On Thursday, October 24, 1929, the New York stock market crashed. This event, called Black Thursday, signaled the start of the unprecedented economic crisis known as the Great Depression.

The catastrophe was a global phenomenon: its effects were so far-reaching that it seemed almost impossible for any economy in the world to evade a serious slump. The crash on Wall Street led to a financial crisis, followed by the collapse of the United States’ lending policy. As deflation spread from country to country via international financial links, these countries’ purchasing power declined. The resulting downturn in international trade encouraged protectionism in the United States and in other industrial nations, which only served to increase pressure on primary producer countries in developing regions. The continuing difficulties and worsening balances of payment led to defaults in Latin America (1931), Central Europe (1932), and Germany (1933). This situation had detrimental effects on creditor countries such as the United States and Great Britain, and the world economy sank into an ever-deepening crisis.¹

How did China fare during this global economic crisis? My aim in this book is not merely to show that China—like many other countries—could not escape the dire consequences of the worldwide economic slump but also to offer a new perspective for understanding both modern Chinese history and the extent to which the Great Depression changed the modern world economy.² On one hand, the Great Depression was a watershed in the making of modern China but is often

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neglected in the existing literature on modern Chinese history. When deflationary pressures of an unusual magnitude hit the Chinese economy, its economic institutions ceased to operate properly. In coping with the unprecedented crisis, the state shifted its policy toward the market significantly, from “laissez-faire” to committed intervention. In this book I argue that this transformation in the relationship between the state and the market had profound impacts on Chinese politics and economics from the 1930s on.

On the other hand, China’s experience during the Great Depression merits special attention in comparison with that of other countries. The severity and spread of the Great Depression reveals the integrity of the world economy in the early twentieth century. In *The End of Globalization: Lessons from the Great Depression*, Harold James rightly argues that the crisis in the 1920s and 1930s tested the first major phase of economic globalization. As the financial crisis spread to many parts of the world, a strong resentment against the globalized economy emerged, and this in turn prompted governments to turn to stern protectionist policies. Consequently, systems for sustaining the international flow of goods, capital, and labor were seriously handicapped. China was not immune to the fragility of financial mechanisms or to foreign governments’ emphases on national priorities. Nonetheless, because China was the only country on the silver standard in an international monetary system dominated by the gold standard, the external shock to the Chinese economy and China’s reactions differed from those of other parts of the world.

The thrust of my argument is that these two issues, the domestic state-market relationship in China and China’s position in the international monetary system, were closely related. Fluctuations in the international price of silver during the Great Depression critically undermined China’s silver-standard monetary system and destabilized its economy. Establishing a new monetary system, with a different foreign-exchange standard, required committed government intervention; ultimately the process of economic recovery and monetary change politicized the entire Chinese economy. By analyzing the impact of the slump and the process of recovery, I examine the transformation of state-market relations in light of the linkages between the Chinese economy and the world economy.
Introduction

In investigating the causes and the consequences of the Depression in China, an understanding of China’s special position in the international system is crucial. From the late nineteenth century to 1931, except during World War I and the early 1920s, the gold standard provided the framework for international monetary relations. Most national currencies were convertible into certain amounts of gold on demand and linked internationally at fixed rates of exchange. As virtually the only country that used silver as the basis of its monetary system, China was unique in the international monetary system but was not isolated from it.

On one hand, outside China, silver was an internationally traded commodity, whose price was influenced by various factors, irrespective of the Chinese economy. On the other hand, because foreign-exchange transactions in China, that is, the trade between the silver-based Chinese currency and foreign currencies, were not controlled, China’s financial market was closely linked to the world silver market, and the Chinese exchange rate was inevitably influenced by changes in the international price of silver.

China’s experience during the Great Depression highlighted its special position in the international monetary system. While much of the world was suffering from a severe deflation from 1929 to 1931, only the silver-standard Chinese economy did not experience a vast drop in prices. Because silver was heavily depreciated in terms of the gold-standard currencies, China avoided deleterious effects during the first two years of the Great Depression.

From September 1931 on, however, many governments abandoned the gold standard and devalued their currencies in an attempt to inflate their economies. Great Britain was the first country to do so; other countries followed suit—Japan in December 1931 and the United States in March 1933. The move away from the gold-standard international monetary system had a serious impact on the silver-standard Chinese economy. As devaluations raised commodity prices, the international price of silver rose, as did the exchange rate for Chinese currency. Handicapped by a higher exchange rate, Chinese goods experienced intensified competition from foreign products both inside and outside China. The trade
deficit increased; at the same time, inflows of remittances from Overseas Chinese and of investments by foreign companies decreased. China saw a net outflow of silver and a drop in commodity prices. When the American Silver Purchase Act of June 1934 further pushed up the international price of silver, large amounts of silver flowed out of China. The Chinese economy sank into a severe deflation, even as the economies of other parts of the world were recovering.

The contrasting economic trends caused by changes in the international price of silver illuminate the vulnerability of the Chinese monetary system to changes in the world silver market. One of the central questions explored in this book is why this structural weakness—namely, the lack of separation between the domestic currency system and the international circulation of silver—was not widely recognized until the financial crisis in 1934.

Mass Expectations and the Financial Crisis

To understand the causes of the Chinese economic slump, it is also crucial to note that the rise in the international price of silver beginning in 1931 followed a long-term depreciation in world silver prices. Beginning in the mid-nineteenth century, a number of countries abandoned silver and chose gold as the basis for their currency. As the monetary usage of silver diminished and the supply of silver increased, its international price gradually declined. Because of this gradual but continuous drop in the international price of silver, Chinese price levels generally trended upward from the mid-nineteenth century until 1931. After years of rising silver prices and mild inflation, adjusting to a sudden reversal in trends was apparently onerous for the Chinese public. In investigating the impacts of the vast increase in the international silver price on the Chinese economy, I will draw attention to how the depreciation of silver prior to 1931 shaped economic institutions and influenced people’s expectations in China.

Referring to a number of case studies on previous financial crises, from the monetary crisis in the early seventeenth century at the outbreak of the Thirty Years War to the bursting of the Japanese real-estate bubble in 1990s, Charles Kindleberger rightly points out that public expectations seed crises, particularly when people finance investments through bank credits. Kindleberger argues that people invest in primary
products or domestic and foreign securities for different reasons, such as the outbreak of a war or a crop failure. In many cases, the boom is fed by an expansion in bank credit. As the boom proceeds, prices rise and new profit opportunities increase, attracting more firms and investors. However, prices ultimately level off, and investors realize that the market will not grow further. At this point, people change their portfolios to secure liquidity, most typically by converting assets into money. The consequent drop in asset values and commodity prices ushers in the vicious cycle of panic. The decrease in prices reduces the value of the collateral used to secure loans and forces banks to call in the loans or refuse new ones. This, in turn, induces merchants to sell commodities and industrial enterprises to postpone borrowing. If firms fail, bank loans go bad, and then banks fail. Concerned depositors withdraw their money from banks, and this puts further pressure on financial institutions.

In China, prices did not rise sharply because of the speculative booms that are the focus of Kindleberger's study; rather, they rose gradually because of the decline in the world silver prices. Kindleberger’s observation is most relevant to China’s economic slump in the 1930s in terms of the debt structure, which critically deepened the crisis.

Modern industrialization in China, which started in the late nineteenth century, occurred precisely during the era of silver depreciation and the ensuing gradual inflation. In this book, I focus on the cotton-spinning and silk-reeling industries in the Lower Yangzi Delta, the two major industries in the leading industrial center in early twentieth-century China. For the purposes of this study, the significant feature of the textile businesses was their reliance on bank credit. The financial institutions’ trust in the lending process rested heavily on the value of the collateral backing the loans. During the upward price trend in the early twentieth century, creditors and debtors did not foresee a great drop in the value of assets and commodities that were offered as collateral.

This expectation ceased to operate when the decline in the international price of silver halted and the general inflationary trend ended in 1931. Export-oriented industries such as silk reeling lost the comparative advantage that they had enjoyed when the exchange rate for the Chinese yuan was low. Industries targeting the domestic market such as cotton spinning faced diminishing demand. As business slumped, enterprises found it almost impossible to secure bank loans as managers of
financial institutions realized that their faith in the safety of loans backed by collateral was unfounded. Consequently, they reined in credit but could not evade the losses resulting from the devaluation of collateral items. When the real estate market collapsed right after the heavy drain of silver in 1934, a number of financial institutions involved in the mortgage business were hard hit. The negative consequences of the silver drain and the downturn in commodity prices were amplified by credit-loan relationships formed prior to the Great Depression.

The impact of the Great Depression on China was not only grave but also unexpected and unprecedented. By early 1935, abandoning the silver standard seemed the only way to break this deflationary spiral. As we shall see, restructuring the monetary system, however, had crucial political implications.

Market and State and the Monetary System

On November 4, 1935, in order to shield the economy from the negative effects of fluctuations in the international price of silver, the Nationalist government implemented a currency reform, declaring notes issued by the three government banks to be the only legal tender. At the same time, the Chinese yuan ceased to be backed by silver; instead, it could be converted into British pounds or U.S. dollars at fixed rates. Silver, which for centuries had been the basis of China’s currency, had to be surrendered, and the multi-currency system was ended. Only the notes issued by the three government banks were allowed to circulate. Once the Chinese yuan was no longer pegged to silver and devalued in relation to foreign currencies, Chinese trade started to revive, and the deflationary trend in commodity prices was reversed. The currency reform of November 1935 was crucial for the recovery of the Chinese economy.

The shift from the silver standard to a managed currency system obviously had grave political implications. For the first time in Chinese history, the government controlled the money supply; this greatly strengthened the Nationalist government’s position in the monetary and the financial systems. Still, before concluding that the government came to control the economy during the recovery from the Depression, we need to examine in more detail the relationship between the market and the state in the monetary system.
The role of the Nationalist government in the market as well as the effectiveness of its economic policies in general has been much studied but is still controversial. Parks Coble, in his book on the relationship between Shanghai capitalists and the Nanjing Nationalist government, writes: “Nanking’s involvement in industry and commerce mushroomed from 1935 to 1937.” Coble claims that the government exploited the predicament of Shanghai capitalists during the economic slump to seize control of the economy. It is true that during the “Nanjing Decade” of 1927–37, the Nationalist government’s presence in the economy became markedly more important from 1931 onward. But in later works, scholars have argued that the Chinese government intervened in response to requests for help from troubled enterprises. As Harold James points out, in a number of countries suffering from the negative effects of the Great Depression people commonly looked to the government to shield their nation’s industries from global economic trends. What makes the Nationalist government exceptional in this regard is its limited grip over the economy. Unlike many other governments, the Nationalist government did not control trade, foreign-exchange transactions, or industrial production during the recovery from the Depression.

Observing the weakness of Nationalist governance, scholars of Chinese history prefer domestic political explanations: the limited success of the Nationalist government was due primarily to its domestic shortcomings—for instance, a lack of organizational institutions in rural areas, a weak tax base, and factionalism and parochialism among government officials. Domestic politics, however, fail to account for the success of the most important economic policy, the currency reform. How did the state successfully legitimize the issuance of new currency? If the government was incompetent and corrupt, why did the public accept the notes issued by the government? In this book, I argue that the dynamics of the new monetary system, in which both market and state played key roles, were central to the simultaneous strength and weakness of the Nationalist government’s economic administration.

Traditionally, the Chinese state’s involvement in the monetary system was minimal; the imperial government left the management of silver to private smelting shops and monetary arrangements to the markets. Both
the foreign silver coins that China acquired in exchange for its products such as tea and silk and uncoined silver bullion circulated freely. Monetary standards varied from place to place.\textsuperscript{12}

To eyes accustomed to a world in which every nation-state has a national currency, the Chinese monetary system looks peculiar. Nonetheless, as Benjamin Cohen rightly points out in \textit{The Geography of Money}, prior to the nineteenth century, it was common for multiple currencies to circulate within or between political jurisdictions.\textsuperscript{13} States rarely expected to monopolize the supply of currencies within their frontiers. Rather, users of money on the demand side of the market chose currencies to perform the three major functions of money: to serve as a medium of exchange, to function as a unit of account, and to store value.

Cohen argues that to be selected for these purposes, a currency needs trust, a mass belief in its present validity for both payment and accounting purposes. The sources for such confidence vary from state actions such as legal fiat to the slow accumulation of market practices. The premodern monetary system in which various currencies competed for the trust of users began to change in the mid-nineteenth century. States started to control both the creation and the management of money inside their territories. Control of money was an important part of the process of nation-building. National governments sought to build up the nation as a unified economic and political unit led by a strong central authority. Governments consolidated and unified the domestic monetary order. All forms of money, not only specie but also paper banknotes, were fixed in relation to one another and tied to a uniform metallic standard. Ultimate authority over the supply of money was limited to a government-sponsored central bank. Moreover, the free circulation of foreign currencies was banned in most countries. Foreign coins, which had served as legal tender, were withdrawn from circulation. At the same time, the currency that could be used to pay taxes or other contractual obligations to the states was limited to domestic money. Toward the end of the nineteenth century, each currency’s territory came to overlap with political jurisdiction in the West.\textsuperscript{14}

The vital issue here is that in China the imperial monetary system was inherited by Republican China and continued past the 1911 Revolution. Depending heavily on foreign loans from gold-standard countries and thus burdened with the declining exchange rate of its silver-based
currency, the government attempted several times to change the monetary system. Nonetheless, the monetary reform was never accomplished until November 1935. During the confusion of the 1910s and 1920s, the silver standard provided a safeguard against political interference. Whenever warlords and local governments tried to manipulate the monetary system to compensate for budgetary deficits, they were checked by the public’s refusal to accept notes not fully backed with silver. By retaining the right to select currencies, actors on the market constrained the arbitrary exercise of governmental authority.

However, once the world economic slump hit the Chinese economy in the 1930s, China found that it lacked an institution that could halt silver exports or stem the deflationary trend. It was apparent that the continued autonomy of the monetary and financial systems was unfeasible, but the public remained suspicious of arbitrary issuance of banknotes by the government.

This historical background and the legacy of the silver standard continued to have an impact after the new monetary system was implemented in November 1935. Although the Chinese public abandoned silver in favor of legal tender, they carefully monitored the foreign-exchange rate of the Chinese yuan. When they sensed the slightest drop in the value of the Chinese notes, they sold Chinese yuan on the foreign-exchange market. Nationalist government officials were well aware of the public’s doubts about their commitment to sound monetary management. Therefore, they regarded maintaining the convertibility of the Chinese yuan and the stability of the exchange rate as crucial elements in enhancing public trust in the new currency. The market continued to influence the government through the monetary system.

The problem was that convertibility and exchange-rate stability required that the government coordinate a wide range of other economic policies. Most important, the government could not issue notes or float bonds in excessive amounts in order to sustain the value of the currency. These constraints on fiscal policy in turn influenced other domestic economic policies. Because of this limitation on budgetary expansion, the government succeeded in reforming the currency but became less active in the areas of industrial promotion or agricultural improvement. The strengths and weaknesses of the economic policies of the Nationalist government were not purely incidental matters. Policy makers had a
concrete idea of their priorities, and it is against their own policy targets that their achievement should be evaluated. The consensus of policy makers was that the success of the currency reform was their primary goal, even if it meant sacrificing the autonomy of governance.

Linkages Between China and the World Economy: The Two Crises and Beyond

The openness of the Nationalist government in sacrificing its autonomy in fiscal policy for exchange stability and currency convertibility merits special attention, especially at a time when governments in many parts of the world were closing their national economies. In this book, I argue that this decision reflected the close linkage between the Chinese economy and the world economy in the early twentieth century. Exchange-rate instability and monetary confusion would have discouraged the trade, capital flows, and labor movements that were indispensable to the health of the Chinese economy. Well aware of how disastrous such an outcome would be, Nationalist policy makers had to shape their strategies accordingly.

How is it possible to retain autonomy to formulate economic policies when the economy of the country is closely integrated with the world economy? The problem facing the Nationalist government in the 1930s is familiar to a number of governments in the contemporary world, in which cross-national economic integration is proceeding rapidly. The emergence of a similar problem is not coincidental. To cope with the devastation caused by the Great Depression, governments restricted international trade, capital flows, and labor movements, which up till then had by and large been free: the world reverted to an almost autarkic national economic management. It took many years to recover from the grave shock of the Depression. Economic integration started to resume only in the 1960s and accelerated steadily toward the 1990s.

In the process, the dominance of the nation-state came to be challenged by cross-border transactions, particularly in terms of the banking and the monetary systems.

In 1997, interstate tensions and cross-border transaction networks heightened in Asia, when, decades after the Great Depression, another severe financial crisis rolled through the region, affecting Thailand, Malaysia, Indonesia, South Korea, and Japan. Although explanations vary,
scholars emphasize that a large flow of foreign short-term capital destabilized domestic financial markets in Asian countries. China was relatively immune to the 1997 Asian financial crisis. Although its open-door policy had begun in 1979, China had not yet fully opened its market to foreign capital and thus avoided the most severe effects of the 1997 financial crisis. Having survived the crisis, the Chinese economy grew as contact with the world economy accelerated, particularly in terms of foreign trade and direct investment inflows. In the meantime, in shaping its monetary and banking policies, the Chinese government faced increasing external pressure from foreign investors, trade counterparts, and other governments in the world.\textsuperscript{21}

In the long-term trajectory of the Chinese economy, its relationship with the world economy has influenced the government’s freedom to formulate economic policies and ultimately its grip over the domestic economy and society. Aware of the impact of the world economy, government officials have not only been conditioned by but also learned from monetary and banking decisions made by their predecessors. With this historical perspective in mind, I focus on the Great Depression, when key dynamics among the state, the market, and the world economy were first tested in a critical way.

\textit{The Organization of the Book}

This book has a dual task: integrating China into global economic history and offering critical insights on state-market relations in modern China. The first half of the book is devoted to the decades leading up to 1931, since the economic slump in China originated in economic institutions that developed during the period of inflation. Chapter 1 explains the workings of the silver standard, the key factor linking China with the world economy. Chapter 2 outlines the development of the textile industry. Chapter 3, which is based on a detailed analysis of newly accessible archival sources in China such as company documents, business contracts, and bank records, uncovers the dynamics of credit and loan relations between urban textile enterprises and financial institutions.

Part II first looks at the impact of the Great Depression, particularly fluctuations in silver prices, and then analyzes the political repercussions. In Chapter 4, I investigate the agrarian depression (\textit{nongcan bengkui}). Chapter 5 examines the slump in the urban industrial sector. Chapter 6
shows that the Shanghai financial crisis was the culmination of a growing malaise. Chapter 7 examines the political impact of this economic crisis and untangles the complex international and domestic web of the Chinese political economy by examining the government’s economic diplomacy with the Powers in East Asia (Great Britain, the United States, and Japan), as well as its negotiations with domestic financial markets. In Chapter 8, I investigate the government’s strengths and weaknesses and examine the role of government policies in the recovery of the Lower Yangzi textile industry. I conclude the book by summarizing my findings and evaluating their implications within comparative and historical perspectives. By inquiring into the origins of the economic crisis, I trace industrialization and credit expansion in early twentieth-century China and provide a new perspective on state-market relations.