

The Operation and Characteristics of the Fixed Exchange Rate System in Modern China(1935.11-1938)

Hongmei Li

North China university of technology, Beijing, China,100144

Email: lhm_nuct@163.com

Keywords: Modern China; Fixed exchange rate; Legal currency; Unrestricted trading

Abstract. Starting from the introduction of Legal currency in November 1935 and ending of the beginning of foreign exchange control in March 1938, this paper studies the operation and characteristics of China's exchange rate regime in this time framed by combining historical narrative and economic analysis. The introduction of Legal currency marked the beginning of the fixed exchange rate system in China. During the outbreak of the Sino-Japanese War in July 1937, the Chinese government maintained the fixed exchange rate system by some means, but all of them took "unrestricted foreign exchange trading" as the core measure, which ensured that the foreign exchange rate of Legal currency was very stable and undervalued.

Influenced by the world economic crisis that began in 1929, China also experienced an economic crisis in 1933-1935, which forced the Chinese government to finally introduce Legal currency on November 4, 1935, it marked the beginning of the fixed exchange rate system in modern China and lasted until March 1938. Although the term is short, it has an important position in the history of China. It is of great significance to analyze its operation and characteristics for the formulation and adjustment of exchange rate policies in contemporary countries.

The Beginning of the Fixed Exchange Rate System in Modern China

During the economic crisis of 1933-1935, China was under pressure of falling prices and silver outflow. If effective measures are not taken, the outflow of domestic silver stock would be larger, and China's economic lifeline and political destiny would be unthinkable. Under this background, China began issuing Legal currency in 1935. On October 26, 1935, Xiangxi Kong's telegram showed the urgency at that time: "The currency situation is serious, the foreign exchange is weak and panic, the situation in recent months is extremely unsatisfactory, the domestic and foreign trade have been destroyed. U.S. exports to China fell by 44% in the first seven months of this year. Investors suffered heavy losses. Some important U.S. companies failed or were threatened. The government was forced to take constructive measures to control foreign exchange and avoid collapse."^[1] Therefore, the Chinese Government promulgated the "Notice of Implementing Legal Currency" on November 3, marking the promulgation of the Legal Currency Policy. The announcement contains six articles, among which the contents related to exchange rate are mainly Article 1 and Article 6, that is, "(1) Since November 4, the banknotes issued by the Central bank, Bank of China and the Communications Bank shall be designated as Legal currency... (6) the Central Bank, the Bank of China and the Communications Bank will buy and sell foreign exchange without restriction in order to stabilize the foreign exchange price to the current price."^[2]

The introduction of Legal currency formally started China's fixed exchange rate system. According to Article 6 of the announcement on the reform of Legal currency, Legal currency is non-cash paper money. It has no statutory gold content. Its value must be expressed by the foreign exchange rate. That is to say, the value of Legal currency isn't determined by cash but by foreign exchange. In order to ensure the stability of the value of Legal currency, the Central Bank, the Bank of China and the Bank of Communications will trade foreign exchange without restriction. It shows that the exchange rate between Legal currency and foreign exchange is basically unchanged and is

the fixed exchange rate system.

The world monetary system in the 1930s can be divided into two groups: the dollar group and the pound group. The Legal currency has adopted a fixed exchange rate system which is linked to the US dollar and the British pound, and has become a de facto peg to the US dollar and the British pound. After the introduction of the Legal currency, the foreign exchange rate of the Legal currency was announced by linking with the pound technically and converting the exchange rate of the pound to the dollar and the yen to the exchange rate of the United States and the Japanese yen. On November 4, the first trading day after the introduction of the Legal currency, the Central Bank announced that the opening price for the sale of foreign exchange was 14.375 pence or \$0.295, which could be traded without restriction.

The Maintenance Means of the Fixed Exchange Rate System in Modern China

From the launch of the Legal currency to the outbreak of the Sino-Japanese War (1935.11.4-1937.7.7). During this period, the Chinese government maintained the operation of the fixed exchange rate system through two major means, namely:

(1) Strengthen Foreign Exchange Reserve and Guarantee the Stability of the Value of Legal Currency.

After the reform of Legal currency, the specific amount of foreign exchange reserve of the Chinese government is inconsistent with the existing historical records. According to Yang Ge, an American financial adviser to the Chinese government, as of June 30, 1937, the total foreign exchange, gold and silver held by the Chinese government amounted to 379 million yuan ^[3]. The foreign exchange reserves of the Chinese government are mainly US dollars and pounds, and these foreign exchange reserves are preserved in Britain and the United States, forming a chain and dependence between Legal currency and US dollars and pounds. However, judging from the letter and telegram sent to Xiangxi Kong by the Central Bank on August 2, 1937, which the author consulted, China's real foreign exchange reserves at that time should be about 265 million yuan ^[4]. Although the amount was less than Yang's estimate, it also showed that the Chinese government's foreign exchange reserves were abundant at that time. These abundant foreign exchange reserves are mainly obtained through the sale of silver to the United States (see table 1).

Table 1 The amount of silver sold four times in China from 1934 to 1937

Date of contract	Agreed Sales Number	Quantity [ounces] The number of deliveries on deposit	Price [US dollars per ounce]	net income
November 1934	19,000,000	2,506,000**	53.3***	\$1 , 340,000***
November 1935	50,000,000	50,208,396	65.17&65.03	\$32,256,085
May 1936	75,000,000	75,629,077	45	34,083,085
July 1937	62,000,000	62,574,710	45	28,131,620
Total	206,000,000	190,858,183	——	\$95,761,570

Plus: ** A total of 17 million ounces of silver were purchased from London and shipped to the United States, not from Chinese silver stocks.

*** Approximate average

Sources: Arthur N. Young, Z.X. Chen et al. *Financial and economic situation of China from 1927 to 1937* (China Social Science Press, Beijing 1981), pp. 534-535. (In Chinese)

(2) Control the issuance of Legal currency to ensure the stability of currency value

The issue amount of Legal currency is closely related to the stability of its foreign exchange rate. In modern China, the circulation of Legal currency in the period of fixed exchange rate system was generally in line with the demand in circulation. The amount of money issued by the Chinese

government increased from 488 million Legal currency on November 2, 1935 to 1.68 billion Legal currency on June 30, 1937, an increase of 1.192 million yuan [5]. On the surface, the issuance of Legal currency has increased dramatically. In fact, a considerable part of Legal currency is circulating in the market instead of the silver dollar in the past. From the stability of the market at that time, the issuance of Legal currency is roughly the same as what the market needs. Table 2 reflects the issuance of Legal currency in China from June 1937 to the end of 1939. It can be seen from the table that the issuance index of Legal currency increased slowly from June 1937 to March 1938 compared with the issuance index since then. The relatively stable issuance of Legal currency ensured that the exchange rate of Legal currency remained stable during this period.

Table 2 Issues of Legal Currency in China, 1936-1938

Period	Amount of issue [Millions of yuan]	index	Central Bank Issuance Index	Bank of China Issuance Index	Bank of Communications Issuance Index	China Peasant Bank Issuance Index
June 1937	1,407	100	100	100	100	100
September	1,544	109.8	110.6	106.6	118.6	102.7
December	1,639	116.5	114.6	119	118.4	111
March 1938	1,679	119.3	118.2	128.3	101.7	125.8
June	1,727	122.7	130.3	128.1	102.7	126.1
September	1,925	137	150.7	129.8	137	123.3
December	2,267	161.1	196.4	139.5	173.2	132.4
March 1939	2,411	171.2	226.9	139.3	194.9	143.9
June	2,700	191.9	204.3	194.3	192.2	163.1
September	3,587	254.9	369.4	222.1	221.4	178.9
December	4,287	304.6	500.3	240.6	259.7	175.7

Source: People's Bank of China. *Monetary History of the Republic of China (Part II) (1924-1949)* (Shanghai People's Publishing House, Shanghai 1991), pp.290-293. (In Chinese)

The Sino-Japanese War broke out until the end of the unrestricted sale of Legal currency (1937.7-1938.3). After the outbreak of the Sino-Japanese War in 1937, in order to stabilize the financial situation and the foreign exchange rate of Legal currency, the Chinese government mainly took two measures:

Firstly, the Chinese government issued the Financial Measures for Stabilization in Extraordinary Periods to deal with the run on depositors after the war. After the July 7 Incident of 1937, Chinese financial depositors began to withdraw their deposits in banks, and the wealthy managed to convert Legal currency into foreign exchange and flow overseas. It is estimated that from July 10 to August 12, the withdrawal amounts of Shanghai Bank and Zhejiang Industrial Bank are more than 25 and 17 million yuan respectively, accounting for 16% and 17% of the total deposits. Faced with the panic in the financial market, on August 15, 1937, the Chinese government promulgated the Measures for Extraordinary Period Stabilization of Finance, which stipulated that the measures should be implemented from August 16. The purpose of this measure is to curb the run on Legal currency deposits. However, if the run on Legal currency is reduced, it will naturally curb the arbitrage of foreign exchange, thus ensuring the stability of the foreign exchange rate of Legal currency.

Secondly, the government consumes huge foreign exchange reserves and insists on unrestricted foreign exchange trading. The war began in March 1938. At the beginning of the introduction of the Legal currency, one yuan equaled two and a half Pence of sterling and one shilling, and the exchange rate of 100 yuan equaled 30 dollar remained stable. The Monthly financial and Economic

Journal in 1938 commented on the exchange rate at that time as follows: since the War of Resistance Against Japan, China's coastal provinces have been reduced to war zones, but financial stability is constant, and the foreign exchange rate can always maintain the legal price of one shilling, two pence and a half per yuan. It can be seen that, despite the market panic caused by the Sino-Japanese War, the market exchange rate at that time was still stable, and the means to ensure the stability of foreign exchange rate was to rely on the government to use foreign exchange reserves for unlimited trading.

The main component of the Legal currency policy is "unrestricted foreign exchange trading", which is an important pillar of the guaranteeing the value of Legal currency. This pillar came to an end in March 1938 when the Chinese government began to control foreign exchange. On March 12, 1938, the Chinese Government promulgated the Measures for the Central Bank's Request for Foreign Exchange Examination and the Rules for the Request for Foreign Exchange Purchase Examination, which stipulated that from March 14, only the "legitimate" demand verified by the Central Bank could supply foreign exchange, thus the control of foreign exchange started.

Exchange Rate Performance and Characteristics of China's Fixed Exchange Rate System in the Operating Stage

The foreign exchange rate after the reform of the Legal currency in China is reflected in the number of foreign currencies converted into Legal currency, which presents the following two prominent characteristics:

(1) The foreign exchange rate of Legal currency is completely decoupled from silver, and the foreign exchange rate is very stable.

After the reform of the Legal currency, the Central Bank published daily the prices of silver in London, New York and the exchange rates of Legal currency to major foreign currencies. At the same time, HSBC also published the exchange rate of Legal currencies to major foreign currencies every day. The author consults the listed exchange rates of the central bank and HSBC by Shenlun and finds that the exchange rates of Legal currency to foreign currencies are not exactly same. Generally, the foreign prices of Legal currency quoted by the central bank are higher than those of HSBC, but the two quotations have a common feature, that is, the foreign exchange prices of Legal currency are stable and change little. This stable exchange rate level can be seen in Figure 1.

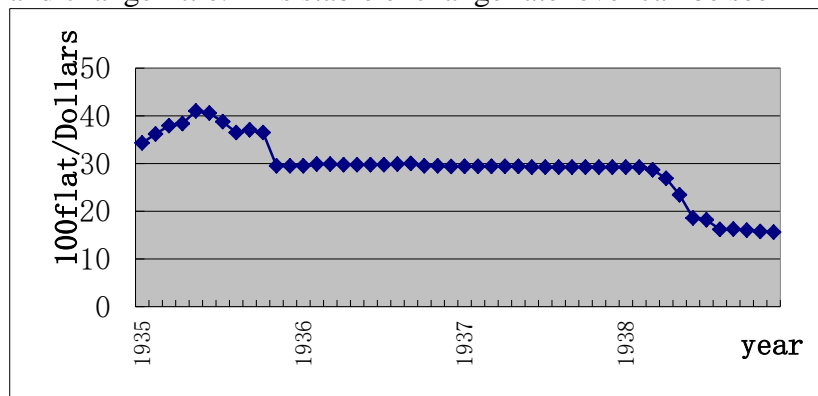


Figure 1 Monthly Exchange Rate of Legal Currency to US Dollar in Shanghai Foreign Exchange Market, China, 1935-1938

Sources: Data of 1935 and 1936 from Shanghai Institute of Economics, Chinese Academy of Sciences, Compilation of Price Data before and after the Liberation of Shanghai (1921-1957), Shanghai: Shanghai People's Publishing House, 1958:113; data of 1937 and 1938 are from 115 pages of the same literature.

Before the introduction of Legal currency, the currency used in China was silver. As can be seen from Figure 1, before the Legal currency reform in November 1935, with the rise of the world silver price, the exchange rate of the Chinese silver dollar and the United States dollar was rising. However, since the Legal currency reform in November, the exchange rate was very stable until

March 1938.

(2) Legal Currency adopts the strategy of undervaluation of foreign exchange rate

Under the modern paper money system, the basis of the exchange rate of the two countries is the purchasing power of their currencies. However, whether the exchange rate of each foreign exchange determined at the beginning of the reform of Legal currency is based on the purchasing power of Legal currency and foreign currency can not be measured. So what level is the foreign exchange rate of the Legal currency? This paper calculates the average foreign exchange rate of silver currency in 1930-1934, and compares this result with that of Legal currency in 1935 (see Table 3).

Table 3 Exchange rates and averages of Chinese silver coins against the United Kingdom, the United States and Japan, 1930-1934

year	British Exchange Rate Silver one dollar in pennies	U.S. Exchange Rate Silver 100 yuan in U.S. dollars	Japanese exchange rate Silver 100 yuan in Japanese yen
1930	14.8	29.9	59.7
1931	12	22.3	59.7
1932	15.1	22	77.3
1933	15	26.6	102.7
1934	16.3	34.3	115
Average exchange rate	14.64	27.02	82.88

Source: Editor-in-chief of Min Kong. *Data compilation of Nankai Economic Index* (China Social Science Press, Beijing 1988), p.449.

Comparing the calculated results of the above table with the fixed exchange rate at the beginning of the establishment of the Legal currency, we find that the foreign exchange rate at the time of the introduction of the Legal currency is higher than the average from 1930 to 1934. When China carried out the currency reform, it announced that the exchange rate was 1 Legal currency equal to 1 shilling 2.5 pence, i.e. 14.5 pence in British currency, which was in line with the average of 14.64 in the previous five years. However, the corresponding US dollar exchange rate was 29.750 cents and the Japanese yen exchange rate was 1.03 yen, which was not consistent with the average exchange rates of 27.02 cents and 0.8288 yen in the previous five years. The calculation shows that the Legal currency has increased about 10% against the US exchange rate and about 24% against the Japanese exchange rate. This is the case. However, when we compare the foreign exchange rate of Legal currency with that of 1934 and 1935, we will find that the situation is quite different. Comparing with the exchange rate in 1934, it is found that the exchange rate of Legal currency is lower than the average exchange rate in 1934, reaching more than 10% each. Comparing with the exchange rate level in January-October before the Legal currency reform in 1935, the Legal currency in January-October 1935 was 18.67 pence, the Legal currency in 100 was 38.10 U.S. dollars, and the Legal currency in 100 was 132.56 yen. The calculation shows that the Legal currency depreciated about 29% against the British currency, about 28% against the American currency and about 29% against the Japanese currency. Therefore, we can conclude that the exchange rate established at the beginning of the establishment of the Legal currency actually belongs to the undervaluation of the foreign exchange rate of the Legal currency, that is, the devaluation strategy of the Legal currency has been adopted.

Conclusion

Through the previous analysis, the main conclusions of this paper are as follows:

1. In order to solve the economic crisis, the Chinese government introduced the Legal currency on November 4, 1935, which opened the era of China's banknote system and became a de facto fixed exchange rate system targeting the pound sterling and the US dollar. With the disintegration of

the World Gold Group in 1936 and the spontaneous formation of the fixed exchange rate system under the gold standard abandoned by various countries, China began the fixed exchange rate system, which is just the opposite of the evolution of the world exchange rate system.

2. From the introduction of the Legal currency on November 4, 1935 to the promulgation of the "Measures for Foreign Exchange Request" by the Chinese Government on March 12, 1938, it is the period of fixed exchange rate system in modern China. The emergence of this exchange rate system is a practical manifestation of the currency reform in the field of exchange rate system in China aimed at ensuring the stability of the Legal currency. During the outbreak of the Sino-Japanese War in July 1937, the Chinese government maintained the fixed exchange rate system by different means, but all of them took the "unlimited foreign exchange trading among the three banks, which are Central Bank, Bank of China and Bank of Communications" as the core measure, which was guaranteed by the expansion of foreign exchange reserves by selling the silver to Britain and US. The foreign exchange rate after the reform of the Legal currency is completely decoupled from silver. The foreign exchange rate of the Legal currency is very stable and undervalued.

3. The Chinese government expects to maintain the stability of the foreign exchange rate of the Legal currency to ensure the stability of the currency value of the Legal currency, and by unrestricted foreign exchange trading, which is equivalent to using monetary policy to achieve external equilibrium and internal equilibrium at the same time. The regulation of unrestricted foreign exchange trading restricts the amount of Legal currency issued, because excessive issuance of Legal currency will lead to the devaluation of Legal currency. In order to ensure the stability of the value of Legal currency, the Chinese government must supply foreign currency to the market and recover Legal currency. This is equivalent to binding the internal value of the Legal currency to the foreign exchange rate, and the monetary policy of the Central Bank bears the responsibility of achieving internal and external balance at the same time. But at that time, the Chinese government's fiscal revenue was insufficient and the central bank did not maintain its independence. Eventually, in order to issue additional Legal currency to maintain fiscal operation, China's fixed exchange rate system was damaged. After March 1938, China entered a new stage of nominal fixed and real floating.

References

- [1] Editor-in-Chief of the People's Bank of China: *Data on the Monetary History of the Republic of China (Part II) (1924-1949)* (Shanghai People's Publishing House, Shanghai 1991), p.240. (In Chinese)
- [2] S. Yao: *Financial History of China* (Higher Education Press, Beijing 2007), p.324. (In Chinese)
- [3] [US] Arthur N. Young, Translated by Z.X. Chen and others: *Financial and economic situation of China from 1927 to 1937* (China Social Sciences Press, Beijing 1981), p.280. (In Chinese)
- [4] People's Bank of China: *Data on the Monetary History of the Republic of China (Part II) (1924-1949)*(Shanghai People's Publishing House, Shanghai 1991), p.279. (In Chinese)
- [5] [US] Arthur N. Young, Translated by Z.X. Chen and others: *Financial and economic situation of China from 1927 to 1937*(China Social Sciences Press, Beijing 1981), p.282. (In Chinese)
- [6] R.T. Huang: Overview and Evaluation of the Kuomintang Government's Foreign Exchange Policy during the Anti-Japanese War, *A Study of Modern History*, (1987) No.4, p.209. (In Chinese)
- [7] Y.X. Zhou: On whether China should depreciate the exchange rate at present, *Monthly Journal of Finance and Economics*, Vol. 2 (1938) No. 2, p.3.(In Chinese)