

Challenges and Achievements of the Nanjing National Government's Fiat Currency Reform from 1935 to 1937

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Abstract. The Fiat Currency Reform in China holds a significant milestone in its financial history. In the 1930s, the Nanjing Nationalist government successfully tackled the deflation caused by the silver crisis and achieved national currency unification through currency reform. Simultaneously, this reform drove domestic economic development, preparing the nation for the subsequent resistance against Japanese aggression. Before this period, numerous scholars had examined currency reform. However, few have connected this policy and its profound impact on the current economic situation. This paper aims to study the currency reform by analyzing its historical context, specific measures, and its effects. It also summarizes its relevance to contemporary China's economy. Presently, China faces issues such as economic stagnation, a sluggish domestic market, and a heavy debt burden. The Chinese government can draw lessons from the currency reform by implementing policies like increased currency issuance and lowered interest rates to stimulate the market, attract foreign investment, and find a way forward for the future development of the Chinese economy.

Keywords: China, Fiat Currency, Nanjing National Government, Great Depression, KMT.

1. Introduction

Monetary policy plays a crucial role in a nation's economy, influencing aspects such as economic stability, growth, and inflation. It can control price increases, maintain a stable level of inflation, adjust interest rates to stimulate or restrain investment and consumption, promote economic growth, affect a country's exchange rate, and influence international trade and competitiveness. Additionally, sound monetary policy shapes market confidence, encouraging investment and consumption.

In the mid-1930s, the newly established Nanjing National Government of the RC was burdened by high military expenditures, debt, and infrastructure development costs. The outflow of silver caused by the implementation of the U.S. silver policy further worsened its financial situation. Against this backdrop, in November 1935, the National government announced the abandonment of the silver standard and the adoption of fiat currency, known as the currency reform. This policy significantly rescued China's economy at that time and effectively stabilized the economic situation in several subsequent political and wartime crises. Moreover, it holds great significance in the entire history of Chinese finance.

Today, China's economy is facing a downward trend and significant external pressures. Although circumstances have changed, some of the problems confronting the Chinese economy remain the same. By summarizing the experiences and lessons from the Nationalist government's monetary policy, we can still seek solutions for the current challenges.

2. Background and motivation

2.1. National Economy and Banking Sector Development

In 1931, China's industrial production index increased by 32.1% compared to 1927[1], and a relatively stable domestic environment facilitated rapid development in the national economy. Details of the development in several key industrial sectors can be found in Table 1. Simultaneously, the banking sector also experienced significant growth. According to statistics from the "National Banking Yearbook," during this period, the number of Chinese-owned banks increased from 171 in

1927 to 315 in 1931, marking a 25.7% increase. This period witnessed a flourishing state of development in China's banking sector.

Table 1. Overview of the development of machinery, textile and chemical industries from 1927 to 1936 (units: yuan) [2]

Year	Engineering industry		Textile industry		Chemical industry	
	Increase in amounts	Index	Total Amount	Index	Total Amount	Index
1927	194060	100	89743472	100	22073168	100.0
1928	778180	400	101052472	112.5	24885941	112.7
1929	1626450	837	107572102	119.8	26493841	120.0
1930	4304500	1908	121941222	136.0	28531939	129.2
1931	4809700	2168	133813512	149.1	32679239	148.0
1932	5875146	2717	139856452	155.8	34184039	157.6
1933	6701446	3148	145614002	162.2	37327439	169.0
1934	7433546	3525	156195302	174.0	40995439	185.7
1935	8028746	3832	190309207	199.8	42791439	193.9
1936	8681496	4168	202218142	255.3	43912439	199.0

2.2. Increase in Government Credit

The implementation of currency reform required not only a strengthened government financial capacity but also the establishment of government credibility, especially the latter, which holds significant importance in economic and financial activities. In 1935, the Nanjing National government restructured the Bank of China and the Bank of Communications, ensuring control over these two most powerful domestic banks. A brief financial crisis that emerged in early 1935 was quickly resolved, partly due to the government's financial strength and credibility. Additionally, successfully controlling the financial crisis further enhanced the government's reputation. By 1937, government-controlled bank assets totaled approximately 5.4-billion-yuan, accounting for about 74% of the total assets in the banking industry. Private banks, numbering around 120, comprised only 26% of the total banking industry assets. The Nationalist government's financial strength was in an overwhelmingly advantageous position, significantly boosting its credit and altering the long-standing dependence on banks that had persisted since the Beiyang Government.

2.3. Impact of the Silver Crisis

From 1929 to 1933, the capitalist world experienced the Great Depression, and after 1931, many countries abandoned the gold standard, making it no longer possible to simply price silver in terms of gold. This resulted in significant fluctuations in international silver prices, as seen in Figure 1.1. These changes in silver prices had a profound impact on China's monetary system. In 1934, the implementation of the U.S. Silver Purchase Act led to substantial silver outflows. In that year, China's silver outflow reached 200 million yuan, and by 1935, it had increased to 600 million yuan [3], causing severe deflation in China. To stabilize the domestic economy and consolidate its rule, the Nationalist government had no choice but to implement currency reform, abandoning the silver standard to mitigate the impact of silver outflows on the Chinese economy.

2.4. The Situation of Domestic Deflation and Foreign Inflation

Before the currency reform in 1935, China's economy and finances were facing a severe crisis, primarily characterized by recurring issues of "deflation" and a "tight money supply" as repeatedly mentioned in the annual reports of Chinese banks [4]. The outflow of silver resulted in a reduction in the circulating currency, leading to a contraction of the money supply. Concerning foreign-owned banks, a significant decrease in silver deposits naturally led to the need to "restrict credit operations"[5]. The tightening of market funds around the Chinese New Year of 1935 inevitably affected industrial and commercial operations. Wu Tiecheng, the Mayor of Shanghai at the time,

reported to Chiang Kai-shek, stating that the emergence of difficulties in Shanghai was mainly due to "the emptiness of silver chips overflowing abroad, the financial industry's self-absorption, and the consequent adoption of an extremely conservative policy, which severely affected industry and commerce". In stark contrast to the severe domestic deflation in China, major countries worldwide were implementing economic stimulus policies with inflation. Due to the active implementation of inflationary policies by various countries, currencies were devalued. From 1931, the United Kingdom and Japan, as well as countries within the British pound sterling bloc, began to devalue their currencies. In 1932, the United States also decisively abandoned the gold standard, reducing the value of its currency. By the spring of 1934, the U.S. dollar's value had decreased by a staggering 40%, while the British pound had depreciated by more than 40%, and the Japanese yen had depreciated by as much as 65%. The UK, the U.S., and Japan collectively accounted for 70% of China's foreign trade, and the devaluation of these three countries' currencies dealt a heavy blow to the Chinese economy, which was based on the silver standard and unable to devalue its currency arbitrarily. As of 1931, the average exchange rates for silver were: 12 pence for the British pound, 22.2 U.S. dollars, and 45.2 Japanese yen. By December 1934, the exchange rates for silver had risen to an average of 16.5 pence for the British pound, 33.9 U.S. dollars, and 116.4 Japanese yen, representing increases of 37.5%, 52.7%, and 157.5%, respectively. The exchange rate for silver in Shanghai, with 1931 as the base year (100), had increased to 128.3 in 1932, and then further to 145.9, 173.1, and 199.2 in 1933, 1934, and 1935, respectively, nearly doubling in just four years [6].

2.5. The Demand for Unified Currency

Around April 1927, when Chiang Kai-shek established the Nanjing National government, various forms of currency, including silver dollars, Mexican silver dollars, sycees, and independent currencies issued by local warlords, were in circulation in the Chinese market. For example, Yan Xishan issued Jin Chao (Shanxi banknotes), Sichuan copper coins circulated in the Sichuan region since the late Qing Dynasty, and Soviet currency issued by the Communist Party in their controlled areas. From Chiang Kai-shek's perspective, currency reform was not just an economic issue; it was also a political issue. By unifying the currency system, he aimed to break down regional barriers and achieve uniformity in national orders and military commands. This was a matter of paramount concern for Chiang Kai-shek as a political leader. Besides Chiang Kai-shek, Chen Guofu also suggested, "We can use this loan (referring to the American Cotton and Wheat Loan) to carry out the unification of the currency system and the consolidation of the central bank, making the government politically and economically independent from the control of the Shanghai financial sector"[7].

2.6. Financial Crisis Caused by War

From May to October 1930, warlords belonging to the Guizhou clique (Li Zongren), Shanxi clique (Yan Xishan), and Northwestern clique (Feng Yuxiang) allied against Chiang Kai-shek's Nanjing National government. They aimed to seize power and challenge the Nanjing government, leading to intense battles in the Central Plains region. The total military forces involved on both sides reached a staggering 1.4 million, imposing a heavy burden of military expenditure on the Nanjing Nationalist government. In some cases, the government had to rely on loans to maintain its operations and military expenses (see Table 2). After the end of the Central Plains War, although there were no warlords capable of directly challenging the central government, the Nationalist government still faced pressure due to the Soviet Union's actions on the Eastern Route, Japan's January 28 Incident (Shanghai Incident), and the September 18 Incident (Mukden Incident). Expenditures for the five "anti-communist" campaigns and the large-scale training of new-style military forces exacerbated the financial crisis of the Nanjing Nationalist government. Chiang Kai-shek himself acknowledged this, stating, "The central government is facing financial difficulties. It is not easy to accumulate large sums of money. In the past two years, we have encountered national crises. Military expenses have been reduced, and there is still a lack of funds to cover temporary expenses"[8].

Table 2. Statistical table of financial expenditure of Nanjing National Government from 1928 to 1931 [9]

Year	Total Expenditure (100 million yuan)	Total military expenditure (100 million yuan)	Percentage (%)	Aggregate Liability (100 million yuan)	Percentage (%)
1928	4.34	2.10	48.3	1.60	36.8
1929	5.19	2.45	45.5	2.00	37.1
1930	7.14	3.12	43.7	2.90	40.6
1931	6.83	2.03	44.4	2.70	39.4

3. Concrete schemes

Before implementing the fiat currency policy, the Nanjing National government initiated a restructuring of the banking system. In early 1935, Chiang Kai-shek and Kong Xiangxi (H. H. Kung) conducted a capital increase and restructuring of the Bank of China and the Bank of Communications, establishing three major government banks: the Central Bank, the Bank of China, and the Bank of Communications.

On November 1, 1935, an assassination attempt on Wang Jingwei occurred at the opening of the Sixth Plenary Session of the Fourth Central Committee of the Kuomintang (Nationalist Party). To prevent potential financial market turmoil, on November 3, 1935, the Nationalist government announced the long-planned fiat currency policy. The main contents of this policy included:

(1) Starting from November 4, 1935, the banknotes issued by the Central Bank, the Bank of China, and the Bank of Communications were declared as fiat currency. All transactions involving grain payments, taxes, and any public or private funds were to be conducted exclusively in fiat currency, and the use of cash was restricted.

(2) Except for the Central Bank, the Bank of China, and the Bank of Communications, banknotes previously approved by the Ministry of Finance for circulation were allowed to continue being used. However, the circulation amount was limited to the total amount in circulation up to November 3. No further issuance was permitted. The Ministry of Finance would determine a deadline for gradually exchanging these banknotes for central banknotes. The statutory reserve funds for fiat currency, along with newly printed but not yet circulated banknotes and the old banknotes that had been withdrawn, would all be placed under the custody of the Issuance and Reserve Management Committee. Newly approved banknotes to be printed would also be handed over for safekeeping when printed.

(3) The custody and issuance exchange matters related to the fiat currency reserve funds would be managed by the Issuance and Reserve Management Committee.

(4) Individuals, banks, businesses, and other public or private entities holding silver standard currency or other forms of silver coins, raw silver, and the like would be required to exchange them for fiat currency starting from November 4.

(5) Existing contracts based on silver coin units would be settled in fiat currency at the original agreed-upon amounts upon their maturity.

The Central Bank, the Bank of China, and the Bank of Communications had unrestricted authority to buy and sell foreign exchange [10].

4. Challenges

4.1. Hindrances to Public Circulation

Due to the long history of silver being used as a medium of exchange in China, dating back to the Ming Dynasty, the sudden abandonment of the silver standard and the adoption of paper currency were initially difficult for ordinary citizens to accept. Therefore, when fiat currency was first issued, people continued to use silver for private transactions. Additionally, the rampant smuggling of silver, brought about by the outflow of silver, was hard to control, especially in coastal areas. On December 5th, Chiang Kai-shek sent a confidential telegram to provincial governments, pacification bureaus,

city governments, and security command headquarters, instructing them to strictly crack down on the hoarding and illegal export of silver coins and silver in order to profit from price disparities, as requested in Kong Xiangxi's telegram on December 4th. The directive stated, "Conduct thorough investigations, and upon discovery, promptly deliver the cases to the courts for strict punishment, leaving no room for negligence [11]. Furthermore, differences in economic conditions across various regions of the country also posed obstacles to the circulation of fiat currency, with inland and remote areas like Gansu and Sichuan facing particularly severe challenges.

4.2. Profiteering by the Elite

The issuance of the new currency provided an opportunity for the elite class to profit. They attempted to amass wealth through excessive currency issuance. As the expansion of the currency supply was put into practice, inflation became inevitable, and the fiat currency reform took an irreversible path. In the first two years of fiat currency issuance, the value of the currency remained relatively stable, with 1 yuan of fiat currency equivalent to 1 yuan of silver. However, starting in the latter half of 1937, with the outbreak of the Second Sino-Japanese War, the National government began to overprint paper money, leading to skyrocketing prices and a vicious cycle of hyperinflation. In 1937, the National government issued 1.4 billion yuan in fiat currency. By 1945, this had risen to over 500 billion yuan, an increase of 360 times. In August 1948, the Nationalist government replaced fiat currency with the Gold Yuan, and the total issuance of fiat currency exceeded 66 quadrillion yuan, causing prices to increase by a staggering 34.92 million times [12]. The economy of the government-controlled areas collapsed entirely, becoming one of the primary reasons for the KMT's retreat to Taiwan.

5. Achievements

5.1. Mitigating Mild Inflation Alleviated Deflation

The implementation of the fiat currency reform effectively mitigated the deflationary issues in the RC at the time, and the notion of a moderate inflation policy was closely aligned with the growing call for currency reform. As early as April 9, 1935, the Japanese Embassy in Shanghai sent a telegram to the Japanese Foreign Ministry, discussing China's upcoming implementation of an exchange certificate system and its intention to combat domestic financial panic through a policy of inflation. The economist Zhang Naiqi foresaw the need for moderate inflation measures as part of the currency reform, emphasizing that these measures should serve the interests of farmers and domestic industries, maintain relative balance in foreign trade, and transform savings in Shanghai into foreign deposits. He pointed out that the goal of moderate inflation should be "economic, not financial." The economist Mei Yuanmou, based in France, was even more direct, stating that the policy of reform wisely aimed to establish the fiat currency on a new basis with an approximately 40% devaluation [13]. Yang Ge, an economic advisor to the National government, later noted that the 1935 currency reform was a decisive turning point, successfully stabilizing exchange rates and halting deflation, thereby injecting new vigor into the economy and strengthening confidence in the future.

5.2. Enhanced Resilience to Risks

The implementation of the fiat currency policy abolished the silver standard and effectively adopted a foreign exchange standard, mitigating the impact of international fluctuations in the gold-silver ratio on China's financial system since the late Qing Dynasty. It established China's currency at a more reasonable level of international exchange rates, helping the country's industrial and commercial economy further escape the negative effects of the global economic crisis. It also provided a sound institutional framework for the revitalization of the financial industry [14]. The implementation of the fiat currency policy also reduced the impact of political turmoil on financial markets. On March 7, 1937, Zhu Boquan, the manager of the United Preparedness Committee of the Interbank Association in Shanghai, commented on the events of the past year and remarked that every

event had given them reason to believe that the economic situation was showing clear signs of recovery. The political difficulties such as the tension in Sino-Japanese relations and the Xi'an Incident had only caused ripples on the surface of the Shanghai financial market. This was undoubtedly partially attributed to the currency reform measures implemented in November 1935, which overcame all fears of currency shortages. Zhu Boquan noted that if the same political changes and crises had occurred before the new currency policy, the situation might have been much worse [15]. It can be said that the fiat currency policy was the Nationalist government's response to the silver crisis, but on another level, it ushered in a new era, promoting the stabilization and recovery of China's economic conditions. In addition, the government, through the fiat currency reform, concentrated a large amount of cash reserves, significantly increasing its economic strength and laying the economic foundation for the outbreak of the anti-Japanese War in July 1937.

6. Conclusion

6.1. Significance for the Republic of China at That Time

The replacement of silver with fiat currency as China's official currency marked a historic milestone in Chinese financial history. It allowed China to move away from the outdated metallic monetary system, opening doors to catch up with global economic development trends.

The National government in Nanjing skillfully leveraged the fiat currency reform to achieve multiple objectives: it strengthened central control over local economies, consolidating national unity; successfully alleviated the severe domestic deflation, stabilizing the Chinese economy; regained control over the foreign exchange market from foreign powers, stabilizing exchange rates and enhancing China's international competitiveness; bolstered the central government's ability to manage funds, facilitating economic adjustments and preparations for the upcoming war.

6.2. Relevance for Modern-day China

China's economy is currently experiencing an overall downward trend, with a GDP growth rate of only 3% in 2022, compared to a high of 6.1% in 2019 [16]. In terms of imports and exports, in June 2023, mainland China's total import and export value decreased by 10.1% year-on-year, with exports decreasing by 12.4% and imports decreasing by 6.8%. The real estate sector, which is considered a pillar of the Chinese economy, is also in a downturn. Starting from April 2022, real estate investment has decreased month by month, reaching a severe 10% decline in October 2022, and that month's sales of commercial real estate also decreased by 26.7%. Unemployment rates have also risen significantly, with youth unemployment reaching an unprecedented 21.3% by June 2023 [17]. In addition, in mid-August, the exchange rate of the Chinese yuan against the US dollar briefly exceeded 7.3, causing adverse effects on the market. The A-share market has been declining since August 3rd, with the Shanghai Composite Index falling from 3322.13 to 3082.24 at the close on August 25th.

Today, although the situation is quite different, the Chinese government can still draw lessons from the methods used by the Nanjing National government in the past to alleviate economic pressure through monetary policy adjustments. The government can increase the money supply, even directly provide additional subsidies to citizens, reduce tax rates, and employ other policies. This can promote short-term consumption, increase domestic market demand, and at the same time, utilize currency devaluation to expand foreign trade and attract foreign investors to invest in China.

However, the fundamental problem in the Chinese economy lies in the side effects of rapid economic development over the past three decades. The rapid development of cities has created a large number of job opportunities but also brought enormous living pressures. Many young people cannot afford the high cost of living and housing on their own and have to support themselves through personal loans and other means. This will lead to a significant portion of their income being devoted to loan repayments in the coming ten or even thirty years, reducing consumption. Some believe that it is the bond market, rather than the stock market, that supports China's economic development, and this viewpoint now seems to have some validity. To address such issues, the Chinese government has

already taken some measures. For example, after 2022, the Chinese government introduced over 4.2 trillion yuan in tax reductions, fee cuts, and tax refunds, reducing the tax revenue as a percentage of GDP from 17% in 2018 to 13.8% in 2022 [18]. At the same time, after the National Two Sessions in 2023, mortgage interest rates in various regions were further lowered to stimulate the real estate market and reduce the burden of home purchases for young people. In the future, the Chinese government should continue to reduce tax rates and mortgage interest rates, as well as lower commodity taxes. It should also provide low-interest or interest-free loans to young people and offer living subsidies to alleviate the burden on citizens. In the long term, the Chinese government should gradually abandon the debt-driven economic structure and rely on the development of the consumer market to drive economic growth, while increasing the role of monetary policy in the market.

In summary, the immediate priority for the Chinese government is to adjust the industrial structure, stimulate the domestic market, attract foreign investment, and achieve a virtuous economic cycle.

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