

Evaluation of "Shock Therapy" in Russia

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1. Introduction

The purpose of this paper is to evaluate the "shock therapy" which has been implemented in Russia since the beginning of 1992. We focus our attention on price liberalization, which is the core of this shock therapy. Although seemingly deficient at the present time, some economists, both Russian and Western, still maintain that price liberalization is advantageous. Therefore, it is still meaningful and worthwhile to discuss theoretically and statistically the fundamental defects in the shock therapy, which have brought about various problems, before we search for an alternative policy.

In the next section, we examine arguments for and against price liberalization. In the third section, the scenario resulting from price liberalization is analyzed based upon some statistical data. In the final section, we consider an alternative policy.

2. Arguments for and against price liberalization

The argument in favor of price liberalization is supported by the following four points:¹

Point 1: price liberalization is a necessary condition for the transition to a market economy.

This can be explained by syllogism: normalization of price relations and of distribution of goods is necessary for the

transition to a market economy, and in turn price liberalization is a necessary condition for this normalization.

Normalization of price relations means that prices should approach equilibrium. In the Russian context, it means that the distortion in price relations caused by administrative price setting should be eliminated and price relations should approach world standards. This is necessary for a number of reasons. First, distorted prices lead to an inefficient distribution of resources and impede competition among enterprises. Because efficiency and profitability have been inaccurately assessed in Russia, efficient enterprises under normal price conditions run the risk of bankruptcy while unprofitable ones stand to prosper. Second, without properly evaluating assets, privatization is impossible. Third, without narrowing the gap in price relations between domestic and world markets, convertibility of the ruble will be difficult to attain. Fourth, normalization of price relations is also required for creating a new system of interrepublican transactions within the CIS.²

Normalization of distribution of goods implies the creation of an atmosphere where people can buy goods by spending rubles without having to resort to barter or the use of foreign currency. It is realized through virtual legalization of the underground economy: as a result of price liberalization, prices in the first and second economy should coincide.

Point 2: if the government cannot regulate prices to a considerable degree, then all prices should be liberalized at one time.

Undeniably, the Russian government had lost control on most prices by the middle of 1991. Therefore, price liberalization in the beginning of 1992 might be regarded as just a ratification of the situation in process.

Point 3: if all prices are liberalized at one time and strict fiscal and monetary policies are pursued, then excess liquidity could be absorbed and inflation could be stopped within a very short time.

Point 4: if all prices are liberalized at one time, then all subsidies could be liquidated and budget expenditures could be reduced substantially.

We admit that all four of these points are true. We can, however, present the following three points which argue against price liberalization and which substantially refute those points.

Point 5: price liberalization is not conducive to normalization of price relations under the dominance of state ownership.

"Liberalized" prices under the dominance of state ownership are not equilibrium prices. First, in Russia, as in most former socialist countries, state ownership has engendered monopoly or oligopoly in the majority of domestic commodity markets. Needless to say, without free competition, prices do not reach equilibrium. In addition, we have to take into account the existence in Russia of the monstrous military-industrial complex in which total monopolization has nearly been attained. This means that in Russia the problem of monopoly is far more serious than in any other former socialist country.

Second, price liberalization does not necessarily mean a free hand in price setting for state enterprises in Russia. On the one hand, there have been a great number of reports by the Russian mass media showing various incidences of administrative intervention in price setting by state, and in particular, local organizations. On the other hand, most state enterprises have no idea how to establish prices and thus frequently refer to state organizations for price setting. Therefore, numerous Russian economists, including Nikolai Petrakov and Valery Makarov, argue that Yeltsin's price liberalization was just a repetition of Pavlov's price revision in the beginning of 1991.³

Some might argue that precisely for the purpose of overcoming these deficiencies due to the dominance of state ownership, liberalization of foreign trade is needed. If, however, we take into consideration the low competitiveness of

Russian industry, we have to confront the vast devastation which will inevitably follow a complete liberalization of foreign trade. Therefore, although the liberalization of foreign trade has already been declared, its implementation, if any, has been rather slow in Russia.

Point 5 undermines Point 1. This seems to suggest a necessity of a coordinated policy between price reform and other organizational measures, and of a firm price policy for state enterprises.

Point 6: if, together with price liberalization, strict fiscal and monetary policies are pursued, the financial condition of enterprises will undergo extreme deterioration.

In Russia, as in other former socialist countries, enterprises are accustomed to "soft budget constraints", and are unable, on their own, to adjust the supply and prices of their goods in response to changes in the prices of other goods. As a result, prices are inflexible and the elasticity of supply is very low. Hence, if financial and credit assistance from the state is cut under the condition of a general increase in prices, most enterprises, having no effective alternative, encounter financial difficulties.

Russian society, however, cannot withstand mass bankruptcies. This is true for all former socialist countries. Therefore, a peculiar situation develops here: a series of insolvencies is occurring through the economy. In Russia, overdue credit repayments from enterprises to banks and suppliers grew from 33.9 billion rubles on January 1st to 140.4 billion rubles on February 1st, increased to 605.8 billion rubles on March 1st, and reached 780.3 billion rubles by April 1st (*Ekonomika i zhizn'*, 1992, No. 17, p. 14). It seems that excess liquidity is not maintained by the central financial authority, as in the past, but through this mutual credit situation devised by enterprises.

As is readily understood, Point 3 and Point 6 together represent a real dilemma. On the one hand, if fiscal and monetary policies are relaxed, then excess liquidity and hyperinflation will continue. On the other hand, if a strict

financial policy is adhered to, then insolvencies will remain prevailing among enterprises. The real situation in Russia in terms of this dilemma will be revealed in the next section.

Point 7: fuel prices in Russia, particularly oil prices, have been extremely low by international standards, and as a result, abrupt liberalization of these prices is impossible: gradual liberalization is the only option available.

If this is indeed the case, in other words, if we accept a very important exception to price liberalization, then the significance of Points 1 through 4 is considerably reduced. First, because up to now the price of oil has represented the most serious distortion in price relations in Russia, if its liberalization is delayed, the normalization of price relations will also be delayed. This means that the difference in price relations between domestic and world markets will not be reduced right away, and that the establishment of a single rate for the ruble and hence convertibility of the ruble into foreign currencies will remain difficult.

Second, if a gradual liberalization of the price of oil is inevitable, the government has to maintain regulation of the price of oil. This contradicts Point 2. While Point 2 argues the ability of the government in terms of price regulation, here such control becomes a matter of obligation (*Sollen*). Which point is correct? It seems that the government simply cannot dispense with price regulation, no matter how inefficient the government is.

Third, if the price of oil is raised gradually, then the price of almost all other goods will gradually increase as a result. Thus, Point 7 denies a precondition of Point 3 and hence the possibility of a rapid halt to inflation is reduced.

Fourth, as long as price regulation is maintained on some goods, the necessity of subsidies continues. In the former Soviet Union, almost 90% of state budget subsidies were appropriated for agricultural products, and the rest for agricultural machinery, chemical fertilizers, and coal. Subsidies accounted for about 15-20% of the budget expenditure. In the Russian plan for budget expenditure for

the first quarter of 1992, these subsidies accounted for only 2-3% of total expenditures, indicating that the government succeeded in subsidy reduction. On the other hand, as a result of price liberalization, subsidies for energy and fuel have increased. Thus, price liberalization which does not cover all goods does not remove subsidies. In Russia, what has happened is the replacement of one economic system, where the majority of subsidies are earmarked for agriculture, by another where fuel industries are heavily subsidized.

Thus, if we accept Point 7, almost all arguments in favor of price liberalization seem to be significantly refuted. We have to bear in mind the special role that oil has played in the recent Russian economic development. The increase in oil prices in the world market has provided not only abundant export and budget revenues directly, but also has provided subsidies to all industries indirectly. The low price of oil has functioned as a kind of universal subsidy sustaining inefficient manufacturing industries until now. Therefore, the increase in domestic oil prices to the international level implies a complete conversion of the existing industrial system and structure. It is, however, precisely the need for this conversion that necessitated price liberalization. Accordingly, price liberalization, exclusive of the price of oil, is almost theoretically meaningless.⁴

In reality, the Russian government was not able to free the price of oil quickly and thus intends to increase its price gradually to the level of the world market by the end of 1993.⁵ This policy of the government is explained by the consideration that if the price of oil is freed simultaneously with other prices, the problems referred to in Point 6 will become far more serious than in the present situation, while, as described in Point 5, one of the aims of price liberalization will not be accomplished.

3. The reality of financial and income policies

In this section, we examine the financial and income policies of the Russian government and their results, for the purpose of illustrating the real state of the dilemma between Points 3 and 6.

The most striking feature of the Russian policy in these fields, compared with other countries at the stage of introducing shock therapy (for example, Poland and Czechoslovakia), is its lack of rigidity. In Russia, a policy of reducing the budget deficit has not been aggressively pursued and yet the liberalization of wages has been declared. Accordingly, improvement in the financial situation in Russia has not been dramatic at all.

(1) Financial policy

First, there were plans to reduce the budget expenditure considerably. Among others, centralized state investment in 1992 was to be reduced to the level of 60% of its amount in 1991 (by the government decree on December 30th, 1991 in *Pravitel'stvennyi vestnik*, 1992, No. 2) and subsidies for price compensation were to be a mere 11.4 billion rubles in the budget plan for the first quarter of 1992, compared with 112.7 billion rubles in 1990 for the whole former Soviet Union (*Ekonomika i zhizn'*, 1991, No. 25, p. 7).⁶

Second, the tax system has undergone some fundamental changes. A value-added tax and excise tax were introduced, for the purpose of automatically increasing revenues in accordance with price increases, substituting the notorious turnover tax and sales tax. A number of other new taxes, patterned after those in effect in Western countries, were levied. During the first quarter of this year, however, a series of tax exemptions was introduced.⁷

Third, as a result of these measures, in January the goal was to reduce the budget deficit to zero, but later its increase was approved. The budget plan for the first quarter of 1992 was quite unusual. On January 24th, the law on the

republican budget of the Russian Federation was approved formally, and on March 17th, the government decree to support this law was adopted (*Rossiiskaia gazeta*, 1992. 2. 25, 3. 25). At that time, a balanced budget of 420.5 billion rubles in both expenditure and revenue was pursued. However, the Memorandum of the economic policy of the Russian Federation, adopted at the end of February and sent to the IMF, had previously stated that the original goal of the budget deficit (4.4% of GDP) was apparently unattainable and could even reach 14.2% of GDP.⁸

On April 4th, the final, specified draft of the budget for the first quarter was approved by law (*Rossiiskaia gazeta*, 1992. 5. 14). It included 67.5 billion rubles of the budget deficit. Peculiar still was that 219.7 billion rubles of the expenditure and revenue related to foreign economic relations were deducted from both sides of the balance sheet: as a result, the total expenditure and revenue was roughly half of that listed in the original plan. Apparently, this phenomenon resulted from the failure to collect export taxes. Andrei Vavilov, the first deputy minister of finance, reported that this budget deficit was still 4.8% of GNP.⁹ Regardless, it is apparent that the government's intentions have not been fully realized.¹⁰

(2) Income policy

By presidential decree on November 15th, 1991, the liberalization of wages was declared and all restrictions on wages were eliminated (*Vedomosti*, 1991, No. 47). The only measure designed to restrict wage increases was a new taxation scheme aimed at the profits of enterprises. This plan, the purpose of which was to tax excess wages, was introduced by law on December 27th, 1991 (*Vedomosti*, 1992, No. 11). According to the Supreme Soviet decree, issued on the same day, the wage standard for 1992 was set at a level 4 times as large as the legal minimum wage (*op. cit.*). It is widely recognized, however, that Russian managers are accustomed to this type of scheme and have mastered ways to evade it.

Therefore, we could say, literally, that there have been no restrictions on wage increases in the first quarter of 1992.¹¹

In budget institutions and organizations, i. e., those in the non-productive sphere, such as education and social security, wages were raised by 90% on December 1st, 1991, by another 45% on March 1st, and by 80% on June 1st.¹² Therefore, during this period, wages increased roughly fivefold.

If we look at total income and expenditure of the population, shown in Table 1, it is evident that savings, i. e., the difference between income and expenditure, remain large, especially in the form of cash accumulation (increase in cash holdings). This would indicate that excess liquidity has not been reduced to the extent as had been anticipated. It is true that this trend occurred, in part, due to the decrease in demand caused by stocks in households accumulated before the price liberalization. If, however, we take into consideration the above mentioned increases in wages and other incomes of the population, it is certain that the mechanism for engendering excess liquidity will be maintained for a certain period of time.

By definition, cash accumulation, as indicated in Table 1, almost matches with cash currency issued (*emissia* in Russian), due to the fact that cash holdings by enterprises are negligible. In fact, the Central Bank reported that the cash currency issued in the four months from January through April in 1992 reached a total of 143.1 billion rubles, compared with 89.2 billion rubles for the entire year of 1991 (*Rossiiskaia gazeta*, 1992. 5. 09, *Ekonomika i zhizn'*, 1992, No. 10). Thus, the amount of cash currency issued continues to increase correspondingly to the increase in population income, as was the case in the former Soviet Union.

(3) Financial difficulty for enterprises

As we have seen, the financial and income policies in Russia have not been aggressively pursued. The budget deficit remains large and incomes are increasing rapidly. Notwithstanding, as described above, the financial situation of enterprises has deteriorated rapidly, and a series of

insolvencies has occurred.¹³ In turn, this financial disorder caused further dislocation of economic relations among enterprises and further decline in their economic activities. It goes without saying that if the policies in these areas are rigidly implemented, the financial difficulties of enterprises will become graver still.

As a footnote, we would like to point out that although most enterprises are reported to be experiencing difficulties, the wages for their workers continue to increase, as was stated above, and the profits of enterprises in the first quarter of 1992 increased six times compared with the same period of 1991 (*Ekonomika i zhizn'*, 1992, No. 17). This would suggest that enterprises accustomed to "soft budget constraints" put different priorities on various purposes as compared to those enterprises operating in a market economy. We should not expect that the behavior of these enterprises will change quickly. It follows that the government should urge state enterprises to behave properly in a changing environment.

4. Concluding remarks

Our evaluation of the shock therapy being implemented in Russia can be summarized as follows. First, its contradictory nature should be pointed out. Price liberalization without a free oil price is theoretically meaningless. Second, without other organizational measures, one of the main goals of price liberalization, i. e., normalization of price relations, is scarcely attainable. Third, there exists a real dilemma between hyperinflation and financial difficulties for enterprises. This dilemma will become extremely acute, if the oil price is liberated.

Thus, we have argued against the shock therapy undertaken in Russia since the beginning of 1992. In the place of shock therapy, what should be done? At this point, we would like to sketch out some basic principles for an alternative policy.

First, it has to be recognized that the government cannot dispense with the control over state enterprises. It goes without saying that privatization is necessary and should be pursued aggressively. It is, however, also evident that it takes many years to privatize a large portion of state enterprises. It follows from this that the large state sector and growing non-state sector will coexist for a considerable period of time. Thus, the transition period from a command to market economy is characterized as a two-sector economy. Accordingly, the control over state enterprises should not be abandoned. Among other things, price regulation is indispensable because, as was indicated above, what was enacted in January was not a liberalization of prices in the true sense of the word, at least as far as state enterprises are concerned. The government has to set explicit guidelines for price setting, as long as it is desirable and necessary. Thus, together with the two-sector economy, a double system of prices will be maintained: state-regulated prices and free prices. Of course, the gap between the two systems of prices will be reduced gradually, if an adequate policy in this area is pursued by the government.

Some might argue, as was stated in Point 2 of the second section, that the present Russian government has lost the ability to pursue such a well-ordered and consistent policy. Although this appears to be the case, we would like to point out that under the contemporary form of a market economy, the ability of a government to regulate its national economy has become crucial for the development of that country. One might even contend that without acquiring this ability, the transition to a market economy is utterly impossible.

Second, a special policy is needed for fuel, especially for oil, because it is evident that Russia has a relative abundance of oil and that inevitably oil will remain the most important source of economic prosperity for Russia. It is not only inevitable, but indeed advantageous for Russia that for several decades to come, Russia will exist as a great power based upon its huge supply of fuel and natural resources. As was argued

by Dmitrii L'vov and Vsevolod Pugachev, there is even a possibility of establishing a unique tax system that almost wholly depends upon fuel and exempts almost all other incomes of enterprises and individuals. Although this possibility cannot be discussed in detail here, evidently a special scheme of coordinated measures regarding the price and tax on oil is needed. It is clear that there is no universal way for the transition from a command to market economy: each country should take account of its advantages and disadvantages.

We would like to argue that in the oil industry privatization is not necessary. The state should create a system which ensures essential financial resources for the entire economy based on the oil industry. Moreover, the state should give top priority to the development of the oil industry in terms of state and foreign investment.¹⁴

Third, it should also be recognized that the transition to a market economy requires decades. Appropriate measures should be taken step by step to promote creation of a market atmosphere, and concurrently the government should eventually learn how to manage the economy. Gradualism is inevitable, because the transition requires a fundamental change in the behavior of enterprises, managers, workers and bureaucrats. The only obstacle to this gradualism is the problems of foreign debt. Foreign creditors are not willing to wait for very long. We anticipate that this problem will be solved forthwith, if top priority is placed on the development of the oil industry, as was mentioned above. We believe that foreign assistance is only warranted in the development of oil and other industries which will ensure earnings of hard currency in the near future. Other forms of assistance would, at best, be meaningless, and, in some cases, detrimental.

Notes

1 See Aslund, 1992, Sachs, 1992 and Sachs and Lipton, 1990.

2 The Russians fear that their energy and fuel resources continue to be

- sold to other republics of the former Soviet Union at unrealistically cheap prices.
- 3 Based on a personal interview with Makarov in December, 1991 and see Petrakov, 1992.
 - 4 Dmitrii L'vov and Vsevolod Pugachev have argued consistently for a swift liberalization of the oil price.
 - 5 In accordance with this policy, on May 18th, 1992, the government decree concerning the price regulation on fuels and other goods and services was issued (*Rossiiskaia gazeta*, 1992. 5. 20). Although it did not free the price of oil, its new regulated price (1800-2200 rubles per ton) seems to be very close to the free market price: in April, the state regulated price was 400 rubles, the price in commodity exchange — 3200-4800 rubles and the free price outside commodity exchange, i. e., by direct contract, including barter, — 1500-2000 rubles per ton (*Kommersant'*, 1992, No. 19, p. 12). It is said that the new regulated price of oil is equal to one third the price on the world market, if converted at the rate of \$1 = 50 rubles. This shows how low the price of oil has been in Russia and how high the possibility to earn extra revenues, if the price of oil approximates the world market price.
 - 6 By the government decree on May 8th, 1992, the subsidy for livestock products was restored (*Rossiiskie vesti*, 1992. 5. 19). Its total amount for 1992 was estimated to be 60 billion rubles (*Izvestiia*, 1992. 5. 14, p. 1).
 - 7 For example, by the decree of the Presidium of the Supreme Soviet and the government on February 3rd, value-added tax is exempted for public catering and its rate is reduced from 28% to 15% for some food products (*Vedomosti*, 1992, No. 7).
 - 8 These figures are calculated using the methodology of the IMF, different from the one employed by the Russian government, and include not only the republican budget, but also local budgets.
 - 9 He insisted that in the last year it was 17%, or 24% if calculated using the IMF methodology.
 - 10 Besides these fiscal policies, the interest rate of the Central Bank of Russia was increased from 2-9% in 1991, to 20% in January, to 50% in April, to 80% in May of 1992. Taking into consideration hyperinflation, this increase in itself seemed to be not enough to curb credit extension. See *Izvestiia*, 1992. 5. 25, p. 1.
 - 11 The above mentioned Memorandum revealed a tougher restriction on wage increases in state enterprises, to be introduced from April. This restriction consists of a high progressive taxation on abnormal increases in wages: roughly speaking, the norm of wage increase is set at 70% of price increase.
 - 12 See presidential decrees (*ukaz*) on November 15th, 1991 and April 15th, 1992, and presidential orders (*rasporiazhenie*) on January 24th and February 26th (*Vedomosti*, 1991, No. 47, 1992, No. 6, No. 10,

- Rossiiskaia gazeta*, 1992. 4. 18). For workers in the area of health care and social security, the second and third increases were to be enforced on February 1st and on May 1st, respectively.
- 13 On April 3rd, the government and the Central Bank of Russia signed an agreement concerning the normalization of settlement in the national economy. It specifies the allocation of 200 billion rubles for state enterprises in 1992 for the purpose of purchasing raw materials and of completing unfinished construction, especially in agriculture (70 billion rubles), construction (70 billion rubles) and industry (50 billion rubles). It is expected that by this credit the chain of mutual non-payments will be broken (*Ekonomika i Zhizn'*, 1992, No. 15).
 - 14 A number of presidential and government decrees were issued on June 1st, 1992, for the purpose of promoting the development of the oil and gas industries (*Rossiiskaia gazeta*, 1992. 6. 5). Although it is apparent that the Russian government has recognized the necessity of special treatment for fuel industries, especially after the sixth Congress of People's Deputies held in April, 1992, the measures taken toward this end have been weak and totally insufficient.

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Table 1 Money income and expenditure of the population
(In billions of rubles)

	1991		1992 Jan.-March	
		%		%
Total income	756.0	100.0	519.2	100.0
Total expenditure	601.6	79.6	411.0	79.2
Expenditure on goods and services	510.2	67.5	358.3	69.0
Taxes and other expenditure	91.4	12.1	52.7	10.2
Savings	154.4	20.4	108.2	20.8
Accumulation of savings deposits	65.3	8.6	31.1	6.0
Accumulation of bonds	2.0	0.3	-1.1	-0.2
Cash accumulation	87.1	11.5	78.2	15.1

Note: Accumulation of savings deposits in 1991 excludes the deposit compensation for the price increase on April.

Source: *Economika i zhizn'*, 1992, Nos. 4, 17.

Table 2 Average monthly wages and price indexes in 1992

	Dec. 1991=100						the previous month=100				
	Dec.	Jan.	Feb.	March	April	May	Jan.	Feb.	March	April	May
Average wage (rubles)	...	1470	1994	2725	3052	3650	...	136	137	112	120
Wholesale prices											
Electricity	100	369	572	852	1150	1519	369	155	149	135	132
Fuel industry	100	494	622	797	845	1757	494	126	128	106	208
Ferrous metallurgy	100	461	1199	1498	1993	2531	461	260	125	133	127
Chemicals	100	602	1072	1425	1910	2387	602	178	133	134	125
Petrochemicals	100	796	1091	1309	1754	2034	796	137	120	134	116
Machine-building	100	512	835	1110	1288	1481	512	163	133	116	115
Wood, wood-processing											
pulp & paper ind.	100	471	1050	1323	1456	1601	471	223	126	110	110
Construction materials	100	482	815	920	1049	1207	482	169	113	114	115
Light industry	100	330	531	616	653	706	330	161	116	106	108
Food industry	100	465	605	701	827	910	465	130	116	118	110
Retail prices											
Food	100	333	410	496	570	...	333	123	121	115	...
Non-food	100	394	425	508	570	...	394	108	120	112	...
Service	100	316	427	542	645	...	316	135	127	119	...
	100	227	303	351	408	469	227	133	116	116	115

Source: *Argumenty i fakty*, 1992, No. 14, p. 3; *Izvestiia*, 1992. 6. 8, p. 2, 1992. 6. 27, p. 1; *Economika i zhizn'*, 1992, No. 23, p. 18, No. 26, p. 7, No. 27, p. 6.

Table 3 Estimates of cash currency issued in 1992

billion rubles	
January	17
February	24
March	37
April	64

Note: Estimates based upon data in *Economika i zhizn'*, 1992, No. 15, p. 1, No. 17, pp. 14-15, No. 25, p. 1, *Rossiiskaia gazeta*, 1992. 5. 9, p. 8, 1992. 6. 4, pp. 1-2.

Table 4 Overdue credit repayment from enterprises to banks and suppliers in 1992

	billion rubles
(at the beginning of each month)	
January	39
February	140
March	390
April	780
May	1300
June	2000

Note: Estimates based upon data in *Ekonomika i zhizn'*, 1992, No. 15, p. 1, No. 17, pp. 14-15, No. 25, pp. 5, 14-15, *Izvestiia*, 1992. 3. 28, p. 2, 1992. 4. 3, p. 3.