the exchange rate encourages exports and the pent-up demand for imported products is gradually satisfied, prices would tend to fall, giving the impression that the purchasing power of the ruble is improving. This subject will be studied by Working Group 2.

### Intermediate Phase (1993 - 1995)

Price controls are lifted for certain products and/or geographic areas. Enterprises operating in industries and/or areas which fall within the Open Sector will have to operate without price controls whether they like it or not. The scope of currency auctions is extended.

### Final Phase

If the partial experiment is successful, it is extended to the rest of the economy, either gradually or at a predetermined time all at once.

X.

The Soviet side of the present international study group could evolve into the Planning Agency by carrying out its work along both theoretical and practical lines concurrently, engaging the necessary staff and receiving the necessary authorization. This would have the advantages of a small staff drawn from other agencies and institutions instead of a permanent bureaucracy; direct contact with and authority of the Prime Minister; involvement of the relevant agencies (*Vnesheconombank, Gosbank, Gosplan, Goskomtsen*, the relevant ministries, etc.) at the highest level; and the support of foreign experts.

George Soros

Wassily Leontieff

Ed Hewett



R411



PEMBROKE COLLEGE  
OXFORD OX1 1DW  
Telephone (0865) 276444  
Direct line: (0865) 2764.64

3 January 1989

Mr Charles Powell  
10 Downing Street  
London S.W.1

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Dear Mr Powell

I am writing to you at the suggestion of David Willetts of the Centre for Policy Studies. David knows me and Mr George Soros and will be glad <sup>to</sup> illuminate the background to this letter. Mr Soros, in whose educational schemes to bring young Polish, Hungarian and Soviet graduates to Oxford I have been deeply involved, has recently embarked on a bold and original initiative in the field of foreign and economic relations. He has proposed the formation of an "Open Sector" in the Soviet Union - a privileged quasi-market environment within which capitalist-style Soviet firms would be established to produce, with Western managerial know-how, goods and services for sale to Soviet consumers and for export. Mr Soros sees it as a way of supporting the flagging perestroika and influencing internal developments in a way the Soviet Union may well find acceptable

The idea is being discussed by a Soviet-American working group while Mr Soros is taking it up with the Soviet leadership at the highest level. He believes that a British involvement in the discussions would be most beneficial and that the idea might appeal to Mrs Thatcher personally because of her support for Mr Gorbachev's efforts. A small dossier of background material is being sent to you from New York by Federal Express. Mr Soros is coming to England for a week or so on 7 January and will be staying in his London residence

where you could contact him to find out more about the "Open Sector" concept. His phone numbers in New York are office, and home.

Yours sincerely,

Zbigniew Pelczynski



10 DOWNING STREET

~~Stephen Hasbaine~~ noted  
S.

Ed. you let me  
know if Mr.  
Willetts contacts  
you about this.

EDP  
3/9.

- ① Mrs. Gaisman to note also
- ② Retkin to copy

S.



Foreign and Commonwealth Office

London SW1A 2AH

3 September 1987

*Dear Charles,*

*R319*

George Soros

George Soros, the American millionaire and philanthropist, will be in Britain from 22 to 26 September. Dr Zbigniew Pelczynski of Pembroke College, Oxford, has been in touch to suggest a meeting with the Foreign Secretary. We understand that he has also been in touch with David Willetts at the Centre for Policy Studies about a possible meeting with the Prime Minister. You may perhaps receive such a request through the Cabinet Office.

Soros is a highly successful investment fund manager. He has put a lot of money and energy into developing academic and cultural exchanges with Eastern Europe, through the Soros Foundation which he runs jointly with the Hungarian Academy of Sciences, and other schemes involving also Poland. A number of scholars from Hungary and Poland visit Oxford every year under his Foundation's auspices and with some help from the FCO Scholarship Scheme. He wants to extend his activities to other Eastern European countries. In September he will be visiting Poland and the Soviet Union, where he will be negotiating the establishment of a "glasnost foundation" which also will run a programme of post-graduate scholarships for Soviet students to visit Oxford University. A feature of Soros' scheme is that his Foundation, not the host government, selects the Eastern European scholars to visit the West.

The Foreign Secretary will be in New York at the time of Mr Soros' visit to Britain, but David Mellor has agreed to see him. The Foreign Secretary does not consider that there is any need for the Prime Minister to see him unless she is particularly interested in his work.

*Yours ever*  
*Tony Galsworthy*

(A C Galsworthy)  
Private Secretary

C D Powell Esq  
10 Downing Street



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