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The Importance of Sound Money and Banking: Lessons from China, 1905-1950

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Next month, I will be opening your Chicago conference and speaking on the topic "Global Market Volatility: The Role of China, Central Banks and Monetary Policies - the real risks and the implications for the global economy."

As a precursor to Chicago, you may find the following article a useful primer in beginning to grasp the various drivers which have so influenced China's approach to fiscal management…

The history of China's banking system in the first half of the 20th Century offers powerful insights into the conduct of monetary policy and the consequences of government intrusion into banking and monetary institutions that are well worth considering today. Monetary economists and monetary historians would do well to study China's example and, in particular, Chang Kia Ngau's 1958 book, *"The Inflationary Spiral: The Experience in China, 1939-1950"*. As you'll see, sound money and sound banking matter a great deal in creating a harmonious and prosperous society.

In 1905, during the final years of the Qing Dynasty, the first government bank, the Hupu Bank, opened in Peking. It was established by the Imperial Ministry of Revenues when China was still on the silver standard to help finance government deficits by issuing paper currency. In 1908, the bank was renamed the Ta Ching Government Bank (Great Qing Bank), and in 1912, under a new charter, the bank became known as the Bank of China. Another government bank of issue, the Bank of Communications, was established in 1908.

The constant pressure for central and provincial governments to increase spending beyond revenues led to attempts to suspend convertibility. For example, in 1916, President Yuan Shih-kai of the Republic of China ordered the Bank of China and the Bank of Communications to halt convertibility of their bank notes, and the public was instructed to accept those irredeemable notes at par. The largest note-issuing bank, the Shanghai Branch of the Bank of China, refused to comply with the President's order and was able to defend its notes against a bank run. The Peking Branch of the Bank of China, however, complied with the order, as did the Bank of Communications (Chang: p. 5).

In Manchuria, officials imposed the death sentence on individuals who exchanged irredeemable bank notes at less than par. Despite this severity, there were heavy discounts on provincial government bank notes "which placed a very real limit on the extent to which these issues could be increased." By 1922 all irredeemable notes from the Bank of China and the Bank of Communications were withdrawn (Chang: p. 5). The public then slowly regained confidence in paper currency as banks recommitted to redeem their notes in silver.

Institutional Limits on the Quantity of Money

In March 1928, the Bank of China sought to enhance the credibility of its currency by embarking on institutional reform to limit note issue. The bank established a "Supervisory Committee" in Shanghai, comprised of members from the Chamber of Commerce, the Bankers' Association and the Native Bankers' Association, designed to ensure that the bank had sufficient silver backing for its notes. The Committee published quarterly reports on the bank's reserve position that were certified by a public accountant (Chang: p. 6).

This institutional check on the credibility of the bank's promise to honor its commitment to maintain a convertible currency was also adopted by the newly created Central Bank of China, as well as by the Bank of Communications and private banks. To quote Chang (p. 6), "The public became less wary of holding bank notes, and note circulation increased rapidly in the years after 1928. Sound currency gradually drove the unsound notes of the provincial banks out of circulation except in Manchuria and Canton" (emphasis added).

Currency Reform

The silver backing of bank notes was relaxed by the rule change that allowed banks to back up to 40% of their note issues with government bonds, and, in November 1935, the central government replaced the silver standard with a foreign exchange standard. The currency reform provided that only notes issued by the Central Bank of China, the Bank of China, and the Bank of Communications would be acceptable as legal tender, and would henceforth be called "the Chinese National Currency" (CNC). Silver could no longer be used to back bank notes, and the public would have to return all monetary silver to a government appointed Currency Reserve Board or to its agents in exchange for CNC (Chang: p. 7).

Those who drafted the new currency plan had recommended additional measures to safeguard the value of money:

1. Make the Central Bank of China independent of the Ministry of Finance;

2. Establish a Supervisory Committee to limit note issue and avoid inflation; and

3. Rationalize government financing to minimize deficit spending and debt monetization.

However, these sensible measures were never instituted and instead bank notes in circulation were increased from CNC $453 million in 1935 to nearly CNC $1.5 billion by mid-1937 (Chang: p. 8).

Fiscal Dominance, Inflation, and Repression

Demands on the country's fiscal income (taxes) increased during the Second Sino-Japanese War (1937-1945). The lack of central bank independence and the lack of any hard anchor for the price level under a pure government fiat money system led to an inflationary spiral. During the early war years, from 1937-39, inflation in "Free China" (areas not held by the Japanese) averaged 40-50% per year; inflation then accelerated to 160% per year until the end of 1941, and during the last four years of the war averaged more than 300% per year (Chang: p. 12).

Following the war, the Nationalist government continued to rely on the printing press to finance deficits, inflation spiraled upward, and the government imposed wage and price controls to suppress inflation.[1]

Direct measures were also used and "economic instability finally led to a general loss of confidence in the Nationalist government, and total collapse of political and social morals followed" (Chang: p. 367).

Lessons

Several lessons emerge from China's experiences prior to the Communist Party takeover in 1949. The first lesson is that long-run economic growth and prosperity depend on "respect for the soundness of private enterprise and banking." When the government engages in massive debt monetization, the resulting inflation destroys "popular confidence in banking institutions" (Chang: p. 368).

Second, allocating capital to state-owned enterprises crowds out private investment. "Overzealousness in forcing the pace of economic development [by supporting state-owned enterprises] often results in little more than the destruction of private capital formation, thus defeating the very purpose of development" (Chang: p. 368).

Third, the inclination of underdeveloped countries to inflate means that "the establishment of an institutional framework for budget control and the independence of the central bank are of paramount importance for the long-term welfare of the population" (Chang: p. 368).

Fourth, "once inflation is under way, the government is perforce led to the path of increasing intervention and direct control." Thus, inflation inevitably leads to the loss of economic and personal freedom as the government imposes wage and price controls and allocates resources. Corruption becomes endemic (Chang: pp. 368-69).

Fifth, the experience of Nationalist China shows "without equivocation that the complexity of modern economic life defies the grasp of any single individual" (Chang: p. 369). This point may seem trivial but is one that Nobel Laureate economist F. A. Hayek often emphasized in such works as *"The Use of Knowledge in Society"* and *"The Fatal Conceit"*. Central bankers who favor pure discretion in the conduct of monetary policy - as opposed to rules - are prone to think that their intricate macroeconomic models capture the complexity of the real economy and that they can accurately forecast the path of the economy. In contrast a rules-based regime recognizes the difficulty of monetary planning and the benefits of what legal scholar Richard Epstein calls "simple rules for a complex world."

The most important lesson, perhaps, is that "inflation is no less an enemy of the free society than Communism and, as we have seen in China, may be a harbinger of a Communist triumph" (Chang: 369).

Conclusion

China's economic experiences during the first half of the 20th century reinforce fundamental principles about the importance of sound money and banking, fiscal rectitude and economic freedom for creating a harmonious society. It also suggests that the adoption of a rules-based monetary regime, which limits money creation and allows competing currencies, also deserves further attention.

[1] This was the second time the Nationalist government resorted to wage and price controls; the first use was in December 1938. However, enforcement was difficult because as Chang (p. 343) notes, "The public … was antagonistic to all forms of government controls on the economy; still prevalent was the laissez faire view that market problems would best solve themselves if only the government would not interfere."

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