PRIME MINISTER

MEETING WITH SOVIET DEPUTY PRIME MINISTER

You are stopping briefly at Moscow airport on your way to Tokyo on Monday. The Russians are sending their Deputy Prime Minister, Mr Leonid Abalkin, Chairman of the State Commission for Economic Reform, to see you at the airport. He is a close adviser on economic questions to Gorbachev and attended your lunch with Soviet intellectuals in Moscow in April 1987.

The FCO have done the attached note suggesting a number of lines of questioning about the Soviet economy. You might also like to see the attached article about the state of the Soviet economy which appeared in the Wall Street Journal today. It makes very gloomy reading. I have also included my notes of your conversation with Gordievskiy and my talk with Kossov in case you wish to refer back to them.

C.D.P.

CHARLES POWELL
15 September 1989

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 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.

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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 households 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.

Foreign and Commonwealth Office

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15 September 1989

Dear Charles,

Refuelling stop in Moscow: 18 September

Deputy Prime Minister Leonid Abalkin, Chairman of the State Commission for Economic Reform) will probably be at the airport during the refuelling stop on 18 September.

Abalkin is one of Gorbachev's key advisers on economic reform, and was brought into the government in June after a career spent principally as an academic (but one with very good access to decision-makers). He has spoken at Chatham House, and attended the Prime Minister's lunch in Moscow in 1987 for Soviet intellectuals (an occasion which she may wish to mention).

A talk with Abalkin would allow the Prime Minister to get a first-hand account of the progress of economic reform in advance of her meeting with Mr Gorbachev. She might begin by asking him about the programme of emergency measures to improve the economy which Gorbachev has said will be presented to the Congress of People's Deputies in October. What will this contain? Is there any prospect of a radical move to break the still-dominant mould of centralised planning and command? Does the programme mean that the government shares the very gloomy prognosis of many Soviet economists? The Prime Minister might ask whether there is a real danger of the Soviet economy seizing up as money becomes effectively worthless, as rationing is introduced more widely (one particularly radical economist has predicted 100% rationing during 1990), and as the shadow economy expands and workers have no incentives to be more efficient and productive.

Turning to specifics, the Prime Minister could raise:

(a) Cooperatives: are cooperatives developing in the manufacturing industry rather than simply offering small-scale services? How big a problem is popular hostility towards cooperatives based on the belief that they are profiteering? What are the authorities doing to overcome this?

(b) Agriculture: the decision to pay state and collective farms in hard currency for above-plan grain and oil-seed production seems an important step towards introducing real incentives in a key sector. Is it already in force and will it also apply to cooperatives? Are any restrictions to be imposed on how enterprises choose to use hard currency they receive?

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(c) Ownership: Gorbachev has said a good deal about the need for new forms of ownership to end the alienation of workers from the means of production and of peasants from the land. This is obviously a critical issue. But the present proposals for limited leasing seem insufficient (not least because people may well be loath to commit themselves when they feel the political wind from Moscow could still change dramatically - as happened at the time of Krushchev's fall).

(d) Supply/demand: the imbalance between supply and demand is getting worse not better. New rationing has been introduced in Moscow and the Baltic States to prevent outsiders emptying the shops. There is no sign of the Soviet government introducing any effective mechanism to make supply respond to demand: is retail price reform now off the agenda? Can perestroika succeed without it?

(e) Rouble overhang: there are estimated to be 400 bn roubles in bank accounts and under matresses. This means that any move to free prices from state control would lead to rampant inflation. Is a currency reform (eg exchanging one new rouble for ten old ones) a real possibility? Or could the government offer Russians a worthwhile rate of return in order to get them to invest in state bonds or still better encourage them to invest their money in enterprises ?

(f) Attitudes: much of Gorbachev's reform programme is top-down, with central ministries being responsible for introducing many of the important changes. This cannot be a long-term answer. What is being done to induce public support for the painful transition and to prevent workers exploiting industrial muscle to get their own way as happened during the coal miners' strike in July?

(g) Special zones: much has been heard of possible enterprise zones providing expandable centres of expertise and experiment. Is this still a possibility? How would it work?

(h) Expertise from abroad: what more could or should the West do beyond training in market oriented skills? Is any thought being given to a really basic change towards a market economy - which would have to involve an end of centralised planning controls, minimal interference with market forces and encouragement of competition? If a bold transformation of this sort were contemplated, could the West help with enterpreneurial expertise?

/ I enclose a personality note on Abalkin. Further background on the economy and other aspects on the USSR is in the main briefing letter.

Yours,
Stephen Wall

(J S Wall)
Private Secretary

C D Powell Esq
10 Downing Street

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ABALKIN Leonid Ivanovich

Deputy Chairman of USSR Council of Ministers; Academician

Chairman of USSR State Commission for Economic Reform

Born 1930

1968	Head of Department of Political Economy, Plekhanov Institute of National Economy, Moscow.
approx 1977-80	Deputy Head of Department at the Academy of Social Sciences attached to the CPSU Central Committee.
1980	Head of the above department.
1984	Elected a corresponding member of the USSR Academy of Sciences.
May 1986	Director of the Institute of Economics of the Academy of Sciences.
1987	Elected full member of the USSR Academy of Sciences.
June 1989	Appointed Deputy Chairman of USSR Council of Ministers and Chairman of State Commission for Economic Reform.

In the early 1980s Abalkin published two books on the economic policy of the CPSU. He was put in charge of the Economic Institute of the Academy after it had been sharply criticised by the Party, with the task of re-establishing its role as the generator of political and economic ideas. For several years he has been one of the leading reformist economists in the USSR and an adviser to Gorbachev and the government.

Abalkin accompanied Gorbachev on his visit to India in November 1986, and visited China in May 1987. The same year he spoke at Chatham House in February and was one of the guests at the Prime Minister's lunch with Soviet intellectuals in Moscow in March.

Since then he has visited Sweden and Luxembourg.

As a speaker Abalkin tends to have a downbeat style, but willingly and helpfully answers questions. He has radical views on economic reform and would like to see central planning reduced to a minimum and a market economy created. In his new post he occupies a key position in the economic policy-making process. In his capacity as Deputy Chairman of USSR Council of Ministers, Abalkin supervises three state Committees (Prices, Labour and Statistics) and the State Bank (Gosbank).