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LONDON SW1A 2AA

From the Private Secretary

20 November 1987

Dear Lyn,

PRIME MINISTER'S MEETING WITH MR. AGANBEGYAN

The Prime Minister saw Mr. Aganbegyan, one of Mr. Gorbachev's chief economic advisers, for an hour this morning. Mr. Aganbegyan was accompanied by the Soviet Ambassador. Sir Terence Burns was also present.

I have recorded separately an exchange between the Prime Minister and the Soviet Ambassador at the end of the meeting.

The Prime Minister began by complimenting Mr. Aganbegyan on his lecture yesterday evening and said that she was looking forward to hearing an account of economic reform in the Soviet Union. She was impressed by the difficulty of moving from a highly planned society to one in which people took more individual responsibility. It required a massive change in attitudes. She wondered how the Soviet leadership would go about securing this change. Mr. Aganbegyan said that he wished he had the answers. The Soviet Union had little experience of this. They would proceed by trial and error. It was not like making a pie: there were no ready-made recipes. The Prime Minister said that people tended to be afraid of change. They had to be persuaded that it would result in a better life.

The Prime Minister continued that she thought the Soviet Union faced two particular problems: it was trying to make far-reaching changes in a relatively sophisticated economy. In a way, the Chinese faced an easier task simply because their economy was more basic. But because the Soviet economy, and particularly the industrial sector, was relatively sophisticated, it was impossible to control everything from the centre. By stressing the problems, she did not in any way want to imply scepticism of what Mr. Gorbachev was doing. His efforts had our support.

Mr. Aganbegyan said that the Prime Minister's analysis was accurate. Economic reform in the Soviet Union was a complex process. It embraced a number of objectives. The first was to change the balance of the economy towards increasing living standards and solving social problems. A

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dangerous gap had opened up between the highly developed industrial base and people's living standards. There were serious problems in housing, shortages of foodstuffs, lack of consumer goods and inadequacies in health and education. The second objective was modernisation of industry to increase the efficiency of production and improve the quality of products. The main thrust here was heavy investment, particularly in the machine tool industry. The third objective was to reform management practice. This was by far the most difficult. The Prime Minister commented that it would be impossible to achieve the first two objectives without progress on the third. Successful implementation of the economic reforms which Mr. Aganbegyan had described would require a massive change of attitude for managers who had been used to a command economy. We would be very happy to see a team of young managers come to Britain to study the workings of successful companies, like Marks & Spencer or similar enterprises. Mr. Aganbegyan remarked that the first item in his own programme was a visit to Marks & Spencer. He agreed that the Soviet Union had a great deal to learn in this area. If the decision were his, he would take up the Prime Minister's offer to send teams of young managers to Britain. This had in fact happened in the 1920s, when young managers had been sent to the United States, Germany and Britain to learn.

Mr. Aganbegyan continued that management reform had two main objectives: to give firms as much independence as possible and to give workers a larger say in the running of their firms. The Law on Enterprise provided for self-financing, profit and loss accounting and commercial decisions. As these were gradually adopted in industry the whole nature of the Soviet economy would begin to change. The Prime Minister said that she had been surprised by the proposal to elect managers. Surely managers should be chosen on merit. Mr. Aganbegyan acknowledged the problem. But the Soviet leadership were seeking a way to involve working people in the process of reform. They had to be made accomplices and brought along. The extension of democracy to industry was a means of achieving this. It would give the people working in a particular factory a role in shaping its plans and determining how profits were distributed. The better the manager the better off the work-force would be. This would incline them to select the most expert and proficient managers. Undoubtedly there were risks in this course and mistakes would be made. But in Mr. Gorbachev's view there would be fewer mistakes than when appointments were made by bureaucrats in ministries. He believed the new system could produce results. The Ambassador added that Mr. Gorbachev also wanted to get people used to the idea of real elections.

Sir Terence Burns raised the problem of pricing. Evidently, many prices in the Soviet Union did not reflect costs. For example, food was heavily subsidised. Getting prices to reflect costs would mean price rises. How would this be handled? What compensation would people receive? What steps would be taken to deal with inflationary prices? How would people be carried along to accept these changes? Mr. Aganbegyan said that the Soviet authorities were planning introduce price reform by the mid-1990. There was still debate as to whether such reform should extend to the three most heavily subsidised products, dairy, meat and bread. Taken together the subsidies for these three products alone amounted to 57 billion roubles a year out of a total budget of 430 billion roubles. Wide discussion of reform was taking place in the media. But it was quite clear to all professional economists that there would have to be price rises. However, two conditions had been attached to these at the June Plenum of the Central Committee. First, price reform must be democratic. The draft law would have to be published several months prior to its intended implementation so that it could be discussed publicly and the results of this discussion taken into account. Secondly, price reform must not affect living standards adversely. This meant that price increases would have to be compensated. There was an analogy with what had happened after the ending of rationing following the war. He did not under-estimate the difficulties. People in the Soviet Union were used to stable prices and, for that matter, to shortages. There was no doubt that reform would be unpopular. People would not believe that they would be fully compensated. For this reason, price reform would not be introduced until the Soviet economy was able to offer a better supply of foodstuffs and consumer goods. That was one reason why additional funds were being channelled into agriculture.

The Prime Minister said that it was natural that the greater freedom given by perestroika and glasnost led in the first instance to people expressing fears, doubts and criticisms. There would have to be a massive campaign to convince people that things would be better as a result of the proposed reforms. She urged Mr. Aganbegyan, (who is of somewhat lugubrious mien), not to be depressed about the task. It would need endless energy and enthusiasm. The essential problem was to decide how fast to go and how to win people's support.

Mr. Aganbegyan said that he would like to question the Prime Minister about the success of her economic policies, and the lessons which they might offer for the Soviet Union. The Prime Minister gave a brief seminar. It was arranged that Mr. Aganbegyan would have a further meeting with Sir Terence Burns to take this further.

I am copying this letter to Alex Allan (H M Treasury), Tim Walker (Department of Trade and Industry), John Howe (Ministry of Defence) and Trevor Woolley (Cabinet Office).

Yours sincerely,

Charles Powell

C. D. POWELL

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Foreign and Commonwealth Office