

Session 8: International Order of Asia in the 1930s and 1950s

China's Relations with the International Financial System in the 20th Century Historical Analysis and Contemporary Implication

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Introduction

The first half of the 1930s, the years following the Great Depression, marked a major shift in the Chinese economy in terms of China's position in the international monetary system and Chinese government's intervention in the domestic economy. Until November 1935, China was virtually the only country in the international monetary system still adhering to the silver standard. Fluctuations in the international price of silver in the 1930s destabilized its economy. Establishing a new monetary system, the foreign exchange standard, required committed government intervention, and ultimately, the process of economic recovery and monetary change politicized the entire Chinese domestic economy.

Investigating China's relationship with the international financial system and its influence on domestic political economy, this paper seeks to offer critical insights into China's position in the East Asian economy as well as modern Chinese state-market relations. The link between economics and politics is focal also to the international order of East Asia in the 1930s. Although there existed significant economic interdependence between East Asian countries, at the same time, political conflicts were tense over territory (ex. Manchuria, foreign concessions and China), naval force, trade, currency, and so on.¹ Given this complexity of the international relations in the area, a question is how politicians perceived their economic circumstance to formulate policies. Taking China's currency reform in 1935 as a case, this paper is going to investigate this problem.

A brief review of previous literatures on the currency reform is useful to provide backgrounds of the reform as well as to clarify this paper's position. As Takeshi Hamashita notes, Chinese government sought to change its monetary system since the late 19th century. As the international monetary system was on the gold standard, fluctuations of the price of silver in terms of the gold-standard currencies was disturbing for Chinese government which heavily relied on foreign loans.²

¹ As for the economic interdependence and the international order of 1930s East Asia, Shigeru Akita and Naoto Kagotani eds., *1930-nendai Ajia Kokusai Chitsujo (International Order of Asia in the 1930s)* (2000).

² Takshi Hamashita, "Chugoku heisei kaikaku to gaikoku ginko" (China's currency reform and foreign banks) *Gendai chugoku* vol. 58 (April, 1984).

Nonetheless, it was not until November 1935 that the government left the silver standard, linking its currency to foreign exchange.

Why was the monetary system to be changed in the middle of the severe economic crisis? Under what international and domestic circumstances did Chinese government execute the reform? As for international conditions for China's currency reform, the classic work is Nozawa Yutaka ed.. *Chugoku no heiseikaikaku to kokusai kannkei* (*China's currency reform and the international relation*). The collected essays show that competing for the dominance over Chinese economy, foreign powers in the East Asia, namely Great Britain, United States, and Japan had keen interest in the reform. Their policies, however, varied. Japanese diplomacy under Foreign Minister Koki Hirota pursued several contradicted purposes. After the Manchurian incident in 1931, Japan had a constrained relationship with China. On the one hand, Japan tried to strengthen its control over Manchuria. On the other hand, it did not aim to confront with China's Nationalist government. Japanese government tried to avoid international isolation, but it rejected any foreign intervention to China's domestic issues. Especially as regards China's currency reform, Japanese government refused to cooperate with China as well as insisted other foreign governments should not support China's reform on the grounds that Chinese government would be lack of ability to carry out the project.³

Japan's position complicated other government policy options toward China's plea for their supports. Sending Frederick Leith-Ross, a high-ranking official of the Treasury, British government tried to lead international cooperation in lending money to China to support the currency reform. Ultimately, British government tried to increase its influence over Chinese economy through the support. And, it also wished Japanese participation to the scheme of loan would ease the tension between China and Japan, and lead to solve the sovereignty problems of Manchuria. In the end, British aspirations proved impossible.⁴

Inside the U. S. government, there were two opposite policies toward China. The one held by the Department of State that requested international cooperation in intervening Chinese economy. The other formulated by the Department of Treasury claimed unilateral approach to Chinese economy. Depending on which side President Franklin D. Roosevelt took, the U. S. policies fluctuated. During the course of China's currency reform, the U. S. government led by the Department of State first hesitated to commit to the reform, but later under the initiative of the Department of Treasury the U. S. bought silver from China which was crucial for raising foreign reserve.⁵

³ Hideo Kobayashi, "Heisei Kaikaku wo meguru nihon to chugoku" (Sino-Japan relationships in terms of China's currency reform) in Nozawa, pp. 233-264. Sumio Hatano, "Heisei Kaikai he no ugoki to nihon no taichu seisaku" (The currency reform and Japanese policies toward China) in Nozawa, pp. 265-298.

⁴ Yoichi Kitbata, "Leith-Ross shisetsu dan to eichu kankei" (Leith-Ross Mission and British-Japan Relations) in Nozawa, pp. 199-232.

⁵ Kenji Takita, "Roosevelt Seiken to beichu kyotei," (Roosevelt administration and the U. S. - China agreements) in Nozawa, pp. 165-198.

These studies provide profound understanding of foreign government's views and policies on China's currency reform, but a question remains how the Chinese government perceived domestic and international circumstances surrounding the reform. Using Chinese archives previously unavailable, this paper focuses on the policy formation of the currency reform in Chinese government. How did Chinese government negotiate with financial institutions and market participants over the transformation of the monetary system? How did China deal with the foreign confrontation over Chinese economy? Exploring these questions, this paper points that the key issue of the reform concerned how to cultivate people's trust in the new currency which was no longer backed with silver. Similar to the silver standard, the credibility of the currency rested on its convertibility to foreign currencies, the exchange stability was crucial for the success of the reform. Investigating the transformation of the monetary system in a historical perspective, this paper demonstrates relationships of domestic and international dimensions of Chinese political economy.

The paper has five sections. Section 1 is a brief survey of Chinese monetary system prior to the 1930s. Section 2 analyzes the turbulent banking and monetary situation from 1931 to 1935. Section 3 investigates the formation and execution of the currency reform in November 1935, focusing on Chinese government's economic diplomacy with foreign institutions as well as its negotiation with domestic financial markets. Section 4 examines effects and limitations of the government's economic policy. And, Section 5 concludes the argument by evaluating the evolution of China's link with the international financial system and its influence on domestic political economy from a historical perspective.

1. Silver Standard: The Chinese Monetary System Prior to 1931

Fluctuations in the international price of silver during the Depression of the 1930s had an immediate and massive impact on China. To understand why, it is necessary to examine two questions: How were the changes in the price of silver in the world market passed on to China? How did this external shock wave spread throughout the country? The latter will be examined in the subsequent section. This section focuses on the first one, the connection between the international silver market and the Chinese monetary system. After examining the workings of China's silver standard in relation to the international silver market, this section draws attention to the impact of the devaluation of silver in the world market on the silver-standard Chinese economy. This paper argues that until the 1930s the downward trend in the price of silver conditioned economic activities of industrialists, financiers, and farmers; when, contrary to their expectations, the trend reversed upward, they faced a severe and difficult adjustment. In order to conceive of the gravity of this reversal after 1931, it is necessary to look into the preceding years of silver devaluation.

i. Silver as a Currency or a Commodity

The Chinese monetary system in the early twentieth century was not only complex, it was also very different from those in Western countries. The variety of silver as well as coins in circulation was great: there were wide differences in coinage from province to province and even from city to city within the same province. At the same time, domestic and foreign financial institutions, as well as national and provincial governments, each issued notes. There was no organization like a central bank to coordinate the currency system. Although the Chinese monetary system was complex in terms of money and issuing authorities, it nonetheless adhered to the silver standard. The silver standard indicated a monetary system in which silver was not only a legal standard of value, but one in which the domestic supply of money, whether in the form of coins, notes, or deposits subject to check, was directly and ultimately related to the supply of silver.⁶

Little silver, however, was mined in China. China had to import silver. Produced principally in North and South America and absorbed chiefly by China and India, silver moved around the globe. There were four leading world silver centers, London, New York, Shanghai, and Bombay. London had long been a leading silver market. New York was a trading center for silver bullion mined in North America. The chief receiving port for silver was Shanghai, followed by Bombay. China's silver business was cleared through Shanghai, or, with occasional exceptions, through Hong Kong.

In Shanghai, the importation and exportation of silver was carried out by foreign exchange banks. Exchanges between gold-standard countries were based on fixed par of exchange, which was the ratio of the gold content of the two coins concerned. Actual exchange rates fluctuated around this between the narrow limits of the gold shipping points, which were determined by the cost of shipping coin or bullion. In exchanges between China, on a silver standard, and gold-standard countries, there was no fixed par of exchange. Given a particular price of silver in London (shilling per ounce), however, one can calculate the value of silver per unit of Shanghai silver currency in terms of London gold currency (shilling per *teal* or *yuan*). This was called the parity for that particular silver price; as the price of silver in London varied, the parity varied, but always proportionately.

If the exchange rate in Shanghai was quoted above parity drawn from the price of bullion, it induced the purchase of silver in London, if below parity, it favored the sale of silver in London. It was necessary to add charges (shipping, insurance, and so on) and interest, both subject to changes, to

⁶ Edwin Kemmerer, a leading American scholar of monetary policy who investigated China's monetary and banking situation in 1929 as foreign advisor to the Nationalist government pointed out specifics of China's silver standard. See, Commission of Financial Experts, *Project of Law for the Gradual Introduction of a Gold-Standard Currency* (1930), p. 47. Also, Wei-Ying Lin, *The New Monetary System of China: A Personal Interpretation* (1936), p. 5. Lin was a member of National Economic Council and an acting chief of the Research Department of the Bank of China. The subtitle of the book reflects his emphasis on his own point of view not that of the institutions he affiliated. See, Edward Kann, "Book Review: The New Monetary System of China: A personal interpretation" *Finance and Commerce* 28. 5 (July 29 1936): 5. Hereafter, cited as FC. Kemmerer's and Lin's view was echoed by Tadao Miyashita, an economist at Toa dobun shoin in Shanghai and others. Miyashita reviewed discussions over China's currency standard. Miyashita, *Shina kahei seido ron (A study on Chinese monetary system)* (1943), pp. 142-146.

parity to see whether importing or exporting silver was profitable. These rates were called import and export points which ruled silver transactions.

ii. The Trend of Silver Prices up to 1931

From 1873 to 1931, the value of silver depreciated considerably against gold. The almost continuous downward trend was interrupted only by temporary reversals. Moreover, from the late nineteenth century the price of silver declined in relation not only to gold but also to wholesale commodity prices. The value of silver (that is purchasing power of silver) dropped, and China's prices level rose.

Actually, between 1890 and 1930, China recorded fifteen years of excess silver exports (1890-92, 1901-8, 1914-17) and twenty-six years of excess silver imports (1893-1900, 1909-13, 1918-30). The imported silver bullion went mostly for monetary uses.⁷ When bullion arrived in China, it would be brought to (1) smelting shops, or *lufang*, and converted into sycee, or (2) several regional mints, and minted into coinage. Increased imports of silver thus provided a direct indication of an increase in the money supply.

The increased supply of silver entailed mild inflation during the period. Between 1911 and 1926, wholesale prices in Shanghai rose 33 percent.⁸ Many factors which influenced commodity prices, but the increased silver supply was one of the major reasons for this rise.⁹ Silver provided the basis for multiple credit expansion. Although people had gradually come to accept bank notes, they based their trust in silver. Bank notes had to be backed by hard currency, otherwise, they could not be circulated at all.¹⁰ Purchases of agricultural products in rural areas had to be paid for in silver dollars. Moreover, rising price resulted in the credit expansion backed by collateral items, in this sense, increasing inflationary pressure.

The mild inflation caused by world silver depreciation proved decisive for the Chinese economy from the late nineteenth century until 1931. But, China did not have control over the fluctuations in the international price of silver. Silver was a commodity and its market price was influenced by supply and demand factors, irrespective of China. At the same time, as private banks carried out the transactions of silver and foreign exchange, silver might move in and out of the country on the basis of profit. When it moved, it affected the money market of China and created changes in price levels. In this sense, China was vulnerable to fluctuations in the international price of silver over which it had little control.

⁷ Edward Kann, *The Currencies of China: An investigation of Silver and Gold Transaction Affecting China* (1927), p. 87.

⁸ Zhongguo kexueyuan Shanghai jingji yanjiusuo and Shanghai shehui kexueyuan jingji yanjiusuo eds., *Shanghai jiefang qianhou wujia ziliao huibian* (1958), p.4

⁹ Fukusaburo Hisashige, "Bukka yori mita shina keizai no ichimen" (An analysis of Chinese economy with special attention to commodity prices), *Shinakenkyu* 36 (March 1935): 105-112.

¹⁰ Yang Yinpu, *Zhongguo jinrong lun*(1936), p. 157.

2. Financial Crisis, 1931–1935

Because of its close tie with the international financial market, the Chinese economy was seriously disturbed by the market fluctuations in the first half of 1930's.

When gold-standard foreign currencies depreciated after 1931, and China's silver-standard currency, conversely, appreciated, the country's years of inflation were over. China was forced to adjust to deflation. In 1934, when the United States began to purchase silver at higher prices, China's crisis deepened. Silver flowed out of China in massive amounts, and a further decline in commodity prices followed. Under such deflationary pressure, credit expansion became impossible. As banks curtailed credit, businesses and farmers suffered from a serious liquidity crisis. Banks in turn were burdened with unredeemable collateral and defaults on loan contracts.

This section presents a sequential analysis of the deepening crisis in detail, giving attention to the fluctuations in the value of silver, the changes in commodity prices, and their repercussions in agricultural, industrial, and financial sectors.

i. The Drain of Silver out of China

In the first two years of the world depression (1929-1931), silver depreciated considerably against gold and other commodities, and large amounts flooded into China. In this easy money climate, banks increased loans to business enterprises, which in turn expanded production capacity during the Chinese "boom" years from 1929 to the summer of 1931. Shanghai real estate and governmental bonds were also major items for investments. The temporary "boom" in the urban economy, however, only deepened the severity of the economic crisis that began in 1931.

In September 1931, when England left the gold standard, the downward tilt in the exchange rate of Chinese currency in relation to foreign currencies began to reverse (Table 1). In Shanghai the exchange rates of countries in the sterling area rose in accordance with the depreciation of the pound sterling. One country after another--India, Strait Colonies and Malaya, Japan, and so on--depreciated its currency. The appreciation of China's silver currency had a profound impact on the country's economy in terms of import and export prices, the current of international trade, and the balance of international payments.

Table 1 Exchange Rates on U.S. Dollar and Pound-Sterling, Silver Prices in London and New York: 1929-November 1935

Month/ Year	Exchange Rate	Exchange Rate	Silver Price in	Silver Price in	Exchange Rate/ Silver	Exchange Rate/ Pound
	U.S.\$ Cents/ Yuan	Pound- Sterling Pence/ Yuan	New York Cents/ Ounce	London Pence/ Ounce	Price in U. S. dollar	Sterling

1928	45.53	22.45	58.49	26.74	0.7783	0.8396
1929	41.76	20.65	53.04	24.48	0.7873	0.8435
1930	29.89	14.75	38.24	17.65	0.7817	0.8357
1931	22.26	11.99	29.01	14.46	0.7675	0.8289
1932	21.98	15.07	27.49	17.81	0.7995	0.8462
1933						
January	19.78	17.43	25.37	16.87	0.7796	1.0332
February	20.09	17.38	25.87	16.87	0.7764	1.0301
March	20.50	17.76	27.50	17.56	0.7455	1.0116
April	20.44	14.30	28.62	17.97	0.7142	0.7958
May	24.19	14.56	34.06	18.94	0.7102	0.7687
June	25.87	15.00	35.69	19.19	0.7249	0.7817
July	29.00	15.00	37.25	18.30	0.7785	0.8197
August	27.88	14.88	36.00	17.87	0.7744	0.8327
Sept.	29.25	15.13	38.75	18.25	0.7548	0.8290
October	29.50	15.19	38.00	18.25	0.7763	0.8323
November	32.70	15.31	42.95	18.37	0.7614	0.8334
December	33.25	15.50	43.05	18.62	0.7724	0.8324
1934						
January	33.50	16.00	44.19	19.38	0.7581	0.8256
February	33.97	16.22	45.19	20.06	0.7517	0.8086
March	34.29	16.17	45.88	20.25	0.7474	0.7985
April	33.96	15.81	45.30	19.74	0.7497	0.8009
May	32.22	15.14	44.38	19.28	0.7260	0.7853
June	32.76	15.57	45.16	19.98	0.7254	0.7793
July	33.62	16.00	46.31	20.51	0.7260	0.7801
August	34.66	16.40	48.99	21.38	0.7075	0.7671
Sept.	35.28	16.95	49.48	21.89	0.7130	0.7743
October	35.25	17.13	52.40	23.66	0.6727	0.7239
November	33.06	15.88	54.30	24.34	0.6089	0.6521
December	33.50	16.25	54.40	24.34	0.6158	0.6675
1935						
January	34.31	16.75	54.40	24.54	0.6307	0.6827
February	36.19	17.81	54.60	25.00	0.6628	0.7125
March	37.94	19.00	59.00	27.47	0.6430	0.6917
April	38.38	19.00	67.80	32.25	0.5660	0.5891
May	41.00	20.13	74.40	33.87	0.5511	0.5942

June	40.56	19.75	71.90	32.38	0.5642	0.6100
July	38.73	18.75	68.20	30.75	0.5678	0.6099
August	36.50	17.63	66.40	29.59	0.5497	0.5956
Sept.	37.06	18.06	65.40	29.28	0.5667	0.6169
October	36.50	17.88	65.40	29.47	0.5581	0.6066
November	29.50	14.38	65.40	29.34	0.4511	0.4899
Theoretical Parity					0.7561	0.8166
Import Point					0.7807	0.8439
Export Point					0.7315	0.7892

Source: From 1928 to September 1934: Koh, "Silver at Work," *FC25*. 12 (March 20, 1935): 329. From October 1934 to November 1935, *An Annual Report of Shanghai Commodity Prices 1935*: Appendix 8 and 9.

Note: When the ratio between the exchange rate and the price of silver was above the import point, imports of silver into China were encouraged. When the ratio was below the export point, exports of silver out of China were possible.

China's trade deficit was not in itself unusual. The problem was that until 1931, the trade deficit had been countered by invisible trade, such as investments from abroad and remittances from overseas Chinese. But in a world depression with an appreciating exchange, the amount of invisible trade was diminishing.

The most important source of invisible exports was overseas Chinese remittances. In the early 1930s, unemployment and business failures, along with new legislation in some countries prohibiting new Chinese immigrants and compelling those unemployed to leave, decreased emigration from China and even forced emigrants already working abroad to return home. In 1931 the Chinese Maritime Customs reported, "[o]utward passengers from Amoy, Swatow and Kiungchow to Hongkong, Manila, Formosa, Straits Settlements, Netherlands India, Saigon and Bangkok totaled 200,025--a decrease of 80 percent as compared with the figures for 1930." In 1932, "the outflow of passengers was only 132,302, or a further decrease of 34 percent while the inflow was more than double the outflow and amounted to 278,944, leaving a net immigration for the year of 146,642 persons."¹¹ Owing to the decreasing number of emigrants as well as the shrinking amount per person, the remittances from settlers in Hong Kong, Manila, and so on declined to about a tenth of what they had been a few years before.¹² The same trend occurred for remittances from America.

¹¹ Chinese Maritime Customs, *Trade of China 1932*, Vol. 1, p. 72.

¹² Chinese Maritime Customs, *Trade of China 1933*, Vol. 1, p. 62.

In order to make up for deficiencies in its international trade balance, China was forced to export silver. China recorded net exports of silver valued at 7,346,000 *yuan* in 1932 for the first time since 1918.¹³ Following the slump in import and export prices and reflecting the deflationary consequences of the appreciating silver exchange rate, Chinese wholesale prices experienced a serious decline at the end of 1931. The average annual percentage change in wholesale prices for the six principal cities in China was about -5 percent in 1932, while Shanghai saw the further drop of -11.3 percent.¹⁴

The U.S. suspension of the gold standard in March 1933 had a decisive impact on China's exchange rate for dollars. China's trade deficit was at its largest, 733,739,000 *yuan*. The condition of the Chinese economy worsened. The movement of treasure resulted in a net export of 189.4 million dollars in gold and 14.2 million dollars in silver. The wholesale prices continued to fall, 9.4 percent on average in the six largest cities and 7.7 percent in Shanghai.¹⁵

However, the significance of these changes--the net export of silver and the divergence in its value in China and abroad--was overlooked by bankers in Shanghai, China's financial center then. Funds coming in from the interior made up for the external drain of silver. Silver was sent to Shanghai in part to settle the balance of trade between rural and urban sectors, in part for security, and in part to cover note issues. Although banks did begin to curtail short-term loans taking commodities as collateral, they continued to put money into real estate and government bonds. Yet these operations could not be sustained over the long run. The heavy investment during the boom years of 1929 to 1930, coupled with speculative transactions, raised land values far above the level of rents that businesses and individuals could afford.

ii. The Shanghai Financial Crisis: June 1934 to November 1935

The prosperity in the Shanghai financial market was short-lived. U.S. silver policy suddenly and vastly raised the price of silver abroad, which set off a massive flow of silver out of China.

The Silver Purchase Act of 1934, approved on June 19, declared it to be the policy of the United States to increase its stock of silver with the ultimate objective of making it one-fourth of the total monetary stocks of silver and gold. It was the outcome of the effort by the group of Congress, which represented the silver-producing states, to obtain legislation designed to raise the dollar price of silver.¹⁶ The act provided that the Secretary of the Treasury should purchase silver to this end at such times, and upon such terms and conditions, as he might deem reasonable and most advantageous to the public interest. No silver was to be purchased at a price in excess of the monetary value, 1.29

¹³ Lin, p. 29.

¹⁴ *An Annual Report of Shanghai Commodity Prices 1934*, p. 117.

¹⁵ *An Annual Report of Shanghai Commodity Prices 1934*, p. 117.

¹⁶ Dorothy Borg, *The United States and the far Eastern Crisis of 1933-1938: From the Manchurian Incident through the Initial Stage of the Undeclared Sino-Japanese War* (1964), p.121

dollars per ounce, nor was any silver situated in the continental United States on May 1, 1934, to be purchased at over 50 cents per ounce.¹⁷

The price of silver in the United States rose steadily, from 46.3 cents per ounce in June to 49.5 cents in August, which was slightly below the nationalization price of 50.01 cents per fine ounce (equivalent to 49.96 cents per ounce, 0.999 fine). The market price during August and September remained around 50 cents per ounce, which was suitable for buying up the silver. But in October, it rose to over 55 cents per ounce and fluctuated between 53 and 56 cents per ounce during November and December. The price on the London silver market, where the U.S. government also purchased silver, followed the upward trend of the U.S. silver price, rising 6.7 percent from September to December, from 21-13/18 shillings to 24-1/2 shillings.

This sudden and massive rise in the price of silver caused by the heavy U.S. purchases upset the silver-standard Chinese economy. In the first half of 1934, Chinese silver imports and exports were minimal. But in June, silver valued at 12,936 *yuan* was exported. Compared to net silver exports in all of 1933 of 14,122 *yuan*, this one-month amount was obviously unusual. The outward movement of silver became even more conspicuous thereafter, rising to 24,308 *yuan* in July 1934, 79,094 *yuan* in August, and 48,140 *yuan* in September.¹⁸

An explanation for the rise in exports was the transfer of funds abroad by individuals and corporations. Foreigners rushed to take profits from their business in China out of the country without delay.¹⁹ Wealthy Chinese also purchased foreign exchange and remitted their surplus funds abroad.²⁰ Many were spurred by rumors that if the price of silver rose a great deal, Chinese government would be forced to place an embargo on silver or to devalue the Chinese *yuan*.²¹ Although the government vigorously denied such schemes, the Shanghai exchange and financial market remained "nervous in the extreme."²²

China faced a difficult situation. The supply of foreign exchange on the Shanghai market was insufficient to provide for such an unusually large demand. As a result, the exchange rate of the Chinese *yuan* against foreign currencies fell. It is important to note that the silver par of exchange in terms of either pound-sterling or U.S. dollar moved with changes in the sterling or dollar price of silver; as silver increased in price in terms of sterling or dollar, so the par of exchange moved up: the Chinese *yuan* was worth more in terms of sterling or dollar, and it increased in value against foreign

¹⁷ The calculation is as follows: the monetary value of silver was \$1.2929 per fine ounce. Deducting 61.32 percent thereof for seigniorage, brassage, coinage, and other mint charges, the equivalent of a net price per fine ounce was 50.01 cents.

¹⁸ *An Annual Report of Shanghai Commodity Prices* 1934, Table XII, p. 22.

¹⁹ Dickson Leavens, "American Silver Policy and China," *Harvard Business Review* 14 (Autumn 1935): 52. Lin, p. 27.

²⁰ "Zhongguo yinhang minguo ershisian niandu yingye baogao," *Zhongguo yinhang zonghang and Zhongguo dier lishi danganguan eds. Zhongguo yinhang hangshiziliao huibian shangbian 1912-1949* (1990) 3, p. 2135. Hereafter cited as *Hangshiziliao*

²¹ *FC* 24. 1 (July 4, 1934): 10. *FC* 24. 8 (August 22, 1934): 204.

²² *FC* 24. 8 (August 22, 1934): 304.

currencies as the price of silver rose.²³ However, since the demand for foreign exchange remained high, Chinese *yuan* did not keep pace with the increased price of silver.²⁴ Chinese *yuan* 's exchange rate in terms of U. S. dollar recorded 4.1 percent below parity in July 1934. The gap widened in August and September to 7.1 percent and 5.8 percent, respectively.²⁵ When the exchange rate remained below the export point, it was economical to export silver abroad.²⁶

Large exports increased fears that the government would have to take action to depreciate the value of Chinese currency and further increase silver export before it was too late. The anxiety in the Shanghai financial market fed on itself, as the possibility of an embargo on silver and the disparity that made silver exports very profitable provided a rationale for further exports.

The government was alarmed by the massive outflow of silver. On September 8, the Ministry of Finance issued an order that, until further notice, the purchase or sale of foreign exchange would be prohibited except to finance 1) legitimate and normal business requirements; 2) contracts entered into on or before September 8, 1934; 3) reasonable traveling or other personal needs. This order was intended to check speculative transactions, but it could not succeed, for the government had no control over foreign banks and banks would be forced to use silver to cover their transactions.²⁷

The government found itself with only two remaining options: either to prohibit the free trade of silver or to devalue its currency. On October 14, 1934, the Minister of Finance, Kong Xiangxi announced a duty of 10 percent (less 2.25 percent in the case of silver dollars and minted bars, which already had paid the amount in seigniorage) together with an equalization charge, on the export of silver. The equalization charge would be adjusted daily so that, with the duty, it would make up for any discount in the exchange rate below parity, and rendering the export of silver unprofitable.²⁸ Explaining the purpose of the policy, Kong said,

There is no reason to expect that the forces that have been stimulating the price of silver abroad will soon cease to operate. Therefore, the government, out of regard for the economic welfare of the people of China, have taken this measure as necessary to safeguard China's currency from a potentially dangerous strain on the country's reserves and to place a check upon the harsh deflationary forces that have been reflected in falling internal prices.²⁹

²³ See, section one of this paper.

²⁴ FC 24. 1 (July 4, 1934): 10. FC 24. 6 (August 8, 1934): 147. FC 24. 7 (August 15, 1934): 176.

²⁵ *An Annual Report of Shanghai Commodity Prices 1934*, p. 22.

²⁶ Leavens, "American Silver": 53. Edward Kann, "Financial Notes" FC 28. 26 (December 23, 1936): 689.

²⁷ FC 24. 12 (September 19, 1934): 316.

²⁸ Dickson Leavens, *Silver Money* (1939), pp. 299-301.

²⁹ "Kong Xiangxi guanyu zhengshou baiyin chukoushui ji pinghengshui yi fangzhi baiyin wailiu tian" (October 14, 1934), *Zhongguo dier lishi dangan guan ed., Minguoshi dangan ziliao* 5. 1 (4) (1994), pp. 173-174.

The export duty on silver virtually took China off the silver standard, even though silver remained obtainable for bank notes within China. Because the free movement of silver between China and the rest of the world was ended, the value of the Chinese *yuan* no longer depended on the world price of silver. The decision to impose the tax and the charge was difficult, as Song Ziwen, the general manager of the Bank of China, pointed out:

Indeed, this measure [export duty and equalization charge on silver], while effective temporarily in preventing a further fall in commodity prices, eventually placed the country on the horns of a dilemma. If exchange rates moved up in sympathy with the rise in the value of silver, the export trade would be handicapped and internal deflation continue. If, on the other hand, exchange rates fell substantially, it would increase the difference between the internal and external value of the currency, and a large-scale continuous smuggling of silver would ensue.³⁰

As if to confirm Song's concern, soon after the announcement of the equalization charge, the exchange rate dropped over 10 percent in a few days.³¹ Thereafter, it fluctuated around 19 percent below parity with New York silver prices.³² Legal exports of silver continued, and more seriously, there were cases of large-scale smuggling. The imposition of duty and equalization charges caused recorded exports of silver to fall off sharply, from 57 million *yuan* in October to around 12 million *yuan* per month in November and December. Beginning in 1935, recorded exports of silver practically ceased. However, the estimated amount of silver smuggled out of China was calculated to be as large as the amount legally exported in 1934.³³ The disparity between the exchange rate and the export parity of silver remained and increased significantly after April 1935, and this the export duty and equalization failed to offset. As long as the large difference between the price of silver abroad and the price in China existed, it remained profitable to export silver.

Silver flooded out of the country. The impact of this massive outflow was most keenly felt in Shanghai, which since 1929 had benefited from the inflow of silver. It is significant that by the latter half of 1934, silver started to move from Shanghai to other parts of China. Given the fact that the rural economy remained in distress, the silver was not in demand for commerce or investment purposes. What is more likely is that the silver went to Xiamen, Swatow, Qingtao, and Jinan, and was

³⁰ "Ershisi niandu Zhongguo yinhang baogao: Zhongguo yinhang dongshichang Song Ziwen xiansheng zhi gudong dahui baogaoshu," *Hangshi ziliao* 3, pp. 2178-2179.

³¹ FC 24. 17 (October 24, 1934): 458.

³² *An Annual Report of Shanghai Commodity Prices* 1934, Table XII, p. 23.

³³ Leavens, *Silver Money*, Table 18, p. 303. Based upon reports by Bank of China for 1934 and 1935, Leavens estimated the net export of silver from China in 1934 totaled 280 million *yuan* (211 millions of fine ounces), out of which 260 millions *yuan* was officially recorded, only 20 million *yuan* was smuggled. In 1935, the recorded amount decreased to 59 million *yuan* but 230 million *yuan* of silver was estimated to be smuggled out of China. The total net export thus amounted to 289 million *yuan* (218 million ounces.)

then illegally shipped to Hong Kong or northern China to be smuggled out.³⁴ Facing the flight of capital, the drain of silver, and the unstable exchange rate, the Shanghai financial market was totally paralyzed.

The silver drain and the uncertainty of the future of *yuan* ushered in a struggle for liquidity after September 1934. Due to large silver exports, silver reserves shrank rapidly. Foreign banks began to restrict and later to refuse any collateral loans against real estate. Since real estate had been the most important collateral in Shanghai since the late 19th century, this practice put pressure on Chinese banks. The decline in land values led to liquidation, which in turn, led to further declines in land values. Once this vicious cycle had set in, it became impossible to liquidate assets based on real estate. Given the extent to which Shanghai financial institutions had committed themselves to real estate, the consequences of “frozen” assets were enormous.

Native banks heavily involved in real estate mortgages in particular faced a serious management crisis.³⁵ They served as money brokers to foreign and Chinese banks, although their own financial backing was usually weak, borrowing call loans from the latter two institutions and extending these loans to commercial and industrial enterprises. Once borrowers defaulted, however, native banks could not repay the creditor institutions. As foreign and modern Chinese banks tightened credit, native banks suffered a liquidity crisis.

Falling prices further curtailed credit, which in turn put more pressure on business enterprises. Under this deflationary pressure, the Shanghai wholesale price gradually gave way after February until September 1935, when they were 6.4 % below the level a year before.³⁶ However, the downward movement suddenly turned upward in October. Uncertainty about the future of the Chinese economy, particularly the recurrent rumors of government devaluation of *yuan*, spurred people change their cash into foreign exchange or commodities. Transactions in foreign exchange and gold bars, along with basic commodities like cotton, wheat, and bean oil, became feverish in October 1935. As the rumor of devaluation prevailed, the rates of exchange dropped by 17 percent while the price of commodities traded on the official exchange advanced by nearly 15 percent in the last two weeks of October.³⁷

Chinese currency was overwhelmed by domestic and international distrust toward the end of October 1935.

3. Currency Reform in November 1935

China revealed itself extremely vulnerable to the downturn of the international silver price. It did not have control over fluctuations in the price of silver nor over exports of silver. Once large amounts

³⁴ *Zhonghang yuebao* 9.5: 116.

³⁵ Zhongguo renmin yinhang Shanghaishi fenheng ed., *Shanghai qianzhuang ziliao*(1960), p. 253

³⁶ *An Annual Report of Shanghai Commodity Prices 1935*, p. 27.

³⁷ Lin, pp. 76-77.

of silver drained out of China, a credit crunch followed. But there was no institution able to stem the tide of deflation. Although at this point the government was supposed to cope with the currency and banking crisis by transforming the existing systems, the task was a difficult one. As the large-scale capital flight in 1934 to 1935 demonstrated, the populace strongly resented government intervention.

Until the mid-1930s, the government did not take the lead in regulating the Chinese monetary and banking system. On the contrary, government authorities, whether politicians or warlords, tended to disturb the domestic financial market, as they regarded issuing notes as a convenient way to increase income.

Moreover, note issuance was not restricted to one bank. By 1907 two government banks, one commercial bank, and one provincial government bank all had the right to issue notes. By 1927, in addition to the two government banks, no less than twenty-eight commercial and eleven provincial banks were issuing notes. In 1928, the Nationalist government entered the financial market by establishing the Central Bank, as “the State Bank of the Republic of China.” Capital was fixed at 20 million *yuan*, an amount contributed entirely by the government, and provision was made for public distribution of shares. The bank’s functions included the right to issue notes, the right to act as the fiscal agent of the Nationalist government and of all state enterprises, and the right to act as the Treasury’s agent in floating domestic and foreign loans and in servicing such loans. Although the Central Bank claimed to be the “State Bank,” it did not occupy the special position of central banks in other countries. It shared the right to issue notes with other banks and it was not obliged to keep legal reserves for domestic banks’ management. The government had no way of leading the financial market, for example, by controlling discount rates or rediscounting bills.

The combination of unrestricted issuance of notes and multiple note-issuing institutions could have led to inflation, but public demand for redemption in silver restrained unregulated monetary expansion. Government authorities could not freely issue more notes because people would not accept them unless they were adequately backed with silver.³⁸

Until late in 1931, the silver standard not only provided a safeguard against government authorities, but also resulted in only mild inflation in China as the price of silver in relation to gold dropped. Once deflation set in, however, the monetary and financial institutions developed during the years of inflation ceased to work. Silver flooded out of the country and people competed to restrict credit and save cash. At this point, the autonomy of financial institutions came into question. The need to control currency and credit was recognized, but fear of arbitrary note issuance by government authority remained. It is against this background--a financial crisis occurring in an institutional vacuum and ambivalence toward government intervention--that government currency and financial policies should be analyzed.

i. Search for International Cooperation: The First Approach to the United States

³⁸ Zhang Gongquan (Chang Kia-ngau), *The Inflationary Spiral* (1958), pp. 1-7.

The silver standard gave China immunity to the economic diplomacy over currency issues. When China went off the silver-standard, however, the government had to achieve international cooperation. Whether China's currency was to be linked to gold or the foreign currencies like the U.S. dollar or the pound sterling, China was required to prepare sufficient reserves other than silver. In search of the necessary funds for the currency reform, Chinese government found it difficult to balance the divergent interests of several powers in East Asia, namely Great Britain, the United States, and Japan. Although China's currency reform itself was a monetary issue, it had profound political implications in the international order of East Asia. If a country committed to China's currency reform, other countries would be suspicious of its ambition to dominate Chinese economy. Japan, in particular, opposed any intervention by western countries in the Chinese economy. In April 1934, Eiji Amou, a spokesman for the Japanese Foreign Office, had explained the position of the Japanese government regarding the foreign aid to China. The so-called Amou doctrine proclaimed that Japan had a special responsibility for the maintenance of peace in East Asia and therefore did not always agree with the views of other nations in respect to China. While Japan hoped to see the Chinese preserve their national integrity, restore order, and achieve unification, such objectives should be attained through China's own independent effort. Japan thus would oppose any foreign intervention in the name of technical and financial assistance and any projects such as detailing military instructors or military advisers to China or supplying the Chinese with war planes.³⁹ Japan's proclamation forced British and the U. S. governments to make difficult decisions. United Kingdom and the United States wished the success of China's currency reform, hopefully with their supports, but were reluctant to take risk of antagonizing Japan. Given the complicated relationships between these countries, China sought to secure funds from the United States and United Kingdom.

In September 1934, Kong Xiangxi, the Minister of Finance sent a message to the Secretary of State Cordell Hull, asking whether the American Government was willing to exchange with Chinese government gold for silver, so that China would gradually introduce a old basis currency in the future.⁴⁰ Hull refused Kong's proposal, claiming that it would be natural for China to acquire gold at world markets like London and other points.

This U. S. government's decision was not unanimous. The Department of State, headed by Hull, suspicious of Chinese government's ability to handle the monetary issues, urged the Department of Treasury to stop buying silver or at least to reduce the price to 45 cents. The Department of State also opposed an alternative remedy, American assistance for China's currency reform. The Department of State insisted that any reorganization of China's finances should be an international project. On the other hand, the Department of Treasury, headed by Henry Morgenthau, was against the Department of State. Morgenthau told Hull that no modification of silver policy was politically possible. Instead, as Morgenthau noted, the United States could best help China by assisting in the reorganization of its

³⁹ Borg, pp. 75-76.

currency. Morgenthau criticized Hull's opposition to that course as an undue sensitivity for Japan's opinion about China, most openly stated in Amou Doctrine.⁴¹

Since the U. S. refused to directly purchase silver from China, Chinese government then asked American government to stabilize the price of silver at a lower level. In December 1934, Kong Xiangxi sent a message through the Chinese ambassador in Washington Shi Zhaoqi to the U. S. government pointing out that the rising price of silver drained silver out of China and that China could not bear exchange rates as high as parity. Kong suggested a maximum U.S. purchase price of 0.45 U.S. dollars an ounce, based on an U.S. exchange rate of one Chinese *yuan* to 0.34 U.S. dollars. Kong's proposal was discussed among U.S. officials and submitted to President Roosevelt. The Department of Treasury concluded that silver buying would proceed, even though it would put China off the silver standard. The solution: temporarily kept the price per ounce at 0.55 dollars.⁴²

Kong reacted promptly to the American proposal. On December 20, 1934, he sent a telegram again to the ambassador Shi Zhaoqi saying that China could not accept a price of 0.55 dollars, which would cause disastrous deflation, a negative balance of trade, and ultimately, the collapse of the Chinese currency system. As a compromise, Kong suggested 0.50 dollars per ounce, equivalent to 0.37 dollars per Chinese *yuan*, the rate at which China could abolish its tax on silver and regain the people's trust in the currency.⁴³ But even a rate of 0.55 dollars turned out to be politically unsustainable in the United States. The silver senators continued to oppose the proposal, and Morgenthau, the Secretary of Treasury, had little choice but to cancel it immediately.

Meanwhile, Kong strove to persuade the U.S. government not to push international silver prices up by purchasing silver at higher prices. On January 19, 1935, he sent another proposal suggesting that the United States purchase silver only if it had been newly mined, had been declared under the London agreement in 1933, or could be delivered in a relatively short period perhaps two weeks at New York or London markets. These restrictions, Kong noted, would reduce the smuggling of silver out of China.⁴⁴ The response from the United States was negative; the Silver Purchase Act possessed legal power and could neither be altered in a short period nor circumvented.⁴⁵ The price of silver rose to its peak of 0.81 dollars in April and fluctuated around 0.65 dollars until November 1935.⁴⁶

By early 1935, government authorities had come to regard departing from the silver standard as inevitable. On February 2, 1935, the government appointed a Monetary Advisory Committee consisting of fifteen leading bankers to advise it on the currency situation, stabilizing exchange rates, improving China's balance of international payments, financing internal trade and industry, and so

⁴⁰ United States, Department of State, *Foreign Relations of the United States; Diplomatic Papers, 1933-1934* Volume III, pp. 443-444.

⁴¹ John Morton Blum, *From the Morgenthau Diaries: Years of Crisis, 1928-1938* (1959), pp. 205-206.

⁴² Young, p. 224.

⁴³ Zhongguo renmin yinhang zonghang canshishi ed. *Zhonghua minguo huobishi ziliao dierji*, (1991), pp. 125-126. Hereafter, cited as *Huobishi 2*.

⁴⁴ *Huobishi 2*, p. 130.

⁴⁵ *Foreign relations 1935*, Vol. III, p. 529.

on.⁴⁷ The details of the reform plan, however, were unclear.

On January 31, Song Ziwen sent a message to the U.S. government claiming that China's currency system was expected to collapse some time before June, which would put China under Japan's economic control. In order to prevent an international crisis, China was asking the United States to offer loans. If it agreed, China would peg its currency to the U.S. dollar and provide silver for American needs.⁴⁸ According to an unofficial memorandum submitted by China's ambassador in the United States, China would offer 200 million ounces of silver for the first year in order to secure a loan of at least 100 million U.S. dollars.

The Department of State and the Department of Treasury confronted again; the former was against the U. S. purchase Chinese silver, while the latter supported the idea. At the meeting with staffs of the Department of State, the Division of Far Eastern Affairs on February 14, 1935, the Secretary of Treasury Morgenthau criticized the Department of State's opinion that the loan to China should be supplied under the international cooperation. Claiming that the issue was "a purely monetary matter" and should be handled "aggressively" by the Department of Treasury, Morgenthau stated that he thought the scheme by the Department of State would "get us nowhere"; that, the matter should not be dealt with by joint international action; that the U. S. government should invite Song Ziwen to come to the States to discuss with him the situation.⁴⁹ The President Roosevelt did not support either the Department of State or the Department of Treasury. The President told Hull either not to answer the Chinese at all, or just to go through the motions, and to tell them that the Department of Treasury would discuss their monetary trouble. The President also deemed it important to avoid discussing silver policy with foreign powers who would surely oppose it.⁵⁰ Although Morgenthau sensed that the President was on his side, in the end, the Secretary of State Hull rejected China's proposal: the United States alone could not commit to China's scheme given the unstable international situation. But, Hull added, "if a group of other countries agree to support China's plan, the United States would possibly support China."⁵¹ At this point, the role of the British government became focal.

ii. Negotiations with Leith-Ross

The Chinese government had approached the British government through the inspector general of Chinese Maritime Customs and A. S. Henchman, Shanghai manager of Hong Kong Shanghai Bank.⁵² Although these efforts were unsuccessful, Great Britain played a key role in drawing up a plan for

⁴⁶ Young, p. 225.

⁴⁷ "Appointment of a Monetary Advisory Committee," *FC* 25. 6 (February 6, 1935):142.

⁴⁸ *Huobishi* 2, p. 133.

⁴⁹ *Foreign Relations, 1935*, Vol. III, pp. 535-537.

⁵⁰ Blum, p. 208.

⁵¹ *Foreign Relations 1935*, Vol. III, p. 539.

⁵² *Huobishi* 2, p. 138.

collective aid to China involving the United States, Great Britain, France, and Japan.⁵³ On March 8, the British government notified the Chinese government that Great Britain was willing to help China as long as the plan would contribute to the establishment of peaceful relation between China and Japan. Welcoming the British government's effort, on March 18 the Chinese government replied that it was willing to launch discussions with the other governments.⁵⁴ The British proposed that the four countries send their financial representatives to Shanghai for discussions. Japan promptly expressed its disagreement with the British plan. United States also backed out, concerned that American delegates to China would be criticized for the U.S. Silver Purchase Act.⁵⁵ And France would not participate in the British plan without the cooperation of the other two countries.

In the end, Great Britain announced in June that it would send Sir Frederick W. Leith-Ross, its financial representative, to China.⁵⁶ The proposed visit aroused rumors in China, including expectations of loans from Great Britain, despite repeated announcements that the mission was merely exploratory.⁵⁷

In fact, Leith-Ross, who arrived in China in September 1935, intended to extend loans to China. He aimed to reach a Sino-Japan detant through Japanese collaboration on the loan. Japanese government, however, refused to cooperate with British, claiming that such loans would not be of use to the current the Chinese government without stable domestic support. Even after the Japanese refusal, Leith-Ross stayed in China. Wishing his visit would result in financial support from Great Britain, the Chinese government consulted Leith-Ross about the scheme of currency reform. Even if the reserve for currency reform could be secured from the sale of silver to the United States, China needed funds to improve government finance. Reducing internal and external debt arrears was most crucial.⁵⁸ The Chinese government claimed that the establishment of substantial balance between current income and expenditure was needed in order to place the finances of the government in a stable position, and to create confidence in reform of the currency.⁵⁹ Song Ziwen, the general manager of Bank of China, explained that if a currency reform would initiate without foreign help it would mean a forced conversion or prolongation for domestic debts, and further restriction of payments for foreign debts. Song said that he wanted to avoid the shock to credit that this would cause.⁶⁰

Although British government was "most anxious not to appear to be putting pressure on China to adopt a sterling basis," Leith-Ross warned to Song that loans were only allowed for countries in the sterling area if the Chinese government wanted a loan in London. Song Ziwen, however, noted that he originally regarded sterling most appropriate when China put *yuan* on a foreign currency basis.

⁵³ *Huobishi* 2, p. 162.

⁵⁴ *Huobishi* 2, p. 162. Young, p. 228.

⁵⁵ *Huobishi* 2, p. 166.

⁵⁶ As for Great Britain's domestic politics on Leith-Ross mission, see Stephan Lyon Endicott, *Diplomacy and Enterprise: British China Policy 1933-1937* (1975).

⁵⁷ Leavens, *Silver Money*, p. 311.

⁵⁸ Leith-Ross Papers (Public Record Office, London) T188/118, P.27.

⁵⁹ T188/118, p.79.

He pointed out that sterling was the currency of the most important trade area and the London market was the best place for raising money and holding reserves. Moreover, as Song added, the Japanese currency was more or less linked with sterling.⁶¹ Answering to Leith-Ross who was concerned about the United States' view on the stabilization of *yuan* on a sterling basis, Song said that he thought it might be possible to put *yuan* on something like the same basis as the Japanese *yen*; namely to keep it approximately at the same value in sterling without definitely linking it to sterling.

Song Ziwen also expressed to Leith-Ross his concern of Japanese attitude to China's currency reform; Song said that he thus would like to get on as quickly as possible with the program so as to present Japan with a fait accompli.⁶² Song reasoned that Japan would try to prevent British loan for the reform but that if they found British were going to issue one, the Japanese banks would come in rather than be left out.⁶³

After all, British government did not to offer a loan to China for the currency reform. Even if the Chinese government authorities consulted Leith-Ross about the reform, they had written up the outline of the program before he came; they just deferred its announcement pending Leith-Ross's arrival. Nonetheless, Leith-Ross's influence should not be underestimated. He not only provided the moral support for the currency reform, but also raised to the Chinese government authorities such an important issue as the independence of the Central Bank, which will be discussed in Section 4.

iii. Sale of Silver to the United States

The problem of securing foreign reserves for currency reform remained unresolved before the reform went into effect on November 4, 1935. Large silver sales to the United States were the only solution, but the situation remained precariously in both China's domestic financial market and in the arena of international economic diplomacy.

Until the first half of 1935, the U.S. government was reluctant to purchase a large amount of silver

⁶⁰ T188/118, p.16.

⁶¹ China's foreign trade in 1934 classified in relation to currencies is as follows:

	Imports	Exports
Trade with the U. S. Canada and Philippines	28.5%	19.3%
Trade with gold bloc countries and their possessions	16.2%	9.9%
Total, Gold Countries	44.7%	29.2%
Trade with countries using sterling or basing their currencies thereon	22.7%	18.7%
Trade with Japan, Korea, and Guandong	13.6%	21.5%
Total Sterling Countries	36.3%	40.2%
Trade with Hongkong	2.9%	18.9%
Trade with Germany and Italy	10.2%	4.8%
Remainder	5.9%	6.9%
Grand Total	100%	100%

Source: Arthur Young, "Outline of a Program of Financial Reform for China: A Report presented to His Excellency Dr. H. H. Kung" (September 1935)

⁶² T188/118, p. 145

⁶³ T188/118, p.172.

from China; if it showed support for China's currency reform, the so called silver senators would accuse the government of helping China to abandon silver. In the latter half of 1935, the attitude of the U.S. government gradually changed. Inside the country, the influence of the "silver senators" waned. Internationally, the United States as well as Japan remained suspicious of the Leith-Ross mission, which might result in the new Chinese currency being pegged to the British pound sterling.⁶⁴ At the same time, the Chinese government occasionally warned the United States that Japan would dominate China's economy should its monetary and financial systems collapse under the pressure of the high price of silver. Under these circumstances, the President Roosevelt's position shifted to the Department of Treasury, willing to support China's currency reform by purchasing silver.⁶⁵

The Chinese government seems to have approached to the U. S. government before the end of September 1935. Asked by Leith-Ross whether he had approached the United States as to the possible purchase by them of silver, Kong Xiangxi, the minister of finance answered that the Chinese government had asked the U. S. Treasury whether they would constitute China as their purchasing agent for silver. According to Kong, the U. S. Treasury answered they could not confine their operations to purchases of silver from China because they had also to operate in the world market. Nevertheless, the U. S. Treasury said that they were anxious to help China and would be prepared to purchase any silver which China could release.⁶⁶ Confirming Kong's statement, Song Ziwen, the general manager of Bank of China, told Leith-Ross that the sale of silver to the United States would supply an ample cover for currency reform.⁶⁷ Song was "proceeding with preparations on the assumption that matters could be fixed up with America," and if so, the scheme could be launched by the end of October or during the first fortnight of November.⁶⁸

Finally, on October 26, 1935, Ambassador Shi Zhaoqi was instructed to offer the United States 50 million ounces of silver at 0.65 U.S. dollars an ounce for delivery within two months, plus 50 million more ounces within the next four months, and to ask for an option of another 100 million during the following six months. The proceeds were to be used for exchange stabilization. Given the competition among the foreign powers over their dominance of Chinese economy, the Secretary of Treasury Morgenthau was receptive to China's plea for the U. S. support, as he said to the President Roosevelt, "It is very amusing to have the Chinese come to us with Leith-Ross sitting in China."⁶⁹ Still, he required the Chinese government further information on the new financial and currency program and on how funds were to be used.⁷⁰ On November 1, Kong ordered Ambassador Shi to tell Morgenthau that China was going to launch the currency reform, probably that weekend. Besides

⁶⁴ *Huobishi* 2, p. 167. Young, p. 235.

⁶⁵ Arthur Young, *China's Nation-Building Effort 1927-1937: The Financial and Economic Record* (1971), p. 235.

⁶⁶ T188/118, p. 24.

⁶⁷ T188/118, p. 28.

⁶⁸ T188/118, p. 145.

⁶⁹ Blum, p. 211.

⁷⁰ Young, p. 234.

providing an outline of the program, Shi was instructed to refer to the possible sale of a the Chinese government bond on the London market, explaining that if it materialized China's currency would be linked to sterling, not to another currency or to gold.⁷¹ When Shi met Morgenthau on November 2, Morgenthau agreed to purchase 100 million ounces of silver with President Roosevelt's approval. The offer was based upon several conditions: (1) that the proceeds would be used only for currency stabilization, (2) that the Chinese government would establish a currency stabilization committee that included American bankers, and (3) that the new currency would be linked to the dollar and China would agree to make it convertible at a level of America's own choosing. The currency pegging issue extended the negotiations for China's silver until November 13, although given Morgenthau's attitude in late October, it seemed fairly certain that a sale could be arranged.⁷² On October 29, Song Ziwen told Leith-Ross that "action" would be taken next week, on the following day he told to Hong Kong Shanghai Bank. The scheme was kept secret only to Japan.

By the beginning of November, the Chinese government had managed to secure international circumstances favorable to currency reform. It is significant that the Chinese government made the most of tensions among the foreign powers over Chinese economy, for example, the British and the U. S. governments' concern about Japanese dominance over China, or the competition between Great Britain and the United States over which currency *yuan* should be pegged. However, the situation was still precarious.

iv. The Announcement of the Currency Reform on November 4, 1935

On November 3, 1935, the Minister of Finance, Kong Xiangxi issued decrees establishing the currency reform that would be in force on November 4, 1935. The purpose of the reform was "to conserve the currency reserves of the country and effect a stable monetary and banking reform" and "to prevent a financial catastrophe." The nature of the reform and its procedures were described in six articles:

1. [The Abandonment of the Silver Standard] As from November 4, 1935, banknotes issued by the Central Bank, the Bank of China, and the Bank of Communications shall be full legal tender. Payment of taxes and discharge of all public and private obligations shall be effected by legal tender notes. No use of silver dollars or bullion for currency purposes shall be permitted; and in order to prevent smuggling of silver, any contravention of this provision shall be punishable by confiscation of the whole amount of silver seized. Any individual found in illegal possession of silver with intention to smuggle it shall be punishable in accordance with the law governing acts of treason against the State.

⁷¹ *Huobishi* 2, p. 168.

⁷² Young, p. 235.

2. [Bank Notes] Banknotes of issuing banks, other than the Central Bank, the Bank of China and the Bank of Communications, whose issue had been previously authorized by the Ministry of Finance, shall remain in circulation, but each bank's total outstanding banknotes shall not exceed the amount in circulation on November 3, 1935. The outstanding banknotes of these banks shall gradually be retired and exchanged for Central Bank banknotes within a period to be determined by the Ministry of Finance. All reserves held against the outstanding banknotes, together with all unissued or retired notes from these banks, shall be handed over at once to the Currency Reserve Board. Notes previously authorized and in the process of being printed shall also be handed over to the said Board upon delivery.

3. [Reserves] A Currency Reserve Board shall be formed to control the issuance and retirement of legal tender banknotes and to keep custody of reserves against outstanding banknotes. Regulations governing the said Board shall be separately enacted and promulgated.

4. [Handover of Silver] As from November 4, 1935, banks, firms and all private and public institutions and individuals holding standard dollars, other silver dollars, or silver bullion shall hand over the same to the Currency Reserve Board or banks designated by the Board in exchange for legal tender notes, at face value in the case of standard silver dollars, and in accordance with the net silver content in the case of other silver dollars or silver bullion.

5. [Conversion of Silver to Dollars] All contractual obligations expressed in terms of silver shall be discharged by the payment of legal tender notes in the nominal amount due.

6 [Exchange Rate] For the purpose of keeping the exchange value of the Chinese dollar stable at its present level, The Central Bank, The Bank of China, and The Bank of Communications shall buy and sell foreign exchange in unlimited quantities.

Following these articles, the declaration referred to several important issues related to currency and banking. The first concerned the reorganization of the Central Bank. The reorganized Central Bank was intended to function as a bankers' bank. As the liquidity crisis of the summer of 1934 revealed, when reserves were scattered among financial institutions, no one institution could control the money supply. A strengthened Central Bank would increase liquidity to the commercial banks under sound conditions, allotting them the resources necessary to finance the legitimate requirements of trade and industry.

The second issue was credit. Credit secured by real estate had been particularly important to the Chinese capital market. The decree stated that a special institution would be created to deal with the mortgage business and that steps would be taken to amend the present legal code affecting real estate

mortgages to make real estate a more acceptable form of security for loans.

Third, the decree promised sound government fiscal policy. In proposing the reform programs, the government took into account how its decisions would look in the eyes of the public. There was strong feeling against inflation, rooted in the fear that the Central Bank would become a government cash machine. The government concluded the declaration with the reassurance that, “plans for financial readjustment have been made whereby the National Budget will be balanced. Also with the centralization of note issuance, the provision of adequate reserves against legal tender, and a system of rigorous supervision, confidence in the currency will be strengthened.”

In the Direction of New Currency System, made public on November 18, the government guaranteed that the system would not lead to inflation. By way of “answering people suspicious of the new currency system,” the government emphasized four important aspects of the reforms. The first concerned stabilizing the exchange rate. Referring to those who “doubt the feasibility of the exchange stabilization,” the Direction would guarantee a stable exchange rate, since the three government banks would intervene if the exchange rate varied widely. Second, the government warned of temporary fluctuations in commodity prices but predicted that they would be stabilized within a short period, preferably at a slightly inflated level. The third and fourth points concerned the circulation of silver. The government rejected the position that people accustomed to using silver would not accept notes (Article 3), asserting that notes backed with enough reserves would have no problem circulating (Article 4).⁷³

The Direction of New Currency System illuminates the government’s concerns about implementation. In this, both international (foreign reserves and exchange rates) and domestic (note issuance and credit expansion) aspects were closely related.

4. Reaches and Limitations of the Government Policies after November 1935

In the course of recovery from the depression, the government increased its influence over economy; the silver standard was changed to the foreign-exchange standard; the government tightened its control over the three government banks, namely, the Central Bank, the Bank of China, and the Bank of Communications. Nevertheless, its control was not total, nor were its achievements in industrial promotion and rural rehabilitation sufficient. This section will examine the effects of the Nationalist monetary reform policies, focusing on the linkage between international and domestic dimension of Chinese political economy.

i. The Success of the Currency Reform and Recovery from the Depression

The currency reform presented a particular difficulty since the government had to deal with mass confidence in the currency. The public which customarily used silver as a means of exchange might

⁷³ Zhuo Zun ed., *Kanzhanqian shinian huobishi ziliao (1) bizhi gaige* (1985), pp. 213-214. Hereafter, cited as *Kanzhanqian*.

not readily accept notes instead. Despite the government concern, the issue of notes steadily increased after the reform (Table 2).

Table 2 Note Issue of Government Banks, November 1935-June 1937 (1,000 *yuan*)

Mon/Year	Central Bank	Bank of China	Bank of Communications	Farmers Bank of China	Total
1935					
November	152,221	248,636	143,432	29,847	574,136
December	176,065	286,245	176,245	29,771	668,326
1936 March	252,349	310,151	186,698	34,777	859,447
June	300,099	351,773	204,912	92,035	948,819
September	314,353	377,768	217,110	108,503	1,017,734
December	326,510	459,310	295,045	162,014	1,242,879
1937 March	361,835	501,404	308,577	200,053	1,371,869
June	375,640	509,863	313,548	207,951	1,407,002

Source: Frank Tamagna, *Banking and Finance in China* (1942), p. 144.

Note: The new currency regulations of 1935 did not make any provision as to the status of notes issued by Farmers Bank of China. In February 1936, the government granted a status of legal tender to its notes. See *Hobishi 2*, p.200.

Reserves held against legal tender notes were concentrated under the Currency Reserve Board. This newly founded institution was composed of five representatives of the Ministry of Finance; two representatives each from the Central Bank, the Bank of China, and the Bank of Communications; two representatives each from the Shanghai bankers Association and the Native Bankers' clearing association; two representatives from the Chamber of Commerce; and five representatives from the various banks designated by the Ministry of Finance.⁷⁴ The reserves were deposited with the three

⁷⁴ The members of the board were as follows: Kong Xiangxi (Chair, Minister of Finance, and General Manager of the Central Bank), Song Ziwen (Chairman of the board, the Bank of China), Zhang Gongquan (Minister of Railways), Wu Daquan (President of the Yanye Commercial Bank), Song Hanzhang (General Manager of the Bank of China), Li Jue (Director of the Issuing Office of the Bank of China), Zhou Zuomin (Managing Director of the Kincheng Bank), Hu Yun (Chairman of the board, the Bank of Communications), Tang Shoumin (General Manager of the Bank of Communications), Du Yuesheng, Chen Guangfu (General Manager of Shanghai Bank), Song Ziliang (General Manager of the China Development Finance Corporation), Xu Kan (Vice Minister of Finance), Qin Runqing, He Zongxiao, Yu Zuoting (A Committee Member of Shanghai Native Bankers Association), Qian Xinzhi

government banks.

The beneficial effects of China's new currency policy were readily apparent in the general rise in wholesale prices, which in Shanghai had advanced from 90.5 during the deflationary period of mid-1935, to 103.3 in November 1935, and to 118.8 in December 1936. Since wholesale prices apply mainly to primary agricultural products, an increase in prices means greater purchasing power for producers. It was here that further recovery from the depression began. It should be noted that wholesale price levels were not necessarily inflationary, rather, they were reflationary, since they were almost equivalent to those in 1931, just before the exchange rate started to rise.⁷⁵

The most significant feature of the recovery was China's thriving international trade. The favorable exchange level after the reform was an important factor promoting export. Under the silver standard, China's exchange rate fluctuated with the price of silver. Under China's new managed currency system, *yuan* was fixed in relation to foreign exchange. The Central Bank's initial rates per *yuan* after the reform at which it would support the currency were 14 3/8 d and U. S. \$0.29 1/2 for the selling rate, 14 5/8d. and US \$0.30 for the buying rate. Foreign trade in December 1936 easily established record figures for the year: trade increased in 1936 by 10.1 percent compared with 1935, an increase comprising gains of 2.4 percent in imports and 22.5 percent in exports. Exports of agricultural products were most promising. It was estimated that the annual farm income from the sale of wheat, rice, cotton, millet, kaolian, and tobacco averaged 3,900 million dollars in the years from 1933 to 1935, but in 1936 it reached 5,600 million dollars, an increase of 1,700 million dollars, or nearly 44 percent. When silk, tea, wool, groundnuts, and other minor agricultural products were included, the increase amounted to almost 2,000 million dollars. Song Ziwen emphasized the importance of these increases in agricultural exports as an indication of the increased purchasing power of rural people, which would lead to a revival of domestic trade.⁷⁶

In March 1937, at the annual meeting of the shareholders of the Bank of China, Song Ziwen, the general manager of the bank, declared the depression at an end:

There are no grounds for suggesting that China has left all her difficulties behind, . . . [but] there is no gainsaying the fact that during the past eighteen months the whole outlook in the country, politically, financially and commercially, has changed completely and for the better.⁷⁷

Song's confidence in the recovery of the Chinese economy was echoed by other bankers, such as

(Director of the Bank of China and the Bank of Communications), Xu Xinliu (General Manager of National Commercial Bank), Wang Xiaolai (Chairman of Shanghai Chamber of Commerce), Li Ming (General Manager of Zhejiang Industrial Bank), Ye Zhuotang (General Manager of Siming Commercial and Savings Bank), Chen Jintao, Shen Xuyu. *Caizhengbu mishuchu, Caizhengbu xinhubi zhidu shuomingshu* (1935), cited in *Huobishi* 2, p. 197. H. L. Boorman ed. *Biographical Dictionary of Republican China*, 5 vols (1967-71). Xu Youchun ed., *Minguo renwu dacidian* (1991).

⁷⁵ Tamagna, p.145.

⁷⁶ "Bank of China Annual Report," *FC* 29. 14 (April 7, 1937): 361.

Percy Chu, the manager of the Joint Reserve Board of the Shanghai Bankers' Association, who stated at the annual meeting of the Board on March 17, 1937:

Looking over the events of the past year, it can be said with every justification that definite signs of recovery in economic conditions have begun to show themselves. Political complications, such as arose in connection with Sino-Japanese relations and the Xian crisis, while tending to affect financial and commercial activities, produced scarcely a ripple upon the surface of the Shanghai money market, thanks in part to the currency reform measures of November 1935, which disposed of all fear of any scarcity of currency. Had a situation with the some political uncertainties and uneasiness arisen prior to the adoption of the New Monetary Policy, conditions might have been very much worse.⁷⁸

As Song admitted, the improvements were not due to one factor, such as the currency reform, but to a combination of factors. The explanation offered by the chairman of the Hong Kong Shanghai Bank represents the moderate view: the excellent crops throughout the country were a great boon, "coming as they did at a time when the exchange had just been fixed at a reasonably low level, and when the demand for China's produce was improving."⁷⁹ Altogether, as Chen Guangfu, the general manager of the Shanghai Commercial and Savings Bank, recalled, "[I] would say that the years 1936 and 1937 up to the outbreak of war were banner years."⁸⁰

ii. Exchange Stability as a Norm

What were the factors that enabled the unexpected success of the monetary policies? Why did people accept banknotes as legitimate currency? As Chen Guangfu, the general manager of Shanghai Commercial and Savings Bank, recalled, "the most important function of a managed currency is to enable one to exchange a legal tender note for either cash or foreign exchange."⁸¹ It was crucial that the government keep the exchange rate at the declared level to sustain the credibility of the currency. The specific test of government monetary policy was, in the popular view, the ability of the government to keep the open market rate close to the official rate declared in November 1935. If the exchange rate dropped, the credibility of the new currency would have been damaged and people's subsequent sale of the currency would ruin the new monetary system.

The Chinese government officials were aware of the political implications of China's currency to

⁷⁷ "Bank of China Annual Report," *FC* 29. 14 (April 7, 1937): 361

⁷⁸ "Joint Reserve Board of the Shanghai Bankers' Association: Fifth Annual Report," *FC* 29. 11 (March 17, 1937): 287.

⁷⁹ "Conditions in China As Seen By the Hong Kong and Shanghai Bank," *FC* 29. 11 (March 10, 1937): 249.

⁸⁰ Chen Guangfu, "Reminiscence of Chen Guangfu," (Chinese Oral History project. Columbia University, New York), p. 87.

⁸¹ Chen Guangfu, "Reminiscence," p. 79.

the international relations of East Asia, as once Kong Xiangxi noted, "It would cause jealousy and suspicion on the part of countries whose currency was not selected as a basis for China's currency, and therefore tend to make more difficult China's international position. In this connection it may be added that it has been indicated to the government that the American, British and Japanese governments would each be glad to have China's currency linked to its particular currency."⁸² The Chinese government thus avoided choosing either the U.S. dollar or the pound sterling to peg *yuan*, but decided to keep the declared rates of each currency. The U. S. government at first required linking *yuan* and U. S. dollar as a condition for their purchase of silver from China. The Chinese government, however, were unyielding. Chinese Ambassador Shi took pains to warn the U. S. government of possible difficulties caused by *yuan*'s pegging. For example, if *yuan* were tied to the dollar and something went wrong in China, the United States would be blamed. American intransigence would drive the Chinese to the British or even the Japanese. At last, the Department of Treasury as well as the Department of State came to regard a link unnecessary.⁸³

The rates initially announced after the reform, 14 3/8d and U.S.\$0.29 1/2 for selling, and 14 5/8d and US\$0.30 for buying, reflected a cross rate for fluctuating sterling of about US \$4.92, the approximate rate at the time of the reform. China could retain the position of *yuan*, as long as the cross exchange rate between New York and London fluctuated within narrow limits. However, it became difficult to keep the currency stable in terms of two currencies when the dollar-sterling rate rose to over US. \$5.05. In order to prohibit arbitrage transactions, the Central Bank widened the spread between selling and buying for both currencies, to 14 1/4---14 3/4d. and US\$0.29 1/2---30 1/2, respectively. In this way, the Chinese government did not have to change the official rates prior to the outbreak of the war in 1937.⁸⁴

To keep the exchange value of *yuan* at the pegged value, government banks were required to have on hand and to be ready to sell, foreign exchange at close to the fixed rate. The sale of silver to the United States had not been finalized before November 3, 1935, but even after the agreement on November 13 to sell 50 million ounces, China's reserves amounted to only 62.5 million dollars. The Central Bank was temporarily able to take over the large amounts of foreign exchange accumulated by speculators during October. In order to guard against future short-term instability, however, much larger external reserves were essential.⁸⁵ China kept trying to sell more silver.

On December 10, the Minister of Finance Kong Xiangxi asked Secretary Morgenthau to buy an additional 100 million ounces of silver for delivery before May 1, 1936. But Morgenthau refused to consider any further sale until the first 50 million ounces had been delivered. Given the public's attachment to silver, Kong had even stated, three days after the currency reform was announced, that

⁸² Letter to Chen Guanfu from Kong Xiangxi on March 14, 1936, in Mr. K.P. Chen's Private Papers: Silver Mission 1936, A1 Diaries.

⁸³ Blum, pp. 212-213.

⁸⁴ Young, p.250.

⁸⁵ Young, p. 241.

China was not abandoning the silver standard but was only suspending the use of silver money, although later he denied the comment. Nonetheless, at Morgenthau's urging, Kong ordered that the shipment of the initial 50 million be completed between December 21 and January 7, 1936.

Although Morgenthau rejected Kong's request for purchasing silver, he was supportive to China's currency reform. In the middle of November 1935, Morgenthau learnt from a British diplomat at Washington that Leith-Ross did not have mandate to persuade China to adopt sterling exchange. He also found that the British government had difficulties in offering a loan to China. If the British government lent money to China, *yuan* should be tied to sterling. At the same time, British would not approve a loan without cooperation of the U. S. and Japanese governments. Given that Japan's strong opposition, the scheme of international loan seemed almost impossible. As Morgenthau noted, "if she [China] does not get some help, it looks pretty gloomy over there."⁸⁶

In early 1936, Morgenthau tried to have Song Ziwen at Washington to discuss about issues concerning China's currency reform and American purchase of silver. However, the Secretary of State Hull opposed to Song's visit on the grounds that it might provoke Japanese resentment against the United States or Great Britain. Therefore, the Chinese government asked whether the United States would accept Chen Guangfu, the manager of Shanghai Commercial and Savings Bank, as a substitute emissary, which was approved by the U. S. government.

During his six months' stay in the United States from April to May, 1936, Chen Guangfu met Morgenthau several times as well as submitted a number of detailed reports on China's currency, finance, economy, and so on. As Chen Guangfu observed, the U. S. purchase of silver was not a pure case of goodwill and friendship, but a case of give and take. On the U. S. side, when China and Hong Kong left the silver standard in succession, people came to regard the folly of the silver purchase act in 1935. The danger of having the world's silver dumped on the U. S. was also concerned. The senators from silver-producing states were satisfied as long as the domestically mined silver was taken care of, while economists and others began to advocate the repeal of the silver purchase act. Taking advantage of the popular opposition to the silver purchase act, the Secretary of Treasury Morgenthau let the silver price fall 30 percent between December 9, 1935, and January 20, 1936, when it reached 45 cents per ounce. Still, the U. S. Government did not want China to dump her silver on the world market only to have the silver price drop drastically.⁸⁷

On the other hand, it was crucial for China to export silver to the United States while the States still maintained the price at 45 cents per ounce. If the price dropped to about 40 cents, China could not export silver at a profit. And if the price fell further below 40 cents, it would pay to import silver. Such a fall would seriously impair public confidence in China's currency because of depreciation of the value of silver reserves would lead to a run on foreign currencies and gold reserves. Simply, the

⁸⁶ Blum, pp. 217-218.

⁸⁷ Blum, pp. 197-198.

new monetary system would collapse⁸⁸

Against these domestic backgrounds of each government, the attitude of officials of the Department of Treasury was, as Chen Guangfu put it, “if China agrees to cooperate with the U. S. to stabilize the price of silver, U. S. will assist China to stabilize her new currency. If China has no sincere desire to cooperate with the U. S. and decides to dump her silver on the world’s market, U. S. will cease her effort to maintain the silver price at the present level.”⁸⁹ In order to increase its demand for silver, China promised to the United States to issue subsidiary silver coin as well as to raise the ban of using silver for art crafts. With these cooperation for maintaining the silver price, Chen Guangfu succeeded in reaching an agreement to sell an additional 75 million ounces of silver and receive a credit of \$ 20 million against the deposit of 50 million ounces of silver.⁹⁰ And further sale of silver was agreed on July 8, 1937. Altogether, China’s prewar sales of silver to the United States after currency reform amounted to 187 million ounces. Total the Chinese government silver sales provided a reserve of about 100 million dollars to support its currency reform.⁹¹

With the obtained reserve, Chinese government could protect its currency. From the end of 1935 to the middle of 1937, the Central Bank faced three large-scale sales of *juan*: in December 1935 (the beginning of the new monetary system), in May 1936 (the political crisis in southern China), and in December 1936 (the Xian incident). In each case, the Central Bank met all demands for foreign exchange at the official rate, which maintained and even enhanced the public’s confidence in the currency.⁹²

iii. Constraints on Fiscal Policy

The government’s commitment to stabilizing the exchange rate, at the same time, limited its policy options. Bankers and economists expressed strong concern that the government would increase the money supply to make up for its budgetary deficits.⁹³ The government denied any such intention, pointing out that the reserve board consisted of private bankers as well as government personnel and that the ratio of cash to currency reserves was the same as before.⁹⁴ Despite popular concern over the government’s arbitrary control of the money supply, government policy did not seem to be

⁸⁸ Leavens, pp. 317.

⁸⁹ Letter to Kong Xiangxi from Chen Guangfu on May 29, in Mr. K.P. Chen’s Private Papers: Silver Mission 1936, A1 Diaries.

⁹⁰ Report of the Mission, in Mr. K.P. Chen’s Private Papers: Silver Mission 1936.

⁹¹ Young, pp. 242-244.

⁹² Tamagna, p. 148.

⁹³ There are many articles on magazines and newspapers. Hou Shutong, “Ping zaibu bizhi xinling,” *Dagongbao* (November 16, 1935), reprinted in *Kanzhanqian* 3: Fabi zhengce, pp. 247-264. Huang Yuanbin, “Xin huobi zhengce chenggong guanjian,” *Yinhang zhoubao* 20. 15 (April 1936), in *Kanzhanqian*, vol.3, pp. 336-358, and others. Gu Qigao observed that some bankers opposed to the currency reform because of their distrust in the government. Gu Qigao, “Zhongguo xinhuobi zhengce yu guoji jingji junheng,” *Jingjixue qikan* 7. 1 (June 1936), reprinted in *Kanzhanqian* 3, pp. 373-374.

⁹⁴ *Huobishi* 2, p. 127.

inflationary. The supporting policies for the stabilization of the exchange rate must be to limit the supply of notes and to refrain from excessive budgetary expansion. If the government conducted these policies, the value of *yuan* would immediately drop. Even after the currency reform, Chinese government did not control foreign exchange transactions, because the restriction itself would damage the credibility of the currency. Therefore, if government were suspected of recklessly expanding its budget by issuing new notes and bonds, people would veto its actions by selling out the currency on the foreign exchange market.

Chinese authorities learned how difficult it was to cultivate trust in their government during their negotiations with foreign governments over loans for currency reform. During his twelve interviews with Kong Xiangxi and/or Song Ziwen from September 12, 1935 to November 2, 1935, Leith-Ross most emphasized that balancing the government budget and keeping the Central Bank independent of the government were indispensable to attain credibility of the new currency.⁹⁵ Chinese government authorities recognized the importance of the balanced budget to cultivate people's credibility of the government. Song Ziwen noted that he regarded the budget factor was the vital issue.⁹⁶ However, they were not sensitive to the status of the Central Bank. Leith-Ross told Kong that in connection with any loan for a currency reform British government would require full details as to the reform of the Central Bank, the definition of approved securities, and a Trust Deed ensuring strict control of the proceeds. He questioned why public were given only limited participation in ownership of shares of the Central Bank and suggested that the Board of the Central Bank be elected by the shareholders.⁹⁷ The Governor must be separated from the Ministry of Finance. The restriction of advance to the government by the Central Bank was another problem raised by Leith-Ross to Chinese government. His message was "to maintain confidence the essential thing was to have a really strong Central Bank."⁹⁸

The United States also required Chinese government to submit a detailed plan of its monetary and financial reconstruction as a condition of the purchase of silver from China in 1935. China's plan submitted on November 1, 1935, declared that the fund from China's sale of the silver would be solely used for the currency reform and for the foreign exchange held by the Central Bank and that Treasury would be informed of usage of the fund.⁹⁹ The foreign government suspected that Chinese government would use Central Bank as its cashing machine only to devalue *yuan*. Their fear was quite reasonably also shared by the Chinese domestic market.

In spite of the heavy burden of military expense and foreign and domestic debts, Chinese government had good reasons to refrain from excessive budgetary expansion. The need to enhance the credibility of *yuan*. First, fluctuations of the exchange rate would have negative impacts on the

⁹⁵ T188/118, p. 405

⁹⁶ T188/118, p. 27

⁹⁷ T188/118, p. 27

⁹⁸ T188/118, p. 146

⁹⁹ Huobishi 2, p. 243.

custom revenue on which the government heavily depended on.¹⁰⁰ Second, once most of the foreign loans in arrears were settled, Chinese government wanted to attract foreign investment to develop railways and to rehabilitate devastated rural areas, for which the balanced budgets and the stable exchange rate were prerequisite¹⁰¹ Third, and most importantly, China had long depended on the remittance from overseas Chinese and foreign investment for compensating for its trade deficits. The fluctuation of the currency would discourage the inflow of money, which would be disastrous to Chinese economy.¹⁰² Chinese economy, closely integrated to the international economy, influenced government's policy options.

Exchange stability and balanced budgets thus became focal in the fiscal year 1936. Since the military expenditure could not be easily reduced, the government tried to consolidate domestic debts as well as to restrict new issuance of bonds. These rigid limitations restricted unregulated note-issuance and government expenditures, but they also prevented a needed elasticity in credit.¹⁰³ Credit remained tight even after the currency reform. The most serious problem was the stagnation of the real estate market.¹⁰⁴ It was said that Shanghai would never recover until the large sums of money tied up in property began to earn reasonable interest. The capital of many Chinese firms was derived from land, which was mortgaged to provide liquidity.¹⁰⁵ Business was on the upswing, but most transactions were still carried out in cash.¹⁰⁶ The flotation of frozen assets was inevitable in order to resume long-term investment. The other difficult problem was how to revitalize rural finance which had collapsed during the 1930s depression. In light of the severity of the rural financial crisis, the so called money famine in rural China, the aid that agricultural cooperatives and the Farmers Bank of the government could offer was limited. Industrial enterprises as well as rural households expected government intervention with emergency loans but the government could not offer these because of its conservative fiscal policy.

5. Chinese State and Market Under the International Financial System from a Historical perspective

From late 1929, Chinese currency endured wide fluctuations in exchange rate caused by changes in the international price of silver. The initial drop of the silver price from 1929 to 1931 caused a boom in Chinese economy which only deepened the economic crisis after the price turned upward in 1931. The U. S. silver purchase act in 1934 raised the silver price even higher. As a result, the severe deflation hit Chinese economy. To keep the value of the *yuan* stable, the government was to eliminate the negative effects of fluctuating exchange rates, which it succeeded in doing through its economic

¹⁰⁰ *Chinese Year Book: 1936-1937*, pp. 507-508.

¹⁰¹ *Chinese Year Book: 1936-1937*, p. 473

¹⁰² For example, Chen Guangfu, the general manager of Shanghai Commercial and Savings Bank held this opinion. Chen, "Memorandum to his excellency Dr. H.H.Kung on the study of Mr. T. Chen's Memorandum Regarding Restriction of Foreign Exchange" in "*Reminiscance*."

¹⁰³ Young, p. 272.

¹⁰⁴ Joint Reserve Board of the Shanghai Bankers' Association," *FC* 29. 11 (March 17, 1937): 287.

¹⁰⁵ "Recent Land Sales in the Settlement," *FC* 27. 3 (January 15, 1936): 56.

diplomacy with Great Britain and the United States. The now-stabilized exchange rate following the currency reform was one of the major factors that contributed to the expansions in business and trade after 1935. China's case echoes Kaoru Sugihara's observations of the role of pound-sterling in East Asian economy; as a result of the region's linkage with pound-sterling during the 1930s, the intra-Asian trade flourished; the devaluation of the currencies in East Asia in terms of pound-sterling helped import-substitution industrialization in the area by discouraging imports from western countries.¹⁰⁷

The transition from the silver standard to a managed foreign exchange system had political implications. Under the silver standard, domestic trust in the currency rested on its convertibility to silver. International faith in the Chinese *yuan* also depended on the availability of silver reserves and the price of silver in the world market. Under the new monetary system, however, the government found it necessary to cultivate mass confidence in the legitimacy of the currency to discharge debts and obligations. Internationally, the government had to be ready to buy and sell foreign exchange in unlimited quantities to insure the value of its currency abroad.

These domestic and international concerns were closely tied. The silver standard was an automatic mechanism, while the new monetary system required discretionary management. Under the silver standard, China was exposed to the fluctuation of silver prices in the world market but was relatively free of government arbitration in monetary affairs. Under the new currency system, the government's role in the monetary system became much more important. The legitimacy of government policies rested on exchange stability. Failure to achieve this stability would damage the credibility of the currency both domestically and internationally.

It should also be noted that guaranteeing exchange stability at the same time constrained government monetary and fiscal policies; an unlimited increase in money supply would push the exchange rate down, which in turn would undermine the system.

During the 1930s, the state and the market entered a new phase. The government increased influence over economy, but the tension existed between the government and the people over the currency convertibility. Of equal significance, China's linkage with the international financial system continued to regulate the government in this relationship from the mid-1930 onward. The outbreak of Sino-Japan war in 1937 is regarded a crucial incident not only in terms of Chinese politics but also of the East Asian international order. But still, we should not overlook the fact the currency convertibility was regarded most important well into the late 1938.¹⁰⁸ Fearing that the vast drop of the exchange rate would create a panic among the public, the government supported the exchange rate of the currency through continued supply of foreign exchange to the Shanghai market during the early war years. This action not only mitigated the war-time inflation but also bolstered general confidence in the currency, although it cost a large leakage of foreign exchange.

¹⁰⁶ Mo Yuan, "Shanghai jinrong de huigu yu qianzhan," *Dongfang zazhi* 32. 22 (November 1936): 33-43.

¹⁰⁷Kaoru Sugihara, "The Sterling Area, the Yen Bloc and East Asia's Industrialization, 1929-1939"

The relationship between the state and the public over the exchange stability and fiscal policies deteriorated, after the Nationalist government retreated to the interior province of Sichuan in October 1938. Without enough foreign reserve, the government was unable to sustain the exchange rate. Meanwhile, military expenditures increased in 1940, and the share of government outlays financed through monetary expansion rose steadily. Chinese economy gave way to the inflationary pressure. By the end of 1945, the price level was reported 1,632 times higher than the prewar level. Even after the Sino-Japan war was concluded in August 1945, the Nationalist government fail to halt the inflation, rather intensified it. The rapid expansion of the government spending apparently increased money supply.¹⁰⁹ The flight of capital not only pushed up the market rate for foreign exchange, but also added fuel to the inflation by preventing the use of foreign exchange for the financing of imports. The more restrictive the government's allocations of foreign exchange became, the more importers tended to hoard their goods from the market to profit from the constant rise in prices. The resultant hyperinflation greatly harmed the political legitimacy of the Nationalist government.¹¹⁰

The Communist regime, which established People's Republic in October 1949, tackled the inherited hyperinflation by channeling circulation of money into tightly controlled paths. Gold, silver, and foreign exchange were barred from circulation. The handling of all foreign trade was placed in the hands of state-operated companies (March 1950) and trade was conducted only in foreign currencies, not in Chinese currency, *ren min bi*. In this way, free from the influence of the international market, the government effectively tightened its control over domestic circulation of *ren min bi* from then on.¹¹¹

It was the Nationalist government in Taiwan that learned lessons from its experience with hyperinflation on the Chinese mainland, namely fiscal and monetary conservatism and the avoidance of overvalued exchange rates. Once learned, these lessons were never forgotten.¹¹²

With the end of inflation and the recovery from the war, the Nationalist government launched the first four-year development plan (1953-1956) to promote industrialization. Emphasizing the import substitution, textiles in particular, the government identified promising investment opportunities, drew up plans, and had private entrepreneurs carry them out, offering low-interest loans. The exchange rate was controlled; public sector imports and important raw materials and intermediate inputs needed by the private sector were able to use a lower official exchange rate.

At the end of the 1950s, however, the government shifted its approach from import substitution to export promotion. Given that the former exchange rate was regarded overvalued, the Foreign Exchange Reform of 1958 proved most important. In 1958, the National Taiwan Dollar (NT\$) was devalued from NT\$24.7 to US\$1 to NT\$36.1 to US\$1; the buying rate then further devalued to

¹⁰⁸ Zhang Gongquan (Chang Kia-Ngau), *The Inflationary Spiral*, pp. 95-96. *Huobishi* 2, pp. 284-285.

¹⁰⁹ Chang Kia-Ngau, pp. 98-100.

¹¹⁰ Chang Kia-Ngau, p. 304

¹¹¹ Dwight Perkins, *Market Control and Planning in Communist China* (1966), p. 11.

NT\$40.0 to US\$1. At the same time, the multiple exchange rate system was abolished and replaced by a single exchange rate. Along with other export incentives such as import duty rebates and export processing zones, the Reform realized the export-led growth that was to be the feature of Taiwan economy from the 1960s on.¹¹³

Today, after decades free from the fetters of the foreign exchange market, Chinese Communist Party regime has once again opened the door to foreign investments and assistance, while simultaneously facing the problem of foreign exchange fluctuations.¹¹⁴ In Taiwan, making its financial sector face open international competition with other East Asian financial centers such as Hong Kong and Singapore has become the foremost challenge to both the government and private sectors.¹¹⁵ At this moment, the issue of international financial market constraints on Chinese domestic economic policies may be of more than historical interest.

¹¹² Li-min Hsueh, Chen-kuo Hsu, and Dwight Perkins, *Industrialization and the State: The Changing Role of the Taiwan Government in the Economy, 1945-1998* (2001), p. 184.

¹¹³ Hsueh, Hsu, and Perkins, p. 2, pp. 19-20.

¹¹⁴ Barry Naughton, *Growing Out of the Plan: Chinese Economic Reform, 1978-1993* (1995), pp. 302-304.

¹¹⁵ Hsueh, Hsu, and Perkins, p. 4.