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Our Relations with the Russians

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1. I was interested in David Young's minute to you of 16 February and the frank comments of the Soviet Minister for the Chemical Industry reported by Alan Clark. Such comments are heard increasingly frequently from our Soviet and East European interlocutors and are not confined to private conversations. Parts of the Soviet press have exposed Soviet short-comings in a far more comprehensive and damning way than even hostile Western commentators ever did. Several leading Soviet economists have given astonishingly frank accounts of the fundamental economic problems facing the Soviet Union, writing from a more or less openly "capitalist" standpoint. Criticism of the Soviet/socialist system has always been more frequent in Eastern Europe. You will have noticed the recent root and branch condemnation of Soviet communism and all its works by a Hungarian communist party commission looking into the 1956 uprising.

2. Pessimism about the prospects for Soviet economic reform is also widespread and open in the Soviet Union. It is usually focussed on the excessive centralism still

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inherent in the system, and the lack of real prices (an issue being delayed for political reasons). Hesitantly trying to graft bits of a market mechanism on to the existing system has served largely to increase confusion and introduce further distortion.

3. David Young raises two particular questions:

(i) Gorbachev's prospects: I entirely agree that there is a basic mismatch between the immediate need for concrete improvements in living standards for the Soviet population and the time it is likely to take to produce them. (I would expect it to take far longer than the two or three years which David mentions). New investment is not necessarily the solution. Soviet ability to waste capital investment remains largely intact. Much more radical changes in attitudes/ownership/distribution/retailing/pricing and rouble convertibility are needed before goods of the right sort and quality begin to appear in any numbers. The important thing will be to demonstrate that the prospects are there. Until that can be done the prospects for perestroika are gloomy. That is not the same as saying that Gorbachev is in danger of failing. The threat to him is from the so-called conservatives in the hierarchy, and their motivation is based more on concern about glasnost, political reform, the leading role of the party and their own position than about the economy. There is no alternative programme on offer (although we hear

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that conservative economists are working on one) and no focus for opposition. Gorbachev is more likely to be forced to trim his sails than to be forced out. And when under pressure in the past he has retaken the initiative and moved ahead. He could well surprise us again, eg at a Plenum Meeting on Agriculture in mid-March.

(ii) Economic relations with the West: I agree that we should not encourage Gorbachev to borrow (there is no sign that he wishes to even though Soviet indebtedness has not reached unmanageable proportions): I also agree that the prospects for increased East/West economic activity are poor unless the Soviet Union's hard currency earning capacity improves. The problem is to identify ways in which this can be done, which also accord with Western commercial interests. (This is not to say that massive foreign currency expenditure is the only way in which Soviet standards of living can be raised.)

4. All this is relevant to Mr Gorbachev's April visit. He will no doubt tell you of his difficulties. He is engaged in a process which is bound to involve at best serious disappointment and frustration:

(a) The basic lesson is that free enterprise is the only long-term answer. Neither Mr Gorbachev nor the Soviet people will yet accept this, nor do they wish to see too obvious a Western label on Soviet reforms. Entrepreneurs are still viewed with great suspicion, even hostility, in the Soviet Union.

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(b) Soviet economists are not themselves agreed on the way ahead. Some argue (as George Soros does) for an "open sector" and for special economic zones. Others put the emphasis on a big rouble mark-up on imported consumer goods plus innovations such as share ownership, in order to mop up surplus rouble purchasing power. The problems of price reform and convertibility have yet to be faced. The aim of establishing a disciplined monetary and banking system, and bringing the budget deficit under control, has only recently been acknowledged let alone addressed.

5. We are already doing a certain amount:

(a) We are responding in areas where a Western role has been requested. Management training is being provided both by the Government and by British commerce and industry. More can and will be done. Joint ventures are slowly being established (there are so far 13 Anglo-Soviet joint ventures) which may also help in the long run to introduce Western control and management techniques. British banks are making their expertise available to the Soviet banking reform process.

(b) Consortia are already being established to increase Soviet foreign currency earning power in parallel with imports from the West. New areas such as mineral/oil exploration are being looked at to see if increased efficiency can cut down waste and improve export earnings.

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(c) However the British gas industry however see no requirement to purchase Soviet natural gas for the foreseeable future thus closing off possibly the only area in which Britain could relatively rapidly do something to increase Soviet foreign currency earning capacity in a significant way.

6. The signs are that Mr Gorbachev will not come with any major request for Western or specifically British assistance. I believe there is only very limited scope for offering him practical advice. There may be scope to make the point that Britain is well-placed to supply not only goods but also the management expertise and advice which the Soviet economy and Soviet enterprises clearly need as they adapt to changed circumstances. We could also point to the availability of a wide range of British consultancy firms highly respected internationally and experienced at injecting new life into old industries and companies. British consultants are already beginning to take a close interest in the Soviet market. Some big British firms may also be ready to help on the management side, although it is difficult to see how they could become involved to great effect in practice.

7. I am copying this to David Young and Nigel Lawson (with a copy of David's original minute).

(GEOFFREY HOWE)

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