

A VERY SHORT HISTORY OF CHINESE PAPER MONEY

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June 17, 2004

Introduction

Most of us are aware of the extreme inflation that paper money experienced in the German Weimar republic in the 1920's. Many of us have also heard of the paper money collapse in Eighteenth century France under John Law. We are also aware of rampant inflation and fiscal crises in various third world countries from time to time.

You have probably also heard that the Chinese were the first to use paper currency. What was not clear to me was whether the Chinese experience with paper money had been a good one (it varied), and if they had also experienced paper money collapses (more than once). Since I am interested in any information which might help direct my own investments, I wondered whether there are clear historical parallels and lessons to be learned from the Chinese experience with paper money (yes and no). In particular, is the US dollar likely to collapse and what signs should we look for?

Like all good research projects, I went looking for something and found something else as well. In this case, the "something else" is some insight into Chinese culture and history itself, and at the end of the article I will give two predictions for China.

Also, a good research project raises as many questions as it answers, and this has certainly been my experience in reading up on the subject. In what follows, I'll give a very brief overview, followed by some contextual interpretation, and then try to offer some meaningful general predictions.

2500+ Years of history, 300 Years of Paper Money

That's right. Amazingly, the Chinese only used paper money on any meaningful scale for about 300 years of a 400 year period between 1050 and 1450, overlapping the S'ung, Yuan (Mongol), and Ming dynasties. There were earlier and later instances of military scrip or other emergency measures issued in dire circumstances, but for the most part these notes disappeared quite quickly. For much of its history, China used gold, silver and silk for large sums, and bronze for everyday transactions ("cash" is a Chinese word, and refers to the round Bronze coinage with the square holes).

The first use of paper was for letters of credit transferred over large distances, a practice which the government quickly took over from private concerns. The Chinese, with their great gift for pragmatism, labeled this practice "flying money".

The first real use of a paper money system was in Szechwan province, an isolated area subject to frequent copper shortages (which is a component of bronze). It had reverted to an iron currency, and paper was a very welcome option. Iron banks sprang up to facilitate the trade, and the government was quick to take over the profitable enterprise.

The S'ung dynasty was the first to issue true paper money in 1023, and it did so at first cautiously, issuing small amounts, used in a limited area, and good for a specific time period. The notes would be redeemed after three year's service, to be replaced by new notes for a 3% service charge, a neat way for the government to make money.

The abuses started immediately. Though the notes were valued at a certain exchange rate for gold, silver, or silk, in practice convertibility was never allowed. Then, the notes were not retired as they printed many more of them. The government made several attempts to support the paper by demanding taxes partly in currency and making other laws, but the damage had been done, and the notes fell out of favour.

By 1106, inflation was becoming evident as the dynasty was fighting an ongoing battle against the Mongols, which they eventually lost by 1217. In the interim, many different paper schemes were adopted taking advantage of the government monopoly on tea and salt. All of these schemes were defeated by the lack of commitment to the currency, and the increasing costs of the war.

The most successful period of paper money history in China was during the early Yuan dynasty. They greatly expanded the use of paper currency, both by issuing notes of indeterminate duration, and allowing full convertibility to silver and gold or "strings" of bronze coins. Astonishingly, they also allowed conversion of S'ung notes to their own at very fair exchange rates, greatly smoothing the succession process.

Another clever thing they did was to forbid the use of gold and silver as currency, but allow a certain amount of currency to be exchanged each year for precious metals to be used for jewelry and ornamentation purposes. They, too, also supported the currency by demanding that a certain percentage of taxes be paid in it (as opposed to commodities). Yuan currency was freely exchangeable across the whole country, and a certain period of price stability was enjoyed.

It didn't last. Eventually, the needs of fighting another war (which they in turn lost) against a nationalist minded opponent led to slow and then rampant inflation. Paper money disappeared again. The Mings revived paper currency on limited scales, but never supported it in any meaningful way. It appeared and disappeared under numerous Byzantine legal strictures and currency "reforms", finally disappearing altogether for good with the ascendancy of the conservative Manchu dynasty in the early 1500's.

China then functioned under a silver economy for 300 years, and officials who advocated paper currency were severely rebuked. It finally reemerged with the invasion of European powers in the 1800's along with the notions of solvent banks and fully convertible currencies.

Behind the History

It is difficult to make a value judgment about the use of paper during those 300 years, was it good or bad? Certainly, they all eventually failed, but from Lieng-Shen Yang in "Money and Credit in China";

"It should be pointed out that the period of paper currency...witnessed a spectacular growth of commerce and trade, while the period of silver currency which followed was one of slow but steady economic development."

Some historians interpret the whole of Chinese society as one of continuous decline from 1200 (about the time paper currency appeared?) until very recently. Certainly, up until 1949, the country had been subjugated by someone since almost 1215. There is also the classic split between the somewhat conservative inland North, and the more outgoing Southern coastal peoples.

In terms of economics, the notions of credit available to all levels of society and faith in government created money we take for granted were almost unknown. In a feudal society, business innovation is difficult. If it really was promising, the ruling class would grab it. There was no rule of law, and the only sources of capital were the pawnbrokers or what we would call today worker's cooperatives (which became an important factor in the revolution).

The financial workers were held in low esteem. For many years, their children were prevented from entering the Civil Service, and the Buddhist monasteries got wealthy from the pawn broking trade. The Mongols and the Manchus also viewed currency as a way to extract wealth from their subjugated hosts. Any monetary stability was achieved for primarily political purposes.

Later, the Mings wasted tremendous amounts of human and real capital finishing the Great Wall. It was the Maginot Line and Strategic Defense Initiative of its day, and about as useful. Kept the Mongols out, but weakened the country against Japanese pirates and Manchurian invaders.

A Reflection of the Times

The failures of currency in China are therefore set on a background of feudalism and frequent social upheavals, which make comparison to today difficult. It's a different world we live in, but a few general principles can be garnered.

So what makes a stable currency? Convertibility is good. One piece of paper for one ounce of gold or other store of value. A stable and well organized empire is good. You force everyone to use your money and demand cheap prices for what they send you. Britain did this to Canada and India. The period of stability of Chinese paper money coincided with a strong, steady extraction of real wealth from China. In fact, the use of currency to extract tribute seems to be a fairly common practice of empire throughout history.

An expanding and vibrant economy is good. You're creating real things which are worth something, people trade their real wealth for them, and it shows up in your money. Can the high tech and financial tools we have replaced primary manufacturing with achieve the same ends? I suspect not. How long will Windows dominate the PC universe? How long will the PC dominate the desktops of business? Can we invent another business revolution?

What makes a currency weak? War and other political instability is bad. You lose the war, and the victors get to use your scrip to build bonfires. The Allies forced reparations on Germany in 1919 which had the same effect. You tie the war, your money often goes bad, examples being the S'ung against the Mongols and the US after its protracted and unprofitable war in Vietnam.

Also, if you win a war against an opponent with a much worse off economy than yours, the money sometimes suffers. This was one of the problems faced by the S'ung dynasty, and was a direct factor in its military scrip rapidly devaluing. The US fought many wars in the 1800's, but the territory it seized made it well worthwhile, and it was industrialising at a rapid pace.

Playing political games with the currency is very bad. Short term gain for long term pain sums it up. Particularly noxious is an entrenched leisure class making laws about money to maintain their lifestyles. The ultimate cause of the paper money collapse in Eighteenth century France was the aristocracy living beyond its means. Huge option packages for corporate executives come to mind. Dumping gold reserves to artificially bolster a currency on the exchange markets is a definite possibility under this category.

Competing currencies is a new wild card. There is talk of OPEC demanding payment in Euros, or the reintroduction of a gold backed currency for settlement between Islamic states. The implications for the "Dollarization" of the world's economies are unclear. China had periods of multiple paper currencies in the Ming dynasty which created great confusion (see "political games", above) and all rapidly inflated.

So, in some ways, the bottom line for the US dollar is pretty clear. The US is not going to lose the Iraq or other wars, but it may not get clear spoils of victory and it is increasingly vulnerable to other kinds of attacks. A protracted Vietnam-style war in Iraq or other country would be a body blow to an already fragile dollar.

Even if it does win a clear and decisive victory with clear oil benefits, the reviving effect on the currency may only be temporary. The overall American economy is showing clear signs of saturating, much as Britain's did around 1900. The tech revolution merely postponed (and hid) the decline. At this juncture, there appears to be very few profitable new manufacturing initiatives, and for political purposes, the nation is borrowing itself into severe debtor status.

In other ways, the picture is not so clear. We are currently experiencing a huge global financial experiment. You can buy an other country's money hoping its value goes up relative to yours. You can buy gold as it might cost 6 months from now, or buy the option to sell a government bond at some price at some time hoping it turns in your favour. These numbers flash across a million computers a day around the world (including mine). Everyone wants the game to be playable. Also, the US is the only military superpower right now. They're top dog for now, and everyone is in one way or another forced to play their game.

Is the current level of financial interconnection going to provide stability or instability? I suspect stability. I'm not optimistic about my children's economic futures, but it could very well be a slow slide, not a sudden Great Depression style collapse. One thing is certain. We can't go on using the earth's resources as slavishly as we have done in the past. That reckoning process has already begun, but again, the transition to a new world may be quite slow. In many ways, the world's monetary systems have become continuous and liquid as the risk tolerance programs expect. Some market commentators in 1999 predicted a sudden collapse of the NASDAQ. It slowly deflated instead with no 1987 style dislocations.

Summing up, 300 years of paper money is a short time in terms of the history of China, but a long time in human terms. The decline of currency in the Yuan dynasty alone certainly took longer than one human lifetime. Our own society's experiment with fiat (not convertible to gold) money is only around 70 years so far. The game is still young and you can buy all the gold you want if you're worried. The large financial apparatus may indeed be able to withstand the "10 sigma" shock. A slow economic decline first evident 30 years ago has probably begun, and this slow decline will in all likelihood continue. At this juncture, however, I don't see an outright sudden collapse ahead.

Finally, what of China?

I find China fascinating, but do not claim to be a Sinologist, and have presented the bare facts here. I would have liked to have gotten some more interpretation of the culture of the times to better understand the processes involved. If I have ended up misinterpreting anything due to my cursory knowledge, I apologize.

However, I really got the sense of how much turmoil the country has been through the past 700 years, living for over 500 of them under foreign rule of one

sort or another. The country was split in two or more for large periods of time (e.g. Southern and Northern S'ung dynasties), and had to endure numerous periods of organized banditry and war lords.

One of the books I read (Introduction to the Economic History of China) was published in 1953 and the author, Stuart Kirby, made a number of startling predictions (this was just after the Communists took power). He pointed out that the Marxist doctrines for China are mostly nonsense. There was no proletariat in the classic sense. China was essentially still a feudal society, and was ripe not for communism, but capitalism.

He also pointed out that the Chinese Communists were not a break from history, but part of a continuum of the peasant's cooperatives (which provided some rudimentary banking services) mentioned before. The revolution was part of an age old battle between the values of the more agrarian North versus the entrepreneurial South. It was the Southern S'ung dynasty that had first experimented with paper currency. The Communists were essentially Northerners.

He correctly predicted that the revolution would devour itself over these problems, destroying history in particular, but would evolve away from Russian style orthodoxy;

"Eventually, China must turn again to the sunward side of the world for help and contact; then the brittle dogma of Marxism will crumble, and the party uniform, in which the past history of China is now being decked, will be contemptuously discarded by posterity."

And my prediction is that as the Chinese people become more comfortable with their newfound economic status, they will expand their cultural horizons as well. There will be a resurgence of interest in all things historical, and they will want to rediscover one of the richest and most fascinating histories of all, their own.