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SOROS ②

Rice Institute

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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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,
Chris Turner

(C.D. Powell)

Richard Gozney, Esq.
Foreign and Commonwealth Office.

to