

CURRENT INTELLIGENCE STUDY NUMBER 36

OFFICE OF STRATEGIC SERVICES
RESEARCH AND ANALYSIS BRANCH

R & A 3344S
17 AUGUST 1945

INFLATION IN FREE CHINA

A critical currency inflation in China, mounting steadily during eight years of war, has seriously handicapped the Chinese war effort and threatened a complete breakdown of China's monetary system. Primary causes have been a severe shortage of imported raw materials and consumer goods, inadequate transportation facilities, and the Chinese Government's policy of resorting to printing press financing rather than increased taxation to cover its wartime deficits. Hoarding and speculation have subsequently aggravated the price spiral. Between 1939 and 1944 Chinese commodity prices increased at a rate averaging eight to ten percent a month (or 250 to 300 percent a year). During the winter of 1944-45 the rate accelerated sharply, averaging 25 percent a month at Chungking and reaching a maximum of 30 percent between February and March 1945. By May 1945 the purchasing power of Chinese National (CN) currency had sunk to two-thousandths of its 1937 value. Meanwhile, black market rates for gold and U.S. dollars, long undervalued in relation to goods, spurted upwards. By July 1945, coincident with rumors of impending "stabilization," the price rise had reverted to the earlier rate.

The effects of the inflation on the Chinese people, Government, and economic life have varied widely. Dissimilar local supply and demand and totally inadequate internal transportation have resulted in commodity price differences as high as 1000 percent between major urban centers. The impact of the inflation has been more severe in cities than in rural areas with a subsistence economy. Unpredictable changes in raw material costs have seriously handicapped industrial production. Opportunities for speculation have diverted the attention of wholesalers and retailers from the task of distributing available supplies when and where they are most needed.

Only the opening of normal trade routes into China can remove the basic causes of Chinese inflation. Imports of gold, textiles, or trucks by currently limited supply routes could have merely a superficial remedial effect. Of recent Government measures against inflation, the land tax in kind has been considered by some to have been the most successful. Such attempted measures as price control, Government distribution of rice and cloth, gold sales, subsidies to industry, and administrative reorganization have substantially failed to check spiralling prices. The rise has been so severe—and its variations from commodity to commodity and from time to time so diverse—that price control, retail rationing, and

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APPROVED FOR RELEASE
DATE: JAN 2002

the allocation of raw materials as known in the United States have become administratively impossible. They will remain impossible so long as the Government relies on monetary spending, insufficiently backed up by taxation of those with the capacity to pay, to obtain the goods and services it needs.

The Course of the Inflation

The course of the Chinese inflation is divisible into three periods: the first and mildest stage, from 1937 to 1940; the intermediate stage from 1941 to 1944, during which the inflation developed into ominous proportions; and the critical stage beginning early in 1945.

In 1937 the Japanese seizure of eastern coastal areas and port cities cut off major overseas supply routes, almost eliminated China's most important source of revenue, her customs duties, and denied Free China the use of infant industries which had been slowly developing in those areas since 1927. Forced to retreat into the interior of China, the Government lost not only its customs revenue but its principal sources of internal revenue, salt taxes and excises. Rather than substitute new forms of taxation to cover its wartime deficits, the Government embarked on an ill-fated policy of deliberate currency inflation. From then until the end of 1940, the currency in circulation expanded to 5.6 times the 1937 total. By 1940, prices which had lagged at first were already increasing at a faster rate than currency in circulation.

Attempts to build an industrial base in the interior to provide for military and civilian requirements were limited in their success because of a lack of raw materials, transportation, and plant capacity. With the transfer of the capital to Chungking in October 1938, some 600 factories and millions of refugees migrated to western China from the middle and lower Yangtze region, new industries sprang up, and local industrial and agricultural production increased. These developments tended at first to hold back prices. In the summer of 1940, however, the virtual isolation of China from the outside world resulting from the Japanese occupation of Indochina and the temporary closing of the Burma road gave a new impetus to the upward trend.

During the next period from 1941 to 1944 the amount of currency in circulation doubled or more than doubled each year. Commodity prices at first rose 2½ times in a year and finally more than tripled in 1944. Hoarding and speculation intensified the shortages of food and cloth. There was a breakdown of any semblance of price control and a widespread growth of black markets.

As prices soared money lenders and landlords began to adopt the practice of fixing loans, interest, and rent in kind rather than in money. In 1941 the Government itself began collecting the land tax in grain. The substitution of grain as a means of payment provoked growing loss of confidence in the currency and led to a shift from money to goods as a medium for saving. Buying in advance of needs, bartering, cur-

rency speculation, and hoarding of foreign exchange, particularly United States dollars, became widespread practices in the larger cities. The levy of the land tax in kind decreased the grain supplies available to the public and was partly responsible for raising the price of food-stuffs out of proportion to prices of other commodities. In Chungking, for example, food prices advanced from approximately 3 percent per month in 1939 to approximately 17 percent per month during 1940.

The intermediate stage of the inflation came to a close in the fall of 1944. The westward Japanese drive in southern China and the ensuing period of uncertainty caused a slackening in the rate of increase in prices, although the upward trend continued. Speculators turned to gold and United States dollars as easily transportable forms of wealth. Continued Japanese advances would have made further hoarding of goods useless, and caused losses on existing hoards. Nevertheless, the threatened loss of large and valuable areas of Free China, diminution of confidence in the Government's stability, and the threatened prolongation of the war were enough to keep prices rising, if less rapidly than before. In Kweiyang the influx of hundreds of thousands of refugees created demand for more than the amount of goods released from hoards and drove prices above those in any other city in Free China.

Early in 1945, when the military situation had been more or less stabilized, the price index resumed its spiral at a new average monthly rate of 30 percent in some cities and nearly 50 percent in Kunming. Although in April and May the monthly rate of increase tapered off somewhat, the total rise over six months was unprecedented, amounting in many places to a tripling of the price level. A continuing rise at the new rate would have meant a ninefold increase in twelve months.

The most important factor behind this development was the increase in Government borrowing to foster war production and to improve army rations and pay. New demands of the Chinese War Production Board and added demands of the American and Chinese armies cut sharply into the supply of available goods and at the same time flooded the market with more currency. For example, rice from the collection of land taxes in kind supplemented by grain purchases proved inadequate to cover the expanded food allowances of the Chinese Army under the new ration and pay scales of October 1944 and February 1945. The U. S. Army Services of Supply in China was asked to procure local supplies for 36 Chinese divisions at Chinese Government expense. In addition to increasing appreciably the new currency issues, the transaction has considerably diminished civilian food supplies.

The increase in currency in the four months from December 1944 to March 1945 totalled CN\$76 billion, three times as great as in the corresponding period a year earlier. New currency issued to the U.S. Army for its expenditures represented 17 percent of the total new currency issued from 1 February 1944 to 30 April 1945. Approximately 8 percent of the new currency issues in January-April 1945 resulted from Chinese

War Production Board loans. The impact of these expenditures on market supplies and prices, naturally most severe in the immediate region of disbursement, soon spread to other urban centers.

In addition to these factors the announcement in December 1944 that the Stilwell Road would be used only for military supplies caused renewed hoarding of scarce commodities. Speculators transferred their attention from gold and United States dollars back to cotton and other goods. The loss of important cotton producing areas to the Japanese in 1944 and the deficiency of the cotton purchase program in the remaining producing areas had already limited the amounts available for fabrication in the cotton mills of Free China. Ineffective threats by the Government to do something about price control after its long record of failure increased public interest in hoarding. At the same time the deteriorating price relationship of raw materials to finished goods caused a decline in industrial activity and an aggravation of the commodity shortage.

In June 1945 the exceptionally violent phase of price increase came to at least a temporary end. Both before and after this time, rumors were heard in Chungking and Kunming of an impending stabilization of the Chinese currency. The market rate in Kunming for the U.S. dollar had been CN\$590 in February and March, less than 200 times the 1936-1937 rate. Similarly, the Chungking market price of gold in February was only a little over CN\$35,000 an ounce, corresponding to a CN\$-US\$ rate of about 1000 to 1, or approximately 300 times the prewar rate. With commodity prices already 500 to 2200 times prewar in various cities, there was a very wide margin to attract speculative interest in gold and U.S. dollars. Stabilization would presumably call for an upward adjustment of the relatively low gold and U.S. dollar rates and a downward adjustment of many commodity prices. Meanwhile the Government took steps to readjust the official gold price upward in March and again in June, though both times it failed to narrow the gap between official and market prices, which had reached significant proportions as early as December 1944.

The consequence was a new cycle of market developments, similar in some respects to what had happened in 1944. Speculative pressure shifted first from commodities to gold and when the Government suspended official gold sales on 25 June from gold to the U.S. dollar. Before suspension of sales the official gold price had been raised to CN\$50,000 and the market price had reached CN\$100,000. Between 30 June and 12 July the market rate for dollars in Chungking rose and fell from CN\$2400 to CN\$3300 and back again. At the lower level, this rate was about 800 times the prewar rate. Meanwhile the wholesale commodity price index at Chungking, which was 963 times the prewar level in February, advanced to 1893 in May and well over 2000 by the end of June.

Regardless of month-to-month shifts in the spiral of inflation, which may at times suggest something like a stabilization of commodity prices,

when compared with more violent phases a few months earlier, it is clear that the price trend is still strongly upwards and that inflation of the currency is continuing at an accelerating rate. The velocity of circulation is increasing, though the stage has not yet been reached, especially in agricultural areas, where the increasing rate of circulation reflects a complete and absolute distrust of currency.

Effects of the Inflation

The character of China's economy is to some extent a buffer against the violent impact of the inflation. The near self-sufficiency of agricultural communities, their dependence on cottage industry, and the customary use of cash rather than bank deposits in the hinterland tend to curb the effects of inflation in rural areas. The extent to which China's agrarian economy can absorb the increasing shocks of further currency depreciation depends primarily on the rapidity of depreciation. The Government's attempts to keep the inflation within bounds now appear to be relaxing in favor of rehabilitating the physical condition of the army regardless of the monetary outlay required.

Inflation at first affected the fixed salary groups and urban and industrial laborers more drastically than the entrepreneurs or large and small landowners. After the inauguration of land taxes in kind, compulsory sales and loans to the Government, and forced contributions of grain, the burden of forced saving also fell on the small landowner and tenant farmer. Loss of land to the Japanese has necessitated heavier grain collections from remaining agricultural areas. However, the provinces where the heaviest land taxes are levied are not necessarily those with the largest crop yields. More often those nearest the regional center where the Central Government's control is strongest and those nearest the Japanese lines where army demands are heaviest bear the largest burden. As forced crop levies increased and the currency depreciated, the peasants resorted to their age-old defense of withholding surpluses and even reducing production.

The inflation had a disastrous effect upon the lower ranks of government employees, the army, school teachers, and clerical and factory workers. Their real incomes had declined by the end of 1944 to less than 10 percent of prewar values. Coolie laborers fared comparatively better because they received a large percentage of their wages in rice. The effects of the failure to adjust soldiers' pay and allowances to rising price indices and of inefficient and corrupt handling of rice rations were graphically shown in the fall of 1944 when malnutrition and debilitation in the Chinese Army prevented serious resistance to the advancing Japanese.

The entrepreneurs and the large landowners (landlords) in China may be said to have had a vested interest in inflation. Although many industrialists lost a large portion of their investments as the Japanese occupied the middle Yangtze and coastal cities, they set up new industrial

plants in the interior and have been able to take advantage of rising prices to make up their losses. The lack of an adequate Chinese income tax absolved them from contributing their share to the cost of the war. From the Government's point of view their knowledge, experience, and wartime fortunes were necessary to accomplish China's industrial program. The landlords, although they received an initial setback because of their creditor position, have benefited increasingly from their control of a sizable share of China's agricultural production as prices continue to rise. By fixing in kind the payment of rents, interest, and tenants' guarantee deposits, the landlords have been more than able to cover their own land taxes. In many cases, because of their local political position and influence with the tax collector, they have been able to avoid payment of more than a nominal tax, and to pass the tax burden on to the small landowners and tenant farmers.

Government officials, who were drawn mainly from the landlord and entrepreneur classes, adjusted to inflation in traditional ways. If they considered their salaries and rice allowances insufficient, they commonly resorted to the acceptance of rebates or commissions on Government contracts, the acceptance of gifts in return for official favors, or speculation in commodities, gold, or foreign exchange with the benefit of inside knowledge.

After the rate of increase of prices exceeded that of currency issue, the Government became aware that gains in production would be difficult to attain and that the maintenance of production levels would require pumping currency into the economy at an increasing tempo that would accelerate the inflation. Most of those firms which were able to take advantage of fixed raw material costs, subsidies, tax exemptions, favorable contracts, and convenient advance payments, and were consequently able to continue operations, were Government enterprises producing almost exclusively for Government or army consumption. Some of the more essential idle plants were taken over and integrated with Government plants. Owners of other plants found it more profitable to turn to speculation in goods. Short of complete control of supplies and prices or a fundamental change in the Government's inflationary policy, little could be done to correct the inequities affecting particular industries after 1941.

Counterinflationary Measures

The Chinese Government's efforts to control inflation have been seriously hampered by the Government's technical and administrative weaknesses and its lack of revenue sources. The Chinese people, belonging principally to small, agrarian, economically independent village groups, have become adept at resisting tax payments of all sorts. With inadequate tax collecting machinery, taxes must be levied where they can be effectively collected—for example land taxes, excises, customs duties, and revenue from Government monopolies. Furthermore, the Government's political insecurity has necessitated the appeasement of

the landlord and warlord groups, and a diversified tax policy has not been developed.

Since 1937 the Government, with varying degrees of success, has tried numerous means of controlling inflation, including tax increases, fiscal economies, administrative reforms, measures to absorb currency from circulation, measures to improve production, transportation, and distribution facilities, reorganization of Government monopolies, and price control and rationing of essential goods.

Excises and land taxes have been increased, but their yield in 1944 met only 19 percent of budget requirements. The land tax has been considered the most effective means of countering inflation for a number of reasons. It has given the government a reserve of grain to feed into the market as a damper on rising prices. The use of a portion of the collection as partial salary payment to government employees and army personnel has achieved a double saving. It has postponed the need for salary increases, which would necessitate increased currency issue, and has eliminated competitive Government purchases, which would further boost prices. Not all the effects of the land tax in kind have been salutary. With the necessity of expressing monetary values in terms of grain, popular confidence in China's monetary system decreased and hoarding resulted. Tax in kind increases were accompanied by increased rents on land already producing at maximum capacity. Landlords with increased rent in kind collections entered the speculative market.

Administrative and policy reforms have avoided such drastic measures as increasing tax bases, expropriating hoarded goods, commandeering essential industries for war purposes, and strengthening the Central Bank as an effective organ for monetary management. Some logical reorganizations and shifts of function among government agencies, aimed at improving operating efficiency, have taken place.

The Chinese Government in early 1942 began to try to reduce the amount of currency in circulation through the sale of U.S. dollar-backed certificates and later through the sale of gold. Between February 1944 and May 1945 sales of gold worth US\$97 million brought in CN\$60 billion, while the nominal total of currency in circulation increased by approximately CN\$200 billion. However, some of the gold found its way into Occupied China, where it brought an even higher price. This caused an inflow of Chinese National currency which had previously been outside the economic orbit of Free China.

When the blockade of China cut the supply of goods on the market, production had to be encouraged not only so that China could wage war against the Japanese, but also to counteract the effect of competitive bidding on scarce articles, which tended constantly to drive prices beyond a point of control. The prewar National Resources Commission was given additional power to foster industrial production after the Government moved to Chungking. But NRC-operated concerns as well as

private factories showed little increase in heavy industry production after 1940, partly because of the obstacles created by rising costs. The inability of the NRC to coordinate production of materials and final products and the general deterioration of China's industrial fabric led to the establishment of the Chinese War Production Board in November 1944. The Board has had some success, but the increase in production has been quite inadequate to allay the danger of mounting inflation. Its net effect has been to put added pressure on prices, directly because it created additional demand for scarce materials, and indirectly because one of its main functions was to advance new money to contracting companies for working capital. Thus the WPB, like the U.S. Army through its construction activity, has become a significant contributor to inflation.

Government "monopolies" of salt, sugar, tobacco, and matches have functioned chiefly as excise tax administrations and have not been able to increase production appreciably or to attempt general rationing. Salt prices are controlled, but the tax on this article of universal consumption yielded 39 percent of total tax revenue in 1944.

During most of 1942 a "Commodity Administration" of the Ministry of Economic Affairs undertook to purchase and resell at controlled prices important consumer goods such as cloth, paper, fuel, and vegetable oil. Its success was slight and it was abolished at the end of that year.

The Government has passed many resolutions and regulations to enforce price controls, but their effect has been negligible. The remoteness of other urban markets from Chungking and from each other has limited the influence of Central Government efforts and left to the discretion of local food and price control committees the adjustment of local prices according to local conditions. Price ceilings may have had some moral effect in Chungking, where the Government's influence was greatest, but the merchandising operations of the Government were on too small a scale and confined to too small an area to mitigate the country-wide inflation.