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# Discussions over the Currency Policy in the NEP Period (1921–1928)

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In 1921, Russia's authorities transitioned from the "war communism" policy to the new economic policy (NEP), which was based on the combination of the market principles and the state regulation. In the first years of the reform (up to May 1924) relatively stable chervonets and depreciating sovznak circulated in parallel. Although there was no gold standard, the authorities bore in mind possible return to it. According to the decree on the issue of chervonets, the one chervonets banknote was equivalent to 7.74 grams of pure gold, i.e. the amount contained in the pre-revolutionary 10 ruble gold coin. Exchange for gold at this parity, however, was postponed until a special government order was made. Accordingly, an official exchange rate of chervonets to dollar and pound sterling was linked to the pre-war monetary parities. An official exchange rate was set on the Moscow commodities exchange, where demand and supply were regulated by the state. Market rate could significantly deviate from an official one and to reduce the gap Gosbank made currency interventions.

Sokol'nikov, the Commissar of Finance, considered linking chervonets to the hard foreign currency based on the gold parity to be the main means of securing chervonets' stability. He based his reasoning on the idea that the banknotes should play the role of the gold money. Because the exchange for gold was prohibited, he believed the banknotes could play that role only if certain parity with foreign currency was maintained. Over the whole NEP period there were numerous discussions between the exporters and the People's Commissariat of Finance (NK Fin) as to how to set the optimal exchange rate between chervonets and the foreign currencies.

Narkomfin and VSNH (administrative body regulating state industry) were strongly against sharp appreciation of the foreign exchange rate. At the same time Narkomvneshtorg (People's Commissariat of Foreign Trade) was against its depreciation. At the end of March, Narkomvneshtorg sent a letter to the government criticizing the currency policy of Narkomfin. It accused Narkomfin of setting exchange rate too low for foreign currency and therefore making the export unprofitable. This conclusion followed from the comparison of the pound sterling

and dollar exchange rates (expressed in gold) in the international exchanges in London, New-York, and Paris with those in Moscow. It has been pointed out in the letter that there is mismatch between exchange rates and actual price movements of export goods. As a result “Export of flax, pelts, and timber under current exchange rates is no longer profitable”.<sup>1</sup>

Narkomfin did not agree to those arguments based on the sophisticated theoretical analysis. At the beginning of May, Sokol’ikov sent the government a reply which was signed not only by him, but also by his scientific consultants, professors. Yurovsky and Loevetsky. Having studied the relationship between Russian and British/American commodities indexes on the pre-war basis and the changes in pound sterling and dollar exchange rate to the pre-war parity, the authors concluded that the export is profitable.

They also pointed out that the importance of the currency policy for the development of export should not be overestimated in the Russian reality: “In our environment, when any calculations are rather relative and significant overhead expenses push the production and selling costs up, few points deviations of the exchange rates from the desired parity can not be critical for the foreign trade.”<sup>2</sup> This was very important comment.

After the monetary reform was completed in May 1924, chervonets became the only hard currency. Over more than a year (till autumn 1925), the domestic prices were stable, and so was the exchange rate of chervonets. Nevertheless, even then some well-known economists suggested re-considering the exchange rate. For example, on 8 October 1924, Professor Novozhilov had raised the question in *Finansovaya gazeta* of whether the *chervonets* was overvalued in terms of foreign currency in relation to its purchasing power within the country. This, in his opinion, was impeding exports and obstructing the development of the forces of production. Novozhilov was an adherent of Kassel’s purchasing power parity theory, according to which exchange rates are determined by relative prices in the countries concerned. The *chervonets* rate against the dollar, for example, was set at the 1913 gold parity (US dollar 1 = 1.945 rubles), although after the monetary reform in May 1924 the rise in wholesale prices in the USSR compared with 1913 exceeded that in the USA by around 16%. Novozhilov argued that equilibrium had been disturbed and must be restored, and saw two solutions. The first, which could be long and difficult, was to reduce domestic prices. The second, which he considered preferable, was to lower the ruble exchange rate against the dollar: “Is it not simpler to raise one price – the price of gold – than to reduce all prices?”, he asked rhetorically.

Novozhilov’s article provoked a lively debate in the economic press. The most fundamental criticism came from Yurovsky in *Economicheskaya zhizn*, 23 October

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<sup>1</sup> Goland, *Diskussii ob ekonomicheskoi politike v gody denezhnoi reformy 1921–1924*, M. 2006, p. 469

<sup>2</sup> *Ibid*, p.471.

1924. He pointed out that before the war too almost all countries had used customs measures to create special price conditions. As a result the purchasing power of gold had never been identical in all countries, i.e. exchange rates backed by a gold parity did not precisely reflect differences in the level of prices. For example, in 1913 the level of wholesale prices for all goods in the USA was 91% of the level in Russia. This did not prevent the development of foreign trade because the level of prices of agricultural goods, which formed the main part of Russian exports, was approximately one and a half times higher in the developed countries than in Russia. Roughly the same price relationship for agricultural goods still existed at the end of 1924, which made it possible to export profitably. Prices of industrial goods, however, had increased considerably more in the USSR than in the developed countries. In Yurovsky's opinion this was primarily the consequence of greater economic destruction during the civil war, rather than of monetary policy. "The current exchange rate of the *chervonets* is the normal rate, and the so-called "discrepancy" between the exchange rate and the purchasing power of the *chervonets* correctly reflects the real state of the productive forces of our country at the present stage of reconstruction", he wrote. Yurovsky expressed confidence that the "scissors" between the exchange rate and the purchasing power of the *chervonets* would close as the consequences of the destruction were overcome and the reconstruction of industry led to a reduction in prices. This process, he thought, could be prevented by only one thing: "If we supported the *chervonets* exchange rate at its gold parity and at the same time created new inflation by excessive issue of banknotes."

The subsequent course of events confirmed the correctness of this belief. Wholesale prices in the USSR and the USA converged from May 1924 until February 1925, when the gap was 9%.<sup>3</sup> Thereafter, domestic prices began to rise, caused up to the summer by the effects of the bad 1924 harvest and from autumn 1925 by credit inflation. This revived the idea of revising the *chervonets* exchange rate. In November 1925 Yurovsky, when preparing a book based on previously published articles, substantially supplemented the one written a year earlier. He noted that the rise in prices had also affected exported agricultural products, making exports less profitable. Simultaneously, industrial prices had risen even more strongly than agricultural prices, and these "scissors" had begun to slow the development of agriculture. Consequently the gap between the exchange rate and the purchasing power of the *chervonets* had widened. Yurovsky recognised that if these trends became established the ruble exchange rate would inevitably have to be revised. But he emphasised that this operation would not mean simply corrections to the previous currency policy: "It would mean only that if we give up the firmness of the whole monetary system it would be impossible not to give up the firm ruble exchange rate too. Lowering of the exchange rate would not be the consequence and would be

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<sup>3</sup> *Economicheskii byulleten Konyunktornogo institute* 1925, 11–12, p. 23.

one aspect of the disturbance of the equilibrium of the whole system. The idea of lowering the exchange rate, therefore, in practice is not restoration of the existing monetary circulation but is connected with a policy of inflation<sup>4</sup>.”

Yurovsky observed that there was only one way to bring domestic prices into line with world prices quickly—to open the economy to foreign goods, i.e. to abandon the monopoly of foreign trade and customs regulation. The price of this, however, would be the sacrifice of a large part of manufacturing industry, which could not compete with cheaper and better quality foreign goods. This way seemed unacceptable then, both to the leadership of the country and to the society. He therefore concluded: “The relatively high index of commodity prices was inevitable with any currency policy unless our general policy was willing to take the absolutely unacceptable course of demolishing our industry and turning the Union into a country buying the majority of the manufactured goods it needs abroad and paying for them by exporting its raw materials”.<sup>5</sup> Nevertheless, Yurovsky thought it was still possible to avoid revising the exchange rate and instead changing the economic plans and conducting a cautious credit policy so as to overcome the inflationary tendencies and gradually reduce prices. In November 1925 such solutions were accepted by the leaders of the country.

Two months later, however, this course began to be undermined. In January 1926, the deputy chairman of Gosplan Smilga and the deputy chairman of VSNKh Pyatakov proposed abandoning the policy, pursued since the launch of the *chervonets*, of supporting its exchange rate at the gold parity. The Politburo formed a special commission to study currency policy. This commission included, in particular, chairman of government Rykov, Stalin and Trotsky. At Rykov’s request, Yurovsky wrote a special note for this meeting, on the significance of measures aimed at supporting the *chervonets* exchange rate on the domestic currency market. While earlier, when he discussed this topic in the press, it had been viewed as an academic question, now the choice of different versions of abandonment of the parity exchange rate was a subject of practical policy. His note therefore concentrated on analysis of the negative consequences of this step.

If the private market rate for the ruble against and foreign currency fell considerably, then, Yurovsky predicted, many people would want to convert *chervontsy* into foreign currency, or at least into goods, which would exacerbate the goods famine. Private holders of state loans would behave in exactly the same way. They would dump the loans on the market in order to convert the proceeds into foreign currency or goods. Gosbank could only buy these loans by issuing additional money, thus stoking up inflation. Not to buy them meant allowing their price to fall, undermining the prospects for state borrowing. Thus a fall in the ruble exchange rate on the private market threatened to aggravate the goods famine. Fewer industrial goods would go to the village, the purchase of which prompted the peasants to sell

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<sup>4</sup> Yurovsky, *Sovremennye problemy denezhnoi politiki*, Moscow, 1926, p. 107.

<sup>5</sup> *Ibid*, p.102.

their produce to the state. The result would be a decline in the very exports which the proposal to give up supporting the parity exchange rate of the *chervonets* was supposed to increase.

What was there to set against all these negative consequences? That lowering the exchange rate would make exports more profitable and enable them to grow. Examining this argument, Yurovsky stressed that while exports increased because their prices had risen the cost of imports would rise too. Therefore, either real wages had to fall, which was rejected then for political reasons, or nominal wages had to be increased, which would raise costs and the general price level. The result of this would be the reappearance of a gap between the exchange rate and the purchasing power of the *chervonets*, which could only be eliminated by revising the exchange rate again. He also emphasised that no one could foresee how exchange rates would move, and there was likely to be a need for intervention in any case to keep the *chervonets* rate at an acceptable level.

The opponents of supporting the parity exchange rate suffered from a narrow approach, ignoring the complex interconnections in the economy. This may be seen in the position formulated by Groman and Strumilin, members of the presidium of Gosplan, in their replies to a questionnaire sent out by Rykov. In the middle of January 1926, Rykov, sent a set of nine questions to leading economists and economic managers, asking them to express with complete frankness their views on the reasons for the economic difficulties and on policy for economic development over the next two to three years.

Strumilin's replies focused on criticisms of the monetary, credit and currency policies of Narkomfin, which in his opinion were the main cause of the increasing economic difficulties. He was particularly indignant about the practice of currency intervention: "In Narkomfin they imagine that a firm exchange rate for our ruble is ensured not by its commodity base, i.e. by "exchange" of the *chervonets* for goods at a firm rate in accordance with the Narkomvnutorg price list, but by the "exchange" for gold at parity"<sup>6</sup>. Strumilin emphasised that maintaining too high an exchange rate prevented the growth of exports and thus of industrial imports. He recognised that lowering the exchange rate would cause prices in the country to rise, but expressed confidence that in a short while this would enable a significant increase in the supply of goods to the market thanks to the expansion of exports and the corresponding imports of raw materials and equipment, after which industrial prices would be bound to decline. Here we see the faith in a future paradise and disregard for the insuperable obstacles on the way to it characteristic of the supporters of unrealistic plans.

Groman's reply seconded Strumilin: "The basis of the firmness of our currency is not gold reserves, not the gold parity, but the growth of our production, the

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<sup>6</sup> Goland, Currency Regulations in the NEP period, *Europe-Asia studies*, vol. 46, no. 8, 1994, p. 1272.

improvement of organisation and the reduction of prices of industrial goods, and thus of agricultural products too.<sup>7</sup>” But there was no serious foundation for this contrast; abandoning the gold parity would just have led to an additional rise in prices. Yet Groman argued that with the foreign trade monopoly it was unnecessary to support the parity exchange rate within the country or to have the *chervonets* quoted on foreign exchanges. From the narrow point of view of foreign trade settlements there was a certain sense in this argument. But Groman ignored the influence of psychological factors, the need to maintain confidence in the *chervonets*.

Different points of view on the desirability of supporting the exchange rate existed not only among specialists but also within the leadership of the country. They appeared at the 18 January session of the Politburo commission on currency policy. On the eve of the meeting all the members were sent Yurovsky’s note, and it was the starting point for the speakers discussing whether currency intervention should be continued. Rykov declared that Yurovsky’s arguments had convinced him of the expediency of intervention “on some scale” to support the exchange rate. Trotsky criticised Yurovsky’s note: “The author of the note approaches the question from a technical monetary rather than a national economic point of view”.<sup>8</sup>

Yurovsky, who was invited to the meeting, proposed in his speech that the main measure to reduce the expenditure on intervention should be a tight credit policy, designed to bring down inflation and the demand for foreign currency. Answering Trotsky’s rebuke for a “technical monetary approach, Yurovsky declared: “The root problem is monetary and credit policy, on which equilibrium in the entire economy depends.” The commission did not follow Yurovsky’s advice, and its decision said nothing about credit policy.

Some days later Yurovsky put forward some new arguments in favour of continuing the previous currency policy. In his reply to Rykov’s questionnaire, which is dated 29 January and signed also by the Commissar of Finance, Bryukhanov, whom Rykov had also asked to reply to his enquiry, he drew attention to the contradictory role of centralised administration and the foreign trade monopoly in the development of the crisis in the economy. On the one hand, it had enabled the state to maintain the parity exchange rate for a long time despite inflation and to prevent the kind of crisis phenomena characteristic of the capitalist economy, like falling production, insolvency, bankruptcy and growing unemployment. On the other hand, protected by the currency legislation and the foreign trade monopoly, a wrong economic policy could be continued longer than would be possible under capitalism. As a result the negative processes spread to more and more sectors and economic difficulties were exacerbated, leading, in particular, to an increasing gap between the exchange rate and the purchasing power of the *chervonets* and unprofitability of exports. Yurovsky

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<sup>7</sup> Ibid, p. 1273.

<sup>8</sup> Ibid, p. 1274.

then pointed to the dilemma facing the organs directing the country's economic policy, which had to choose between two alternatives. The first he described as "continuing the essentially spontaneous development of the economy in a planned manner on the basis of further credit expansion."<sup>9</sup> In that case, the author posited, lowering the exchange rate would be inevitable, but it would not eliminate the elements of crisis as the supporters of this move hoped, but "would serve only to initiate the conversion of a potential into an actual crisis."

The second alternative, according to Yurovsky, was as follows: "to use the means of planned action so as to avoid the crisis by making essential reductions where necessary and restoring equilibrium". In more detail, "the crisis is ripe and must inevitably break out generally if we do not make use of the resources of state power which will enable it to be postponed so that it can be avoided, i.e. so crisis can be transformed into lisis,<sup>10</sup> the symptoms in the economy gradually resolved and the widely disturbed equilibrium restored." It was a matter of revising economic plans, reducing credit expansion and changing the general direction of economic policy, in particular, of speeding up the growth of production of means of consumption. These changes, he argued, would restore the profitability of exports by reducing prices.

The advocates of a lower exchange rate wanted precisely avoid the revision of economic policy that Yurovsky proposed and to continue the forced industrialisation line. Consequently, by advancing more and more new arguments in favour of supporting the parity exchange rate he was trying not only to achieve the correct solution of the currency policy problem but also to produce reasons for rejecting excessive rates of industrialisation.

But in some months the government decided to end supporting the parity exchange rate on the free market. It was retained in official external economic transactions. This led to the rise of considerably discrepancy between the official and free exchange rates. The falling rate for chervonets made it more difficult to attract private savings to finance industrialisation on a voluntary basis, without using administrative measures, which grew into coercion and meant the abolition of NEP. It was in the field of currency policy, the most sensitive nerve in the country's entire economy that the first blow at the principles of NEP was struck.

The discussions above are not only of historical interest. Nowadays there is also some controversy in respect to the currency policy. Due to the significant inflow of the foreign currency from export over the last four years (from the end of 2002 to the end of 2006) the nominal exchange rate of dollar to ruble decreased by 17%. The CPI index went up by approximately 51% for the same period. Therefore, the real ruble exchange rate to the dollar was greatly appreciated, and so was the real

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<sup>9</sup> Ibid, p. 1276.

<sup>10</sup> Lisis is a medical term meaning slow reduction of temperature with the illness gradually subsiding, as distinct from crisis.

effective rate of ruble to the currency basket. On one hand, this is positive for the inflation slowdown and de-dollarization of the economy. On the other hand, the competitiveness of the domestic manufacturers is going down both in Russia and abroad. It is not surprising that the industry leaders argue against further ruble appreciation and would like to change the currency policy and devalue the ruble. One of the learning from NEP is that the competitiveness should be improved by reducing the production and selling costs, and real exchange rate devaluation is to be achieved by decreasing inflation rather than through nominal devaluation. However, if these actions do not yield a result, the nominal foreign exchange rate appreciation may be required indeed.