

DECAPTIONED
THEME PAPER: PERESTROYKA
AND U.S.-SOVIET ECONOMIC RELATIONS

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BACKGROUND

Dissatisfaction with the faltering Soviet economy played a role in bringing Gorbachev to power in 1985 and is a major reason for his sagging popularity today. The intervening five years have seen a revolution in Soviet economic thinking, but remarkably little progress in reshaping the Soviet economy. Despite all the rhetoric about economic reform, the Soviet economy still operates in much the same way it did when Gorbachev came to power. Enterprise decisions on production, prices, investment, wages, supplies and product mix are still constrained by central planners; innovators have no incentive to innovate, nor workers to work.

Growing Problems. Ballooning budget deficits, inconsistent reform measures, labor unrest and national conflicts have disrupted the old central planning system, but no new framework has emerged to replace it. The result has been a slow economic deterioration since 1986 that accelerated sharply in 1989. The first quarter results in 1990 were the worst in decades. Economists predict that real GNP could decline by 7-8% in 1990.

Under Gorbachev, wages and government budget deficits have risen much faster than production, resulting in a massive "ruble overhang" of forced savings. This has produced an explosion of shortages, rationing and inflation, putting the legendary passivity of Soviet consumers to a serious test. And the deteriorating living conditions are sharpening social and ethnic conflicts throughout the country.

Labor Unrest. One result is an upsurge in labor unrest that could present a critical challenge to Gorbachev in the upcoming months. Soviet workers are not likely to coalesce into a nationwide Solidarity-style workers' movement, since the fledgling labor unions are deeply divided over goals, tactics and personalities. There is, however, a good possibility that Gorbachev will be faced with a number of loosely allied labor groupings, which may coordinate their strikes and demands. If individual factories, regions or even industrial sectors go on strike, the economic impact will be painful, but survivable. But a well-organized strike in the transport sector -- especially the railroads -- could bring much industrial activity to a standstill.

During the miners' strikes last summer, Gorbachev defused the situation by promising extra pay and consumer goods and focussing popular anger on local rather than central authorities. It will be difficult to repeat this trick, however, since many of the miners feel that the government failed to live up to last summer's promises. If there were serious

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strikes, Ryzhkov would probably be forced out, since he is popularly held responsible for the deteriorating economy and the unfilled promises of last summer. Gorbachev would also come under tremendous pressure to defer the more unpopular aspects of any economic reform measures that had been agreed upon, such as price reform.

The Next Stage of Reform. Gorbachev has responded to the growing economic crisis with a radicalization of rhetoric. In March, after assuming the "executive" presidency, he announced his intention to move to a "full-blooded" market and promised that a radical economic reform program would be presented to the Supreme Soviet May 10. His new economic advisors -- market advocates Nikolai Petrakov and Stanislav Shatalin -- gave interviews suggesting that the Polish-style "shock treatment" would provide a model for Soviet reforms.

But the May 10 deadline passed without a program. The Polish model is not a realistic option for the USSR, for at least three reasons:

- Gorbachev and the CPSU do not now have the political credibility to carry through a program demanding serious economic sacrifices;
- the USSR has too many internal conflicts -- feuding ethnic and social groups -- to achieve the national consensus required for this kind of program; and
- barriers to starting up private enterprises are so strong in the USSR that the economy would have difficulty in responding quickly to market forces.

The key question is whether Gorbachev can draw up and implement a program that is radical enough to produce some progress, but does not demand more sacrifices of the Soviet people than they are willing to accept. A growing number of reform economists argue that he no longer has the credibility to do so. If we want to move to markets, they say, we must first get rid of the Communists.

Gorbachev's advisors, however, argue that he can use his newly acquired presidential powers to develop and push through a program that would include the following elements:

- de-monopolizing the economy by transforming state enterprises into joint stock companies;
- stabilizing the ruble's value by selling housing, land for dachas, and enterprise shares;
- raising interest rates and reorganizing the banking system;

- encouraging the development of small businesses and foreign investment; and
- gradually freeing prices.

Elaborating such a program has clearly been more difficult than Gorbachev anticipated, and his May 10 deadline has now slipped. The first test of Gorbachev's ability to muster support for his brand of economic reform will come in the Supreme Soviet. The next will come during the Party Congress in July. In the meantime, the economy will continue to deteriorate. An upsurge in national or labor unrest could bring the situation to the crisis point.

What is to be Done? A successful reform strategy would have to include the following four elements: monetary stabilization, which would involve cutting the stock and flow of excess rubles; creation of property rights and incentives; microeconomic reform to create enterprise competition; and creation of a safety net based on income subsidies rather than price subsidies. The latter is essential to ensure that support could be targeted to the needy without interfering with market incentives.

The obstacles to successful economic reform in the USSR are immense, but Gorbachev's chances should not be written off too soon. One factor in his favor is the growing realization among Soviets that some kind of major change is necessary. Polls show that people fear rising unemployment and inflation, and many favor rationing over markets. Despite this, however, there is a steady increase in popular acceptance of such concepts as private property and entrepreneurship, and a growing sense of economic crisis and the need for action. So far -- fortunately for Gorbachev -- no other credible leader has emerged.

Looking for Help Abroad? Gorbachev's mounting economic woes are prompting him to reconsider his earlier view that foreign assistance was irrelevant to the success of perestroika. He told Secretary Baker that the transition to a "planned market" will require a massive infusion of capital. Foreign investment will be essential -- and profitable -- according to Gorbachev. He also expressed doubts to the Secretary about the depth, if not the sincerity, of U.S. support for perestroika. Gorbachev told the Secretary that other Western governments were willing to offer material assistance to the USSR, and he chided the U.S. for successfully opposing full Soviet borrowing rights in the EBRD. Obtaining aid and stepped-up private investment may be Gorbachev's highest priority during his U.S. visit.

POINTS TO MAKE

(Perestroyka)

- o I have frequently expressed my support for perestroyka and for the immense political and economic changes you are undertaking.
- o I believe that moving toward democracy and a market system is the best way to ensure a better life for the Soviet people.
- o For this reason, I have been encouraged by your recent statements that you intend to advance the economic reform process and move to a "full-blooded market."
- o I recognize, of course, that the road to markets is not an easy one and I would not presume to give you advice on how to travel this path.
- o But I would like to offer a few comments on how I see the reform process developing and the role the U.S. could play.
- o The longer you remain poised between two systems, the greater your economic problems will become.
- o I believe that rapid movement toward reliance on markets is the only solution to your economic crisis. To do so, you must address four areas in a systematic way:
 - monetary stabilization to restore the value of the ruble by absorbing the ruble overhang and cutting the deficit;
 - guaranteed property rights to create incentives;
 - micro-economic reform to ensure enterprise competition; and
 - a safety net that relies on income subsidies rather than price controls to protect the poor without destroying incentives.
- o My strong support for your economic reform program was evident in the initiatives I advanced at Malta. I'm pleased with our progress in following up.

(U.S.-Soviet Commercial Relations)

- o The trade agreement we are about to sign will open a new chapter in our economic relationship, opening the doors of the U.S. economy to Soviet imports and exports.

- o In the coming months we hope to take further steps, including the lifting of congressionally-mandated credit restrictions, to expand the opportunities for mutually beneficial trade.
- o We're doing everything we can to create the conditions for expanded U.S. trade and investment.
- o Realistically, however, trade and investment between our two countries -- and the economic benefits -- will remain marginal until you take the necessary steps to open the Soviet economy to the outside world.
- o U.S. investment in Soviet joint ventures producing for export will make only a small contribution to your economic well-being if your domestic market remains closed to foreign companies.
 - But if you open up your domestic market, U.S. investment could play a substantial role in satisfying consumer demand, stimulating entrepreneurship and strengthening perestroyka.
- o The investment and tax agreements that our negotiators are working on will make some contribution to encouraging U.S. investment in the USSR.
- o But without access to the Soviet domestic market, Western companies have no incentive to commit themselves to projects that would help you to produce the consumer goods your people want.

(Soviet Integration in the World Economy)

- o I am delighted by the steps that you and we have taken to facilitate Soviet integration in the world economy.
- o Soviet achievement of GATT observership, which we support, is one example of this.
- o So too are the growing Soviet cooperation with the OECD, Soviet participation in the EBRD, and assent to the Final Document of the Bonn CSCE Economic Conference.
- o We hope your participation in these organizations will further acquaint you with market principles, and thereby accelerate your integration into the world economy.

(Technical Cooperation)

- o I am also pleased with the technical economic cooperation program that we began together at Malta.

-- This is a concrete expression of our support for perestroyka.

- o Under Secretary Baker's leadership, these projects have involved a number of U.S. and Soviet government agencies.

-- We have discussed a number of different ideas for expanding technical cooperation, establishing training projects and expert consultations, and a high-level economic dialogue.

- o We would be ready to move forward and develop these ideas if you are interested.

(Contingency Points)

(If Gorbachev complains about U.S. opposition to full Soviet borrowing rights in the EBRD)

-- Given Congressional opposition, full Soviet borrowing rights would have endangered USG participation in the EBRD. You have the same borrowing rights we do.

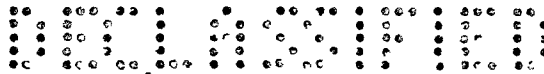
-- Frankly, it would have been hard to defend anything more, as long as the USSR continues to spend billions abroad to support countries like Cuba, Afghanistan and North Korea that are engaged in activities threatening to Western interests.

(If Gorbachev seeks food aid or credits)

-- As you know, there are a number of legislative barriers that prevent us from offering or guaranteeing credits to the USSR. I have pledged to work with Congress to begin to remove these barriers as soon as we are able to waive Jackson-Vanik.

-- The Long-Term Grains Agreement we have just signed should make it possible for us to provide a higher level of food exports to the USSR.

-- In order for the USSR to qualify for our agricultural export credit guarantee programs, a Jackson-Vanik waiver would be required.



SUMMIT THEMES: Perestroyka

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