

PRIME MINISTER

STOPOVER IN MOSCOW

It now seems that the person likely to meet you in Moscow tomorrow night is Mr. Laverov, Deputy Prime Minister and Chairman of the State Committee for Science and Technology.

Rodric Braithwaite's telegram (attached) tells you about his interests and possible themes for conversation. His priorities are:

- information technology
- high-temperature superconductivity
- agriculture and food production
- nuclear and renewable energy
- new materials

Subjects which might be covered in discussion are;

- the Soviet Space programme
- popular opposition to nuclear energy and environment pollution
- conversion of defence industry to civilian use
- the problems of economic reform, and getting Soviet industrial workers to respond to economic stimuli.

You could also seek his forecast of the likely outcome of the Central Committee plenum this week.

C.D.P.

(C. D. POWELL)

17 September 1989

(SRW)

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AND POWELL (NO 10).

THE PM'S VISIT: STOPOVER ON 18 SEPTEMBER.

1. THE FOREIGN MINISTRY TELL US THAT THE PRIME MINISTER'S INTERLOCUTOR ON 18 SEPTEMBER IS NOW MORE LIKELY TO BE NIKOLAI PAVLOVICH LAVEROV (PRONOUNCED 'LAV-YOR-OFF' WITH THE ACCENT ON THE SECOND SYLLABLE) RATHER THAN ABALYIN.

2. LAVEROV SUCCEEDED TOLSTYKH (WHOM THE PRIME MINISTER MET IN LONDON IN NOVEMBER 1987) AS DEPUTY PRIME MINISTER AND CHAIRMAN OF THE STATE COMMITTEE FOR SCIENCE AND TECHNOLOGY, AS PART OF THIS SUMMER'S GOVERNMENT RESHUFFLE. HE IS A SEISMOLOGIST AND SINCE 1987 HAS BEEN A VICE PRESIDENT OF THE ACADEMY OF SCIENCES WHERE HE SUPERVISES ALL EARTH SCIENCES. HE IS WELL-REGARDED AS A SCIENTIST. WHEN I CALLED SHORTLY AFTER HIS APPOINTMENT, HE STRUCK ME AS ALTOGETHER MORE LIVELY, SELF-CONFIDENT AND OUTGOING THAN HIS PREDECESSOR, A PLEASANT BUT RETIRING ENGINEER WHO WAS CLEARLY UNCOMFORTABLE, IN MANOEUVERING AT THE INTERFACE BETWEEN THE SCIENTIFIC, POLITICAL, AND INDUSTRIAL WORLDS.

3. IT IS PRECISELY THIS AREA WHERE THE STATE COMMITTEE FUNCTIONS LIE. ITS TASK IS TO HARNESS THE UNDOUBTED RESOURCES OF SOVIET SCIENCE FOR THE PRACTICAL BENEFIT OF SOVIET INDUSTRY. IT HAS ALSO BEEN ONE OF THE MEANS BY WHICH THE SOVIETS HAVE SOUGHT OUT FOREIGN TECHNOLOGY FOR DOMESTIC APPLICATION. IT HAS ALWAYS HAD A KEEN INTEREST IN WESTERN MANAGEMENT TECHNIQUES. BOTH THE BRITISH GOVERNMENT AND BRITISH BUSINESS HAVE KNOWN IT WELL FOR MANY YEARS. MOST RECENTLY TWENTY MANAGERS SPONSORED BY THE STATE COMMITTEE ATTENDED A VERY SUCCESSFUL COURSE AT THE LONDON BUSINESS SCHOOL IN APRIL. A FURTHER TWENTY-FIVE ARE DUE THERE IN NOVEMBER. LAVEROV HIMSELF HOPES TO ATTEND THE SECOND TRILATERAL (ANGLO-US-SOVIET) DITCHLEY CONFERENCE IN MAY 1990.

4. LAVEROV EMPHASISED TO ME THAT HE SAW HIS NEW TASK AS THE COORDINATION AND ENCOURAGEMENT OF A SENSIBLE SCIENCE AND TECHNOLOGY

POLICY, RATHER THAN ITS MANAGEMENT. HE HAD ALREADY IDENTIFIED FIVE PRIORITY AREAS: INFORMATION TECHNOLOGY, HIGH-TEMPERATURE SUPERCONDUCTIVITY, AGRICULTURE AND FOOD PRODUCTION, NUCLEAR AND RENEWABLE ENERGY, AND NEW MATERIALS. HE WAS WORKING ON 14 MORE SPECIFIC PROGRAMMES AS WELL (E.G. ON THE HUMAN GENOME). BUT HE BELIEVED THAT ALL THESE SHOULD BE PROMOTED BY ECONOMIC, NOT ADMINISTRATIVE MEANS. THE MEANS COULD INCLUDE TAX INCENTIVES (A CONCEPT SO FAR WITHOUT SERIOUS APPLICATION IN THE UNREFORMABLE SOVIET ECONOMY): PROVISION OF A GREATER PROPORTION OF CENTRAL FUNDS TO SCIENTIFIC INSTITUTES THROUGH COMPETITION, NOT ALLOCATION: BREAK UP OF SCIENTIFIC AND INDUSTRIAL MONOPOLIES: DIVERSION OF DEFENCE R AND D TO CIVILIAN USE: PROVISION OF FUNDS TO VERY SMALL GROUPS OF INDEPENDENT RESEARCHERS WITH BRIGHT NEW IDEAS (THE AMERICAN 'SKUNK HOLE' APPROACH, OF WHICH APPLE COMPUTERS IS ONE WELL-KNOWN EXAMPLE). HE HOPED THAT THESE DEVICES WOULD BRING SOVIET SCIENCE AND CIVILIAN INDUSTRY INTO THE MUCH MORE PRODUCTIVE RELATIONSHIP WHICH HAD HITHERTO BEEN LACKING.

5. THE PROBLEMS OF SCIENTIFIC AND TECHNOLOGICAL MANAGEMENT WHICH LAVEROV FACES HAVE ANALOGIES WITH OUR OWN, THOUGH THEY ARE ORDERS OF MAGNITUDE GREATER. SO TOO HAVE HIS IDEAS ABOUT ECONOMIC STIMULI, WHICH ARE IN ACCORDANCE WITH WIDER SOVIET THINKING ABOUT ECONOMIC REFORM. THERE IS MUCH OF INTEREST WHICH - DRAWING ON THE FOREGOING - THE PRIME MINISTER COULD DISCUSS WITH HIM WITHIN HIS IMPORTANT BUT LIMITED AREA OF RESPONSIBILITY.

6. BUT MY IMPRESSION IS THAT LAVEROV WOULD ALSO BE CAPABLE OF SUSTAINING A WIDER-RANGING DISCUSSION. THUS:

- (A) THE SOVIET SPACE PROGRAMME (INCREASINGLY CRITICISED BECAUSE OF THE SCARCE RESOURCES IT CONSUMES):
- (B) POPULAR OPPOSITION TO NUCLEAR ENERGY AND ENVIRONMENTAL POLLUTION:
- (C) THE POLICY OF CONVERTING DEFENCE INDUSTRY TO CIVILIAN USE WHICH GOES WELL BEYOND THE R AND D AREA):
- (D) THE ECONOMIC REFORM AS A WHOLE (WHAT PROBLEMS - POLITICAL, PSYCHOLOGICAL, PRACTICAL - DOES LAVEROV SEE IN GETTING SOVIET INDUSTRIAL, AS WELL AS SCIENTIFIC WORKERS TO RESPOND TO THE ECONOMIC STIMULI HE FAVOURS? DOES HE HAVE VIEWS ON THE AUSTERITY PACKAGE WHICH GORBACHEV FORESHADOWED IN HIS RECENT TV SPEECH?)

6. I DO NOT KNOW WHETHER LAVEROV COULD BE TEMPTED INTO A PURELY POLITICAL DISCUSSION, E.G. ON THE NATIONALITIES ISSUE (THE PLENUM

STARTS THE DAY AFTER THE PRIME MINISTER SEES HIM): OR THE RELATIONSHIP BETWEEN SUPREME SOVIET, GOVERNMENT, AND PARTY (THE SUPREME SOVIET RESUMES WORK ON 25 SEPTEMBER AND ITS ACTIVITIES ARE LIKELY TO TEST THAT RELATIONSHIP STILL FURTHER). BUT THERE WOULD BE NO HARM IN TRYING.

BRAITHWAITE

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Economic Clouds Over Moscow

Wall St. Journal
15-16 Sept 1989

By MARTIN FELDSTEIN

My second visit to the Soviet Union within six months left two very clear and disturbing impressions. First, the Soviet economy is on the verge of collapse. And, second, in the current political environment, the economic deterioration cannot continue for long without provoking a sharp political change.

Ironically, the recent political reforms are making it particularly hard for the Soviets to achieve the economic reforms that they need. And yet it is the new political freedoms that will permit the public to hold the political leadership accountable for the economy's abysmal performance. The Soviet Union's inability to reconcile economic reform and political freedom could cause a repressive political swing to the right in which both will be lost.

The increasing shortages of consumer goods—both a symptom and a cause of the worsening economic situation—are destroying the already poor system of distribution. Leningrad has had to issue ration coupons for soap, sugar and salt. Many basic goods are no longer available to all. And although consumer durables have extremely high official prices, especially relative to Soviet wages, they too have generally disappeared from the shelves.

Black Markets

The rise of nationalism is also contributing to the economic breakdown. The Baltic states and other Soviet republics are preventing the shipment of locally-made products to other parts of the Soviet Union and denying Soviet citizens who are not local residents the right to buy things in their stores. The Moscow government has retaliated by announcing that Soviet citizens from other republics who visit Moscow may not buy consumer durables, imported products and other desirable goods that may happen to be available.

This disintegration of the regular market in consumer goods encourages black markets and widespread corruption. The Soviets readily acknowledge that retailers and others involved in the distribution system help themselves to consumer goods that can be sold on the black market for much more than official prices or, better yet, for dollars or other hard currency.

The combination of shortages and of rapidly rising prices for the limited range of goods for which price increases are permitted is destroying the value of the ruble. Although it is illegal for Soviets to trade rubles for foreign currency, this trading has become blatant. The official exchange rate is \$1.60, while the rate on the street is only 10 to 20 cents a ruble.

A primary cause of the shortages and price rises is the government budget deficit, now estimated at more than 10% of gross national product. Although a deficit need not be inflationary if it is financed by issuing bonds that crowd out private spending, the Soviets do not issue bonds but finance their deficits by adding to the cash in the hands of Soviet workers. In a Western economy, such an excess infusion of cash would cause prices to rise. Soviet experts privately estimate their inflation rate at nearly 10% even though most prices are not allowed to

rise. And with only a limited number of prices free to increase, the excess cash chasing a limited supply of goods causes shortages.

The fear of future inflation encourages people to spend their savings before the ruble's purchasing power decreases even further. With the interest rate limited to only 3%, any kind of good that can be stored for future use is a better investment than money in the bank.

But the shortages reflect declines in production as well as increases in demand. One cause of the reduced output is the new system of factory management in which managers are elected by the workers and

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have some discretion over pay and work requirements. Without the discipline from owners or creditors, managers have raised wages and met production quotas by accounting gimmicks. In addition, workers and farmers whose income is related to their own effort frequently have cut back because the rubles that they would earn by extra effort are of such limited value.

What is needed to rescue the Soviet economy is a radical reform of the price-setting process and a move toward a much more market-oriented economy. Mr. Gorbachev's economic advisers recognized that two years ago but have now abandoned those proposed reforms because they fear that price decontrol would lead to skyrocketing inflation. Such inflation is politically unacceptable in a nation where Lenin's promise of price stability has been repeated for more than 70 years. Moreover, since Soviets do not own shares or homes or other assets that would preserve their value during inflation, a rapid inflation would wipe out the life savings of every Soviet citizen—hardly a propitious start for a government that wants to develop confidence in capitalist ways!

The prerequisite to price decontrol and the establishment of a market economy is therefore appropriate anti-inflationary macroeconomic policies. First, the excess infusion of cash by the budget deficit must be stopped. Soviet officials acknowledge this and say that they will cut the budgetary money growth in half during the next year by a combination of reduced defense outlays, increased revenue from the sale of imported consumer goods, and the use of bond finance. But eliminating a budget deficit of 10% of GNP will not be possible without raising taxes, cutting subsidies or reducing the already low standard of public services. Any such painful changes will inevitably be criticized in the press and reflected in votes against Communist Party candidates in contestable elections.

Even more important than deficit reduction is raising the interest rate that house-

holds receive on their bank deposits. That rate must be high enough so that households will want to leave their past savings in the bank when prices are decontrolled, rather than spending them and thereby bidding up the prices of available goods. At a minimum, that is likely to require an interest rate that exceeds the inflation rate, a substantial rise from the current token rate of interest. Such a rise in interest payments would be unpopular with a Soviet public raised on the communist ideology that all capital income is unfair. Moreover, since the ownership of savings is highly concentrated, paying higher interest rates would conflict with the egalitarian standard of fairness that the Soviet public has come to accept.

Popular opposition to economic reform extends not only to the policies required to prevent inflation but to the basic market reforms themselves. While most Soviet economists continue to recognize the necessity of price decontrol and movement toward a market economy, they report that these notions are not supported by the mass of Soviet people.

Soviet citizens want a higher standard of living but do not see how that will follow from market forces. Instead they see price reform as eliminating the subsidies on bread and rent and adding to a general price inflation that would lower their already low standard of living. And they understand that with fewer regulations some individuals will become much richer than others, in sharp conflict with their values. With democratization, such popular opposition inevitably increases the political reluctance to act decisively.

Some Possibilities

The deteriorating economic conditions make the continuation of current policies very unlikely. One possibility is that the leadership will accept the political risks of adopting radical reforms that simultaneously contain inflationary pressures and move toward a market economy. Or, Mr. Gorbachev might lose power to a politician prepared to adopt the needed reforms.

But there is a darker possibility. The Soviet public and many of those in government or military circles may conclude that inflation, shortages, strikes and corruption are all evidence that the Gorbachev government is too weak. They may yearn for a government that can bring back price stability, crack down on black marketeers and stop the nationalist political movements. Such a political change could spell the end of economic perestroika and of political liberalization. The very fear of such a political ouster might make Mr. Gorbachev and his colleagues adopt a tougher, less reform-oriented stance themselves.

Those of us who want to see an increase in pluralism, democracy and market forces in the Soviet Union can only hope that the current government will have the courage to adopt the needed reforms before it is too late.

Mr. Feldstein, former chairman of the president's Council of Economic Advisers, is a professor of economics at Harvard.