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The Great Chinese Inflation

Inflations have undermined the cultural and economic fabric of society, bringing social chaos and revolution. One example is the Great Chinese Inflation of the 1930s and 1940s. Indeed, the destruction of the Chinese monetary system during this period helped Mao Zedong's communist movement triumph on the Chinese mainland in 1949.

In the nineteenth and early twentieth centuries, imperial and then republican China had no central bank. The monetary system was based on a diverse network of private banks operating in the various regions of the country. While copper was widely used in coins, the primary medium of exchange was silver, and the entire Chinese economy functioned on an informal silver standard for most of this time. A year after Chiang Kai-shek's Nationalist Party came to power in Nanking in 1927, the Central Bank of China was established with its headquarters in Shanghai, and the country was formally put on a Chinese silver-dollar standard.

For the first two years of the Great Depression, beginning in 1929, China not only weathered the international financial and economic storm, but actually experienced an export boom, with many domestic prices rising while the rest of the world suffered a serious price deflation. But in September 1931 Great Britain went off the gold standard and a growing number of countries engaged in currency depreciation, which adversely affected the value of the Chinese silver dollar on the foreign-exchange markets.

The fatal blow came in 1933 and 1934, when, under Franklin Roosevelt's New Deal, silver was remonetized. The U.S. government went on a silver-buying spree at a price above the world price in an attempt to push up prices in the United States. As the export price for silver rose in the financial center of Shanghai, silver flowed from the Chinese countryside to the main port cities on the coast, followed by a massive export of silver from China to the United States. A resulting catastrophic price deflation severely hit both Chinese agriculture and industry.

In October 1934 the Nationalist government imposed foreign-exchange controls on silver exports. Then in November 1935 the Central Bank of China officially took the country off the silver standard, made its bank notes legal tender, and placed the country on a fiat currency with government in full control of the quantity of money.

With no restraint now on the power of the Chinese government to turn the handle of the printing press, Central Bank policy soon led to monetary disaster with the coming of China's war with Japan.

The war between China and Japan lasted eight years, from July 1937 to September 1945. The Japanese army occupied more than one-third of China, including virtually all of the country's leading port cities and industrial centers. Over ten million Chinese civilians lost their lives in the fighting.

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The end of the conflict only reopened the longstanding civil war between Chiang Kai-shek's Nationalist government and the large communist forces led by Mao Zedong. The civil war raged across China for four years, until Mao's communists were triumphant on the mainland and the remnants of Chiang's Nationalist army withdrew to Taiwan in late 1949. Another five million innocent civilians lost their lives in the civil war.

In the war years Chiang's government resorted to the printing press to finance the majority of its spending, covering 65 to 80 percent of its annual expenditures through money creation. During the civil war years of 1946–1949, monetary expansion covered 50–65 percent of the government's spending.

When war with Japan broke out in 1937, the total quantity of money in circulation (currency and demand deposits) was 3.6 billion yuan. By December 1941, when the United States entered the war, the Chinese money supply had increased to 22.8 billion yuan. For the remainder of the war years the figures were: 1942, 50.8 billion; 1943, 100.2 billion; 1944, 275 billion; and 1945, 1,506.6 billion.

The civil war brought a worse inflation. By the end of 1946, the money supply had increased to 9,181.6 billion yuan, with a more than six-fold increase to 60,965.5 billion by December 1947. Seven months later, in July 1948, the money supply had expanded to 399,091.6 billion yuan.

A New Currency

The Chinese government then created a new yuan to replace the old depreciated yuan, at a conversion rate of three million old for one new. In August 1948 the new money supply stood at 296.82 billion yuan. But the government printing presses were set to work again, and by December 1948, the supply of this new yuan was 8,186.33 billion. Four months later, in April 1949, it had been increased to 5,161,240.0 billion yuan.

From 1937 to 1949, prices rose dramatically but to different degrees in the various regions of China, because of war-related scarcities and destruction, and the uneven impact of the monetary expansion. As one very rough indicator, we can use the wholesale price index of Shanghai during this period, with May 1937 equaling 1.

By the end of 1941 the Shanghai wholesale price index stood at 15.98. By December 1945 it had reached 177,088, and by the end of 1947 it was 16,759,000. In December 1948 the index had risen to 36,788,000,000, and in April 1949 it was at 151,733,000,000,000.

The value of China's paper money on the foreign-exchange market reflected this huge depreciation of the currency. In June 1937, 3.41 yuan traded for one U.S. dollar. By December 1941, on the black market 18.93 yuan exchanged for a dollar. At the end of 1945, the yuan had fallen to 1,222 to the dollar. And by May 1949, one dollar traded for 23,280,000 yuan.

It would be an exaggeration to say that China's Great Inflation was the primary cause for the defeat of the Nationalist government and the victory of the Chinese communists. The Nationalist Party was dictatorial in its structure, notorious for its corruption and abuse of political power, and often as ruthless as the communists in its use of military force.

But it is nonetheless true that whatever basis of popular support Chiang's government might have had against the communists was undermined by the inflation. It destroyed the wealth of the Chinese middle class and drove some segments of the rural population into severe poverty. During and after the war, the government imposed unworkable price and wage controls that only succeeded in creating even more distortions and imbalances throughout the Chinese economy.

Its policies produced social and economic unrest that played right into the hands of the communists and helped bring about more than half a century of Marxist tyranny on the mainland of China. □