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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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Z. PELCZYNSKI

6/1

FILE MRM



10 DOWNING STREET

LONDON SW1A 2AA

From the Private Secretary

5 January 1989

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 you please
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 Charles
 Have FIO
 responded?
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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

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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
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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

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3 January 1989

Mr Charles Powell
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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 ^{to} 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

Zbigniew Pelczynski