Modern Asian Studies **34**, 3 (2000), pp. 739–764. © 2000 Cambridge University Press
Printed in the United Kingdom

Another Asian Financial Crisis: Monetary Links between Hong Kong and China 1945–50[1]

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At the beginning of July 1997 Thailand was forced to allow the baht to fall 20% against the $US, triggering a financial crisis across Asia. This crisis toppled governments in the region and sent out a series of shock waves that threatened prosperity in the rest of the world. The main symptom of the crisis was a profound distrust in the currencies of developing countries in Asia which precipitated repeated devaluations in the 'miracle' economies of Indonesia, South Korea and Malaysia. One of the results of the Asian financial crisis is renewed interest in the monetary relations of the region, and in the mechanics of the transmission of currency instability between countries.

Although under constant pressure, the Hong Kong Monetary Authority repeatedly confounded predictions of an imminent devaluation during the peak of the 1997–98 crisis. The reasons for this may be explained by reference to the monetary history of Hong Kong and its unique position in international finance. Hong Kong supported free trade and capital markets throughout the post-war period despite widespread exchange and trade controls elsewhere in the world. As a result, the credibility of the Hong Kong currency has always been an important foundation of Hong Kong's stability and economic prosperity. After the return of Hong Kong to Chinese control at the beginning of the 1997 crisis, it was recognized that the fate of the Hong Kong dollar was closely tied to that of the Chinese Renminbi (RMB). The close relationship between the two currencies has a long history, which must be understood to fully appreciate China's foreign financial relations today. Examining the historical

[1] The author would like to thank the HSBC Group Archive, London, and the Bank of England for access to their archives. Part of this research was funded by the British Academy.

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experience of Hong Kong as a supplier of currency for China also sheds some light on the prospects for currency stability under the 'One Country–Two Systems' approach to the new relationship between China and Hong Kong since July 1997.

Sino-Hong Kong relations in the 1940s are particularly interesting because the monetary problems of this period also show similarities to more recent events now that many of the traditional trade and financial relationships between Hong Kong and China have been re-established.[2] During the 1990s the Chinese government ran a dual exchange rate system with an official fixed rate and a legal floating market, operating through about one hundred designated 'swap centres'.[3] Throughout 1993 the RMB depreciated sharply on the swap market due to inflationary pressure and a 60% increase in the currency in circulation during the year.[4] In response, the Chinese government substantially devalued the official exchange rate in January 1994[5] and introduced a managed floating system, which essentially unified the exchange rates—the same response to depreciation as in 1947. At the same time, hard-currency denominated transactions were prohibited, but this ban was generally considered unenforceable because the HK$ and US$ circulate widely in China, and goods and services are frequently priced in foreign currency.[6] As in the late 1940s, inflation, uncertainty, and excessive currency issue encouraged currency substitution in China.[7]

This paper examines the episode of currency substitution in China in the late 1940s and the impact of this phenomenon on the relationship between China and Hong Kong. Section I summarizes the causes and impact of currency substitution. Section II describes the history of currency substitution in the region. Section III assesses the political as well as economic implications of currency substitution for Hong Kong and China. Section IV concludes with some final observations.

[2] After thirty years of isolation, the Chinese economy was gradually opened to international trade and capital markets from 1979.

[3] At the end of 1993 only about 20% of currency deals were taking place at the official rate. Kaye, 'Deafened by Decree'.

[4] The RMB depreciated 450% from 1980 to 1994. *Ibid*.

[5] The official rate was devalued from RMB5.81 to RMB8.70 per US$1.

[6] Kaye, 'Deafened by Decree'; Stephenson-Yang, 'Easing up'.

[7] For the implications of the dual currency system after 1997, see Lo, 'China's Two Currencies'; Xiao, 'One Country, Two Currencies'; Y. C. Jao, 'Hong Kong after its Return to China; Some Issues in Money and Finance', *Money and Finance in Hong Kong*.

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I

Under certain circumstances, a population may prefer to hold the currency assets of another country rather than its domestic currency. This preference might be expressed in the accumulation of foreign currency deposits overseas or in the domestic banking system, should exchange controls allow. In these cases the economic implications are similar to those of capital mobility. The term currency substitution strictly refers to the case when a foreign currency supplants the domestic currency in general circulation as a medium of exchange as well as a store of value. Currency substitution was a feature of the crisis in Thailand in 1997 and again during the Russian financial crisis of August 1998. For economic historians, currency substitution in inflationary economies such as Germany and the Soviet Union in the 1920s has long been of interest.[8]

There are a variety of factors that contribute to currency substitution.[9] High levels of open-ness between two countries, combined with a lack of effective control on the flow of notes and coin, will increase the propensity for currency substitution. While these institutional factors facilitate the process, the critical variable is the expected real rate of return on foreign versus domestic money. The elasticity of substitution between domestic and foreign currencies will rise with the expected rate of depreciation of the domestic currency both internally and in international exchanges. Volatility in the rate of return will also encourage substitution. This explains why substitution is prevalent in economies with persistently high inflation rates and floating exchange rate regimes.[10] In this situation, residents will prefer a relatively stable foreign currency which supplies the liquidity services required without being subject to the risk of internal or external depreciation.

Most empirical studies of currency substitution have focused on the preference for foreign currency deposits (whether held domestically or overseas) while excluding notes in circulation. This is because it is notoriously difficult to quantify the volume of foreign cash held

[8] For recent examples see, Bernholz, 'Currency Substitution', pp. 297–324; Tullio, 'Inflation and Currency Depreciation', pp. 350–62.

[9] For reviews of the literature see Ortiz, 'Currency Substitution in Mexico'; Vegh, 'Inflationary Finance'.

[10] Currency substitution may also occur in a fixed exchange rate system when the rate is not credible. Cuddington, 'Currency substitution', p. 119.

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by the population.[11] The accumulation of foreign currency is often in the absence of controls that might generate the appropriate statistics, or is the result of a circumvention of such controls and so leaves no statistical record. Testing for the presence and effects of currency substitution using deposits as data ignores part of the means of exchange role of currency substitution and confuses portfolio substitution with currency substitution per se.[12] Relying on bank deposits as a proxy for currency substitution is particularly misleading when the domestic financial and banking systems are relatively undeveloped or under-utilized because of political or economic uncertainty, as was the case of China in the late 1940s.[13]

The policy implications of currency substitution for the 'host' economy include a reduction in the effectiveness of independent monetary and fiscal policy, and a loss of seignorage accruing to the state. In terms of domestic policy sovereignty, currency substitution erodes the tax base and increases the inflationary impact of a given fiscal deficit.[14] The presence of currency substitution may also tend to make the demand for domestic money function unstable and inhibit the effectiveness of monetary policy.[15] These disadvantages have prompted states to resist substitution and to increase the use of domestic currency.[16] One advantage of forcing the use of domestic currency by requiring the population to surrender foreign assets is the instant increase in foreign exchange at the disposal of the domestic government.

In the presence of hyperinflation, currency substitution may have positive effects. Using the experience of Russia in the 1920s, Rostowski has argued that currency substitution enhanced liquidity and therefore had a positive impact on domestic trade and output.[17] The

[11] Ortiz, 'Currency Substitution in Mexico', p. 178n. Jao has estimated currency substitution in Hong Kong during the 1980s using data on US$ deposits. Y. C. Jao, 'From Sterling Exchange Standard to Dollar Exchange Standard; the evolution of Hong Kong's contemporary monetary system', in Jao and King, *Money in Hong Kong*, pp. 119–27.

[12] Calvo and Vegh, 'Currency Substitution', pp. 17, 19. Cuddington, 'Currency Substitution'.

[13] In Shanghai in August 1950, private bank deposits were 4% of their pre-war level. Breakspeare's Economic Report of China, Sept. 1950. UK Public Record Office, (hereafter PRO) FO371/83337.

[14] Calvo and Vegh, 'Currency Substitution', pp. 13–16; Savastano, 'Pattern of Currency Substitution', p. 49.

[15] Savastano, 'Pattern of Currency Substitution', p. 60.

[16] Calvo and Vegh, 'Currency Substitution', p. 5. Mexico, Peru and Bolivia all attempted 'De-Dollarisation' between 1982 and 1985.

[17] Rostowski, 'The Benefits'.

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instability of the domestic currency and the unreliability of price information may reduce transactions to low-level barter in the absence of currency substitution. It will be seen in the following analysis that currency substitution sustained trade between China and Hong Kong, which increased the prosperity of both partners.

The case of Hong Kong is complicated by the nature of Hong Kong's monetary system. Confidence in the HK$ had been established before the war when the exchange rate of the HK$ with sterling was maintained at 1s3d from 1935 to 1939. Some difficulties emerged in 1945 due to the HK$ notes issued by the Japanese during their occupation of Hong Kong, but this was soon resolved in a way that increased the credibility of the Hong Kong dollar. Despite wartime warnings to the contrary, the Hong Kong authorities agreed to recognize the notes issued 'illegally' by the Japanese between 1941 and 1945 which amounted to HK$119.8 million.[18] The exchange rate of the HK$ was then pegged to sterling at HK$16 to £1, reflecting the official sterling cross rate of US$4.06. This peg was maintained until the devaluation of sterling in 1967.

Hong Kong's position was further complicated by the lack of a central bank. The Hong Kong Dollar was issued by three commercial banks—primarily the Hongkong and Shanghai Banking Corporation[19]—and was backed by an Exchange Fund of sterling assets held by the Hong Kong government. Authorized banks purchased claims on this fund for sterling in the form of non-interest bearing Certificates of Indebtedness in respect of cover for their note issue. The interest earned by the currency reserve accrued to the Exchange Fund, not to the issuing banks. The profits of the fund were reinvested in securities so that the actual cover for the local currency was greater than 100 per cent.[20] Today, the Hong Kong Monetary Authority operates as a currency board, although the HK$ is now pegged to the $US.

This rather unique domestic monetary system was also influenced by Hong Kong's place in the international monetary system. From

[18] The use of the HK$ as a medium of exchange in China was a significant factor in the decision to recognize the notes issued by the Japanese. King, *The Hongkong Bank: Vol. IV*, p. 118n.

[19] The Hongkong and Shanghai Bank will be referred to herewith as the Hongkong Bank. The Hongkong Bank issued 90% of the Hong Kong currency. The Mercantile Bank and the Chartered Bank issued the remainder.

[20] In 1949 the backing for the note issue was 116%. King, *The Hongkong Bank Vol. IV*, p. 123.

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1945 to 1971, Hong Kong was a member of the Sterling Area group of countries and colonies that agreed to peg their exchange rates to sterling and to maintain the bulk of their reserves in sterling. Hong Kong also operated a freely floating exchange market for $US in order to function as a trade entrepot. Under this system, local Chinese banks and moneychangers sold currencies at freely floating rates while the large (often foreign) authorized banks operated the official fixed exchange rate market. There was, therefore, an official fixed exchange rate of the HK$ to sterling and the $US which co-existed with a parallel free market exchange rate for regional traders. Residents of other countries of the sterling area (such as the UK) had access to this floating exchange market because of limited exchange control within the sterling area.[21]

Having reviewed the general analytical aspects of currency substitution and the mechanics of note issue in Hong Kong, the history of currency substitution in China will occupy the next section.

II

After liberation from Japanese occupation in 1945, the Kuo Min Tang (Nationalist Party or KMT) led by Chiang Kai-shek struggled to rule China in competition with the Chinese Communist Party led by Mao Tse-tung. Despite American attempts at arbitration, the conflict between the KMT and the Communists escalated to civil war in July 1946. This had an obvious detrimental effect on the Chinese economy that was further exacerbated by the Nationalist Government's corruption and inability to balance its finances. The result was hyperinflation in 1948 followed by the victory or the Communist Party and the establishment of the People's Republic of China in the Autumn of 1949.

The Nationalist Inflation

By the time a new post-war foreign exchange system was established by the Nationalist Government of China in February 1946, the

[21] The free market rate for $US tended to fluctuate at a premium to the official rate. For a discussion of the free market in Hong Kong see Schenk, 'Closing the Hong Kong Gap'.

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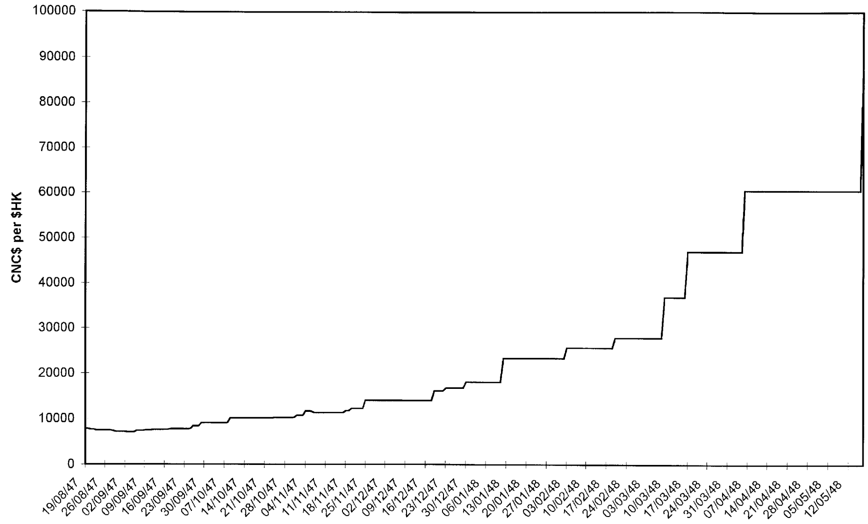

Figure 1. Daily Exchange Fund Rates 19/8/47–17/5/48

exchange rate with the US dollar had fallen from CNC$20 during the war to CNC$2020. Even this rate soon became overvalued, generating a drain on China's foreign exchange reserves that was ultimately insupportable. In March 1947, the exchange rate was adjusted to CNC$12,000 per $US. Within two months, however, this rate became untenable and the Nationalist Government established a Stabilization Fund Committee of four leading foreign-exchange banks[22] to set the official exchange rate daily. In effect (as in 1994) a managed floating rate was introduced.

For a while the Fund tried to maintain its credibility by following the black market rate closely in the expectation that public confidence in the Fund would be encouraged if it reflected 'market' prices. As inflation accelerated towards the end of 1947, however, persistent devaluation came to be blamed for contributing to adverse expectations and price instability. Eventually the link to the black market rate was allowed to lapse, eroding the flexibility of the official exchange rate. The Fund's official rate of CNC$ per HK$ rose from 7800 on 19 August 1947 to 88,505 nine months later, while the black market rate was about twice that level.[23] Figure 1 shows the depreciation of the CNC$ in the official market during this period.

[22] The members of the Stabilisation Fund Committee were Bank of China, Bank of Communications, National City Bank of New York and the Hongkong Bank.

[23] Chou, *The Chinese Inflation*, p. 138.

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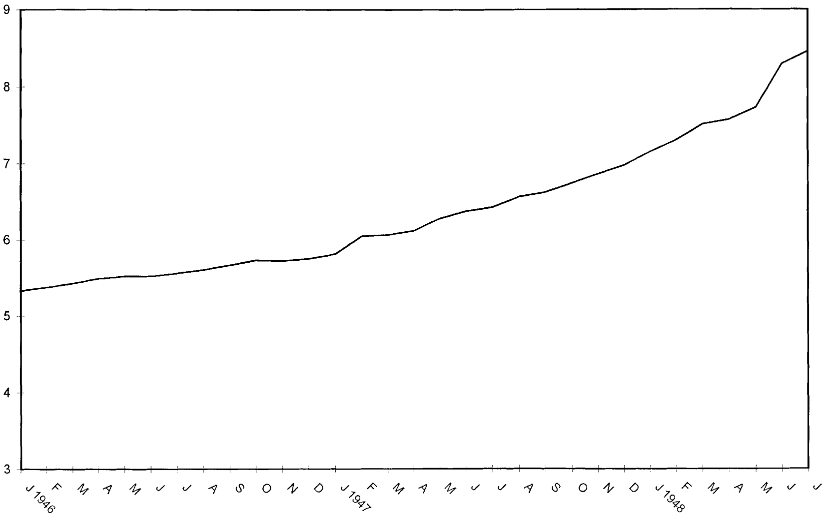

Figure 2. Chinese Price Index 1946–8 (Jan–June 1937=100) Log Values

The cause of the depreciation was the acceleration of inflation. The Nationalist government was unable to fund its military forays through direct taxation and so resorted to printing money. Between the end of 1945 and June 1948 the note issue increased from CNC$1,031,900 million to CNC$374,762,200 million while the Government deficit increased from CNC$1,106,698 million to CNC$434,565,612 million.[24] Figure 2 shows monthly rises in the Chinese price index from January 1946 to July 1948. Interestingly, Canton (where the circulation of HK$ was greatest) experienced less severe inflation than the Northern ports of Shanghai and Tianjin or the country as a whole.[25] In contrast, the Retail Price Index in Hong Kong fell slightly between 1947 and 1948.[26]

In August 1948 the Nationalist government tried to break the cycle by introducing a new currency, the Gold Yuan, and declaring illegal all use of foreign currency. At the same time price controls and sales of state assets were announced to support the value of the Gold Yuan. Chiang Kai-shek's son was appointed to ensure the controls were implemented. In the event, however, the price controls

[24] Chang, *Inflationary Spiral*, p. 374.

[25] In an index where January 1946=100, prices had reached 4385 by December 1947 in Canton, 9012 in Tianjin, 6272 in Shanghai and 5660 for China as a whole.

[26] Based on March 1947=100, the RPI in Hong Kong fell to 94 in March 1948 and to 92 in December 1948. *Hong Kong Government Gazette*, 1949–50.

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Table 1
Collapse of the Chinese Currency System, 1948–49

	Note Issue (GY million)	GY per US$ Official Rate	Market Rate	Wholesale Price Index (Shanghai)
1948				
August 31	296.8	4	4	100
November 30	3204.3	28	42	1365
1949				
February 28	59,663.5	2660	2980	48,195
April 25	2,037,105.7	205,000	813,880	112,490
July 31	125,124,637.2	n.a.	n.a.	n.a.

Source: Chang (1958), p. 26. n.a. signifies not available.

were limited to Shanghai and were only effective for two months. Stacey, manager of the Hongkong Bank in Shanghai, observed that 'the Gold Yuan was ushered in with a blare of trumpets as a panacea to cure all ills, but cynics insisted that it did nothing but lop off six noughts' from the CNC$.[27] Initially pegged at four GY per US$, the rate quickly slipped under continued inflationary and speculative pressure and by May the exchange rate was back to the level of the CNC$ in August 1948.[28] This episode stripped the KMT of any remaining support among the Chinese middle classes.[29] Table 1 shows the collapse of the Chinese currency system. At the beginning July 1949 the Nationalists reverted to issuing silver coins but by this time the KMT had lost all its credibility, and the People's Government announced that the 'silver yuan' would not be exchanged for RMB after liberation.[30] By the spring of 1949 the KMT government itself was using HK$ for domestic payments.[31] As Chou has observed, 'Even at best, the Chinese currency only supplemented and never superseded the role of Hong Kong dollars as de facto standard money in south China'.[32]

[27] Stacey (Shanghai) to Morse (Hong Kong), 11 Jan. 1949. Archives of the HSBC Group (London) (hereafter HSBC) SHG741.6.

[28] Cheng, *Foreign Trade*, p. 184. For an account of the failure of price controls see Chang, *Inflationary Spiral*, pp. 357–60.

[29] Fairbank, *Great Chinese Revolution*, p. 264.

[30] Shanghai fell to the Communists in May 1949. Ling and Lei, *Circulation of Money*, pp. 18–20.

[31] Fairbank, *Great Chinese Revolution*, p. 172.

[32] Chou, *The Chinese Inflation*, p. 149. In October 1948, the British Embassy in Shanghai reported that in Canton, 'use of Gold Yuan now limited to small daily

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The Course of Currency Substitution

The inflationary situation, the unstable and always depreciating exchange rate of the Nationalist currencies, and political instability in China provided the perfect context for currency substitution. As the Governor of Hong Kong noted in February 1947, the 'fact is that if good currency and bad currency are close neighbours people will go to any lengths to obtain good currency'.[33] The $US was a popular store of value but the open-ness of the South China border with Hong Kong, and the stability of the Hong Kong currency made the HK$ the perfect candidate for substitution in port cities and especially in South China. First, the geography of the region made it impossible to police the movement of people, goods and currency between Hong Kong and China, especially given the reluctance of the Hong Kong authorities to threaten their entrepot status by imposing controls. Secondly, unlike the CNC$, the note issue in Hong Kong was strictly linked to foreign exchange reserves through the currency board, and prices in Hong Kong were remarkably stable until the second half of 1949.[34]

During the war Hong Kong notes had been hoarded in China, and in the economic confusion after 1945 the circulation expanded. In Shanghai immediately after liberation from Japanese occupation, the officials of the Hongkong Bank reported that 'there is a lot of speculative buying of Hongkong Dollar notes going on' with preferential rates for notes with 'old' dates of issue which were considered more likely to be honoured by the Bank.[35] By late September 1945 Adamson reported that 'this place [Shanghai] is lousy with Hong Kong Dollar notes, mostly big denominations'.[36] The large denominations suggest that the HK$ was held as a store of value in this uncertain period.

In July 1947 Jamieson of the Hongkong Bank in Canton observed that 'it is said that in the Canton Black Market alone notes to the

transactions' while the black market exchange in GY against HK$ was very busy. Telegram from British Embassy Shanghai to Foreign Office, 28 Oct. 1948.

[33] Telegram from Hong Kong to the Secretary of State for the Colonies, 22 Feb. 1947. PRO T236/681.

[34] Based on March 1947=100, the RPI peaked at 112 in December 1949. *Hong Kong Government Gazette*, 1949–50.

[35] A. S. Adamson (Shanghai) to Morse (London), 5 Sept. 1945. HSBC GHO154. Adamson was released from internment on 16 Aug. 1945.

[36] Adamson (Shanghai) to T. J. J. Fenwick (Hong Kong), 25 Sept. 1945. HSBC GHO154.

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value of HK$1.5 millions change hands daily'.[37] He advised that the demand for HK$ was due to Native Chinese Banks covering remittances between Shanghai and Hong Kong, merchants paying for their imports in HK$, and hoarders of foreign currencies. The supply was chiefly from overseas Chinese remittances to their families in China through Hong Kong, and from organized smugglers. The balance of payments surplus that South China earned from Hong Kong allowed the use of HK$ in Canton.

Evidence of the HK$ as a means of exchange is more difficult to establish, but as testament to the use of HK$ Jamieson observed that

> The value of property is almost always quoted in Hong Kong currency and it is not unusual for the better class of shopkeepers (curio and silverware shops) as well as professional men (doctors, dentists etc.) to request payment in Hongkong dollars.[38]

Given the relative price stability in Hong Kong, the rush to print currency during the post-war years gives an indication of the demand for HK$ notes in China. Between 1945 and 1947 the Hongkong Bank note issue increased from HK$320 million to HK$618 million. Some of the issue was obviously in response to wartime inflation in Hong Kong, but the officials of the Hongkong Bank were convinced that most of the excess demand was from mainland China. In July 1947 Adamson wrote to the Canton office of the Hongkong Bank that

> our Note Issue is still steadily increasing. Everything points to this being due to the greater demand for our notes from South China owing to the depreciation in the value of the C.N. Dollar. We have no means of forming an accurate estimate of what proportion of our total issue is held in China, but it must be very large.[39]

In September 1947 the British Treasury estimated that the circulation of HK$ in China amounted to HK$300 million,[40] an increase of HK$200 million on the pre-war level. This evidence suggests that about two-thirds of the increase in the note issue from 1945 to 1947

[37] Jamieson (Canton) to Adamson (Hong Kong), 23 July 1947. HSBC GHO179.
[38] *Ibid*.
[39] A. S. Adamson (Hong Kong) to C. M. Jamieson (Canton), 16 July 1947. HSBC GHO179. In July 1948 the Bank of England also observed that the note issue of the Hongkong Bank was expanding very rapidly to satisfy demand for the notes in China. Note by Portsmore (Bank of England), 20 July 1948. Bank of England Archives (hereafter BE) OV14/3.
[40] Memo by Granger-Taylor, 31 Dec. 1948. PRO T236/1812.

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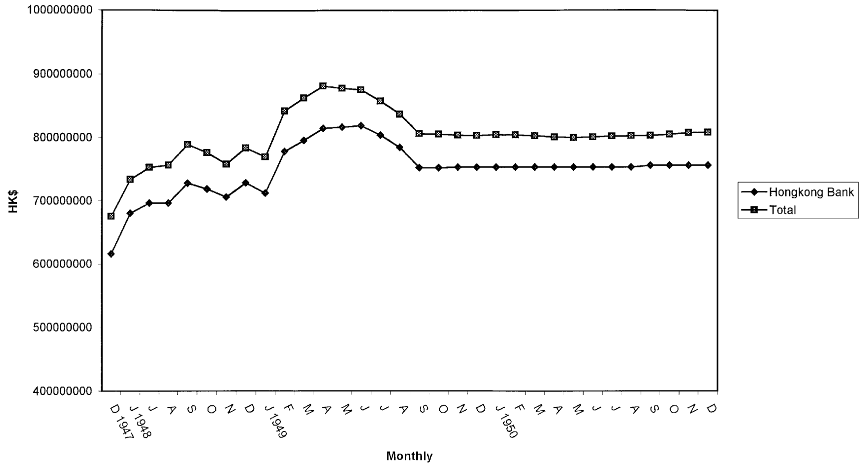

Figure 3. Hong Kong Bank Notes in Circulation 1948–1950

was destined for China. On the basis of these estimates, the circulation of HK$ notes in China was equivalent to about 16% of the total circulation of CNC$ at the end of 1947.[41] Since the use of the HK$ was concentrated in coastal areas and Canton, the ratio in these regions would be higher. Other currencies were also used in China during this period—notably the $US in the north—but no estimates of the volume of $US in China are available.

In the second half of 1948 conditions in China deteriorated as inflation accelerated. Figure 3 shows Hongkong Bank notes in circulation from 1948 to 1950. When the Gold Yuan was introduced in August 1948 only HK$86 million was surrendered under the Chinese Government order for the compulsory redemption of all foreign currency.[42] As the Gold Yuan collapsed and the Communist forces advanced, Figure 3 shows that there was a rapid increase in notes in circulation. At this time it was estimated that HK$400–500 million or half of total HK$ notes in circulation were in China,[43] an

[41] This calculation is based on a circulation of HK$300m at the exchange rate current at the end of December 1947.

[42] Chang, *Inflationary Spiral*, p. 321.

[43] Quoted in the *South China Morning Post*, 26 May 1949. PRO T236/5111. The Communist newspaper *Renminribao* reported that 'particularly in the years 1948–1949 the Hongkong currency dominated the Kwangtung markets. It was the standard currency on which prices were based in cities and the countryside' and they estimated that about half of Hong Kong's note issue circulated in China, of which 88% was in South China, mostly in Canton. Translation from *Renminribao* (People's Daily), 12 Feb. 1950. HSBC GHO179.

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increase of HK$300 million on the pre-war level. Assuming a circulation of HK$450 million, this was equivalent to US$112.5 million or GY23,062,500 million compared to a note issue in China of GY2,037,106 million at the end of April.

Stabilisation of the Renminbi

As the Communists gradually took control of more territory they introduced the People's Bank Dollar (RMB) to replace the Nationalist currency in the regions they conquered. The Foreign Office was not optimistic about its prospects, advising that

> The future of this new currency must be dubious in the extreme, and one can presumably expect that the Communist authorities will have the greatest difficulty in establishing a stable currency, particularly as the Central Government [KMT] have removed large quantities of gold from China to Formosa.[44]

Nevertheless, in January 1949 the introduction of the RMB in the northern port of Tianjin was reportedly a success, with 272 exchange stations crowded with customers to convert their GY to RMB at a rate of 6GY and then 8GY per RMB.[45] It took several months, however, for the RMB to establish itself further South. In Shanghai the exchange rate with the HK$ was set at RMB138 in May 1949 but it quickly depreciated.[46] At the beginning of July, the British embassy in Shanghai noted that

> Recent reports through foreign firms indicate a serious widespread distrust on the part of the Chinese merchants and traders, with whom they are associated, of the new currency which appears to be based both on economic and political grounds.[47]

[44] Minute by P. D. Coates (Foreign Office), 27 Jan. 1949. PRO FO371/75851. The British Commercial Secretary in Shanghai, I. C. Mackenzie, expressed the same opinion in November 1948. I. C. Mackenzie, First Secretary (Commercial) Shanghai to British Embassy Nanjing, 15 Nov. 1948. PRO T236/1812. About three million ounces of gold were shipped from China to Formosa as the KMT retreated. Chang, *Inflationary Spiral*, p. 321.

[45] Report from New China News Agency, 14 Feb. 1949. PRO FO371/75851. For ten days only in January 1949, a preferential rate of 3GY per RMB was used for small amounts up to 500GY for workers, students and the poor. Individuals were also encouraged to use their stocks of GY to purchase goods in areas controlled by the KMT. Ling and Lei, *Circulation of Money*, pp. 18–20.

[46] Telegram from Stacey (Shanghai) to Morse (Hong Kong), 29 May 1949. HSBC SHGII 268.

[47] Telegram from UK Embassy, Shanghai to Foreign Office, 3 July 1949. PRO FO371/75846.

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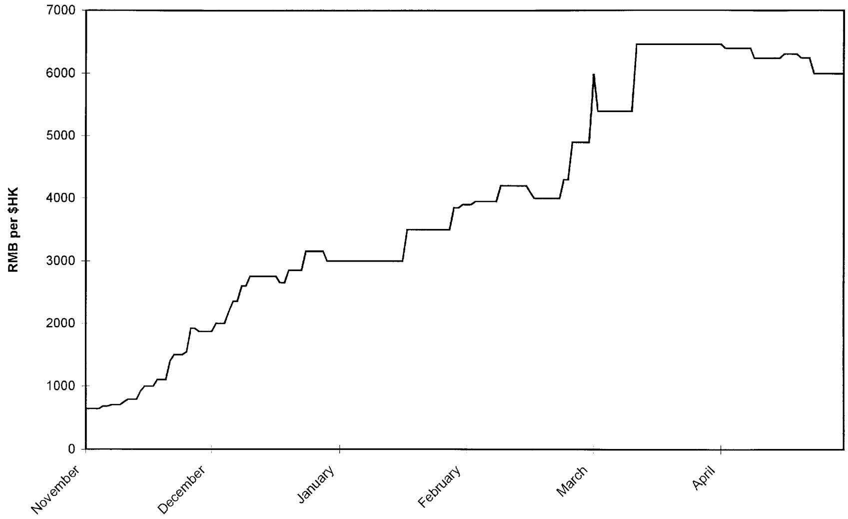

Figure 4. Official Daily Exchange Rate 1 November 1949–1 May 1950

The continued use of the HK$ reflected the lack of confidence in the Communists' ability to maintain the purchasing power of the RMB, and also in the ability of the Communists themselves to retain control of China. Figure 4 shows the official exchange rate of the RMB against the HK$ between November 1949 (once the Communist take-over of China was complete) and May 1950. This shows that the RMB depreciated rapidly through the end of 1949. From the beginning of 1950, however, the depreciation slowed and the currency was relatively stable through the first half of 1950 at RMB6000 = HK$1 before beginning to appreciate.

The new Communist regime took strong administrative measures from the outset to stabilize the value of their currency. The RMB was backed by a reserve of commodities held by the state that could be sold on the market to affect the price level. Such government dumping stemmed inflation briefly in mid-June 1949 but the internal and external value of the RMB continued to decline. On 14 June 1949, Parity Deposit Units were introduced to reduce the currency in circulation, increase confidence, and maintain the purchasing power of savings. Wages were paid in PDUs, which had a fixed value in terms of a basket of basic consumer commodities.[48] This estab-

[48] The value of the PDU was based on the price of rice, cloth, fuel and edible oil and had a unit value of RMB302 on 14 June which rose to RMB522 by 2 July due to inflation in the price of rice. PRO FO371/75846. Indexed deposits which function

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lished a store of value separate from the currency and encouraged savings to remove currency from circulation.[49] While these efforts were being made to decrease inflationary expectations, the HK$ continued to be in demand, especially in the South. In early December W.P. Montgomery, UK Trade Commissioner in Hong Kong reported that

> Indications are that the general public in the Canton area is offering a marked resistance in accepting People's Notes in exchange for HK$ and that in the majority of business trade continues on a HK$ basis. The requests of the Authorities have so far been ignored.[50]

By March 1950 Communist control of China was firmly established through the nationalization of internal and external markets as China moved toward a command economy. As their control of the economy spread, the new regime finally succeeded in stabilizing prices and the exchange rate. In March, the value of the PDU in terms of RMB in Shanghai actually fell 7%.[51] The official reason for this deflation was the centralization of financial control in State Treasuries, which allowed greater control of the money supply, and the rationalization of food distribution that increased supplies to consumers. British representatives reported, however, that the view of 'the average businessman' in Shanghai was that money was so tight after heavy taxation and enforced purchase of Victory Bonds that few could afford to buy anything.[52] The deflation of March proved to be a turning point for the RMB.

The volume of foreign currency exchanged for RMB in March and April 1950 was reported in the newspaper, *Xinwenribao*. This reported that the Shanghai office of the Bank of China concluded 7182 transactions exchanging foreign currency for RMB in March and 35,600 in April.[53] The East China branch of the People's Bank estimated that about one-third of people were using the RMB at the end of February 1950 compared with about 75% by the end of May of

as a means of exchange as well as a store of value may threaten the stability of the currency. See, Bomberger, 'Indexation'.

[49] The encouragement of savings through deposits in state banks was an important instrument of Communist policy after the stabilization of the RMB. Hsiao, *Money*, p. 151.

[50] W. P. Montgomery (Hong Kong) to Board of Trade (London), 5 Dec. 1949. PRO FO371/75858.

[51] Breakspeare's Economic Report of China, 1 April 1950. PRO FO371/83336.

[52] *Ibid*.

[53] Extract from *Xinwenribao*, 5 May 1950. PRO FO371/83359.

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the same year.[54] At this point, the Communist authorities cheerfully reported that 'ever since the latter part of March, banks have been crowded with people exchanging Hongkong dollars for People's Currency—a phenomenal development'.[55] After the RMB started to appreciate on the official market in August 1950, it increased in popularity and deposits denominated in PDU were phased out in favour of RMB deposits.[56]

By October 1950, the Governor of Hong Kong estimated that the volume of Hong Kong currency circulating in China, Macao and Formosa combined had been reduced to about HK$200 million or about half of the level at the beginning of the year.[57] Grantham expected that the repatriation of Hong Kong notes would continue gradually, although 'in view of past experience of recurring currency depreciation, there must be many among the more educated classes of the community who will be reluctant to part with any reserves of foreign currency which they have accumulated'.[58] Nevertheless, by the beginning of 1951, Yoxall of the Hongkong Bank in Shanghai reported to Head Office that 'by price fixing, heavy taxation, and strict control of credit, the People's Government has stabilised the currency, an achievement previously considered impossible'.[59] This was not the end of currency substitution in China, but it marked the end of the extreme conditions experienced after the War. The next section will assess the implications of this experience.

III

There were four parties with conflicting interests in the currency substitution in China during this period. On the Chinese side, the KMT struggled to establish their own national currency, and the Communists viewed the HK$ as an instrument of capitalist pressure while in the hands of the public and as a foreign reserve asset once in the Bank of China. For reasons that will be explained below, the

[54] Report by Breakspeare (Hong Kong), 1 Sept. 1950. PRO FO371/83337.

[55] Translation from *Renminribao*, 12 Feb. 1950. HSBC GHO 179.

[56] Breakspeare's Economic Report of China, Sept. 1950. PRO FO371/83337. For a transitional period depositors could withdraw their deposits in either PDUs or RMB.

[57] Grantham (Hong Kong) to Secretary of State for the Colonies, 12 Oct. 1950 BE OV104/46.

[58] *Ibid.*

[59] Yoxall (Shanghai) to Morse (Hong Kong), 10 Jan. 1951. HSBC SHG 741.8.

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British feared the impact of currency substitution on Hong Kong and on sterling, while the Hong Kong government welcomed the use of HK$ abroad.

The free flow of HK$ in and out of China was vital to the trade of both territories, sustaining the volume of commerce in this politically and economically turbulent period. About one-third of Chinese exports between 1946 and 1948 were consigned to Hong Kong compared with 16% in the mid-1930s, and China accumulated a trade surplus of HK$300 million with Hong Kong between 1946 and 1949.[60] This surplus was despite trade and exchange controls imposed by the KMT to forestall the collapse of their currency. Rather than bolstering confidence in the CNC$ these controls merely encouraged smuggling and currency substitution. From February 1946 all Chinese exporters were required to surrender their foreign exchange earnings at the over-valued official exchange rate. This ensured that exports were much more profitable if they were smuggled through Hong Kong. The HK$ proceeds could be used as a means of exchange in China or to purchase imports. In November 1946 and February 1947 strict controls were also placed on imports into China in order to conserve scarce foreign exchange. This generated a shortage of foreign goods, which again ensured large profits from goods smuggled via Hong Kong. In 1947 smuggling through Hong Kong amounted to about 20% of China's official trade. By 1948, it was estimated that smuggled exports were equal to 39% of official exports and 15% of official imports.[61]

The credibility of the Nationalist Government was seriously undermined by the inflation and currency substitution which took place in the late 1940s[62] so the economic difficulties generated political conflict between Hong Kong and China. Although smuggling sustained producers and consumers in South China, the KMT believed that the circulation of HK$ in China undermined the CNC$ and frustrated attempts to stabilize the currency. These complaints were addressed in late 1946 during negotiations for a China–Hong Kong Financial Agreement. As part of the agreement, the Chinese authorities tried to get Hong Kong to ensure that all HK$ transactions with Chinese

[60] Szczepanik, *Economic Growth*, p. 158.
[61] Chang, *Inflationary Spiral*, p. 385.
[62] It has been claimed that the collapse of the Yuan 'had probably been the most important single cause of the loss of popular support for that [KMT] Government and its eventual defeat by the Communists.' Hughes and Luard, *Economic Development of Communist China*, p. 24.

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residents would go through authorized banks and also to prohibit the movement of HK$ to and from China.[63] Hong Kong agreed to ensure that CNC$ transactions should only take place through authorized banks but they declared that they could not control HK$ transfers beyond ensuring that large shipments of notes by sea or air would be monitored.[64] In May 1947 the Governor of Hong Kong rejected exchange controls because of the threat to the colony's traditional entrepot status.[65] Also, the prosperity of Hong Kong relied on food imports from South China that were paid for in HK$. This vital supply would have been disrupted by exchange controls.[66]

As George Bolton of the Bank of England noted, 'what the [financial agreement] in effect suggests is that the Colony should run an exchange and trade control for China because they themselves are incapable of doing so'.[67] Nevertheless, the Bank of England advised Hong Kong to accept the terms of the Financial Agreement to appease the Chinese despite their doubts about Hong Kong's ability to restrict notes flowing to South China. As Sir Otto Niemeyer observed, 'nothing will prevent the circulation of Hong Kong notes in neighbouring China (if, as is the case, the Chinese themselves can't do it)'.[68] After lengthy and sometimes heated negotiations, the financial agreement was finally concluded soon before the Nationalists lost power in China, and cancelled shortly thereafter.[69]

Currency substitution also prompted political friction between the People's Republic of China and Hong Kong since the Communist regime resented the circulation of HK$ in China. The official organ of the Party, the *Renminribao* (People's Daily) reported in May 1950 that the circulation of HK$ in Canton 'was not only a tool of British imperialism to seize huge supplies of the Kwangtung people but also a means of bandits and special service agents and depraved merchants in their speculative operations'.[70] A report by the Canton

[63] Chinese Aide-Memoir, 27 Dec. 1946. BE OV104/87.

[64] Reply from Hong Kong to China, 7 Jan. 1947, enclosed with memorandum from Young, Governor of Hong Kong, 13 Feb. 1947. BE OV104/87.

[65] Telegram from Hong Kong to the Secretary of State for the Colonies, 24 May 1947. PRO T236/681.

[66] Memorandum by Heasman (Bank of England), 12 Dec. 1950. BE 104/89. Between 50 and 60% of Hong Kong's imports from South China was food in 1946–48.

[67] G. Bolton to E. Rowe-Dutton, 26 Feb. 1947. BE OV104/87.

[68] O. Niemeyer minute, 30 May 1947. BE OV104/87.

[69] For a fuller analysis of these negotiations see Schenk, 'Commercial Rivalry'.

[70] Translation from *Renminribao*, 12 May 1950. HSBC GHO179.

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Branch of the Chinese People's Association for Foreign Cultural Relations in 1959 asserted that by the late 1940s 'the market was flooded and stifled by foreign currency' which helped to make Canton 'the slave of Hongkong and Macao'.[71] Currency substitution was seen, therefore, as an avenue for foreign intervention in the affairs of China. After the painful economic chaos under the KMT, part of the success of the Communist regime relied on the introduction of a viable national currency. A national currency would not only help to stabilize prices, but would also represent an important symbol of national unity.[72]

The Hong Kong authorities themselves had few qualms about the circulation of the HK$ in China, partly because flows of capital into Hong Kong were facilitated by the use of HK$ in China. In May 1946 Morse, manager of the Hongkong Bank, reported that

> In my opinion the freedom of movement of Hongkong Dollar Notes does not lead to any abuses to the disadvantage of the Colony, and rather than leading to export of capital makes the currency more attractive and tends to bring money into the Colony. Of the new accounts opened by the Hongkong & Shanghai Bank since re-occupation, Chinese alone have deposited over $25 million.[73]

The free movement of notes facilitated the inflow of capital that accompanied migration from China to Hong Kong in the late 1940s. The overvalued CNC$ left the Chinese reserves vulnerable to the Hong Kong free market which traded in US$ at a premium of about 40% over the official cross rate.[74] The result was that Chinese sold CNC$ in Shanghai for US$ at the overvalued official rate of CNC$12,000 per US$ and then sold the proceeds at a premium for HK$ or sterling in Hong Kong. The profits could then be used for imports or converted to CNC$ on the free market. It is estimated that there was a substantial flight of capital from China to Hong Kong amounting to HK$500 million between 1947 and 1949.[75] By April 1948 the Financial Counsellor in Shanghai reported that 'From both Shanghai and Canton funds have poured into Hong Kong, not

[71] Translation of *Kuang-chou*.

[72] Ling and Lei, *Circulation of Money*, p. 8.

[73] Morse (Hong Kong) to J. L. Fisher (Bank of England), 17 May 1946. HSBC GHO154.

[74] For the reason why Hong Kong's premium US$ market was tolerated by Britain, see Schenk 'Closing the Hong Kong Gap'.

[75] Chang, *Inflationary Spiral*, p. 320. HK$500m was about equivalent to the total value of China's exports to Hong Kong in 1949.

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only in the form of T/T [telegraphic transfers] and drafts, but, it is popularly reported, in the form of notes by the shipload'.[76] In June press reports in the North China Daily News (published in Shanghai) implied that the independent status of Hong Kong was under threat if the flight of capital from Shanghai to Hong Kong were not stemmed.[77] It is widely recognized that this flow of financial and human capital was vital to the industrialization of the Colony in the 1950s.

In terms of monetary stability, the circulation of HK$ in China did not particularly concern the issuing banks or the Hong Kong authorities.[78] This was no doubt because of their confidence in the automatic nature of the Currency Board system, and the long history of close economic and monetary relations between Hong Kong and the Chinese Mainland. Any attempts to restrict the circulation of the HK$ in East Asia would threaten the attractions of Hong Kong as a trade entrepot and as the channel of remittances from overseas Chinese. Furthermore, if the Hong Kong authorities were to impose any restrictions on the import of their own notes this would instantly bring the currency into disrepute with very damaging effects on the economy in a time of political turmoil.[79] The removal of a mere threat to price stability posed by the notes remaining outstanding was not worth the certain negative impact of imposing controls.

Despite this sanguine attitude, measures were taken to protect against destabilization should there be a large-scale repatriation of notes. The Exchange Fund, which backed the currency issue, was kept especially liquid to allow for cancellation of notes redeemed by issuing banks. In the event, however, the Hongkong Bank chose to hoard notes, which were removed from circulation but not cancelled or redeemed through the Exchange Fund.[80] They kept these notes for precautionary purposes in case demand should resume due to political or economic crisis in China. The mechanism of the currency

[76] Memorandum by H. H. Thomas, British embassy, Shanghai, 2 April 1948, FO371/69566.

[77] Extract from *North China Daily News*, 20 June 1948, FO371/69575.

[78] The preference for Hongkong Bank notes in China did cause some complications between the Chartered Bank and the Hongkong Bank. See F. H. H. King, 'The Extraordinary Survival of Hong Kong's Private Note Issue: From Profit Making to Public Service' in Jao and King, *Money in Hong Kong*, p. 41.

[79] Memorandum by Heasman (Bank of England), 12 Dec. 1950. BE 104/89.

[80] Governor of Hong Kong, Grantham, to Secretary of State for the Colonies, 12 Oct. 1950. BE OV104/46.

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issue encouraged this cautious stance. Issuing banks suffered a marginal loss on the redemption of certificates of indebtedness since the Exchange Fund bought sterling at 1s3d but sold it at 1s2 $\frac{7}{8}$d.

Once the RMB had stabilized in Canton, HK$ were surrendered to the Bank of China and flowed back to the Hongkong Bank in the form of deposits by the Bank of China. The result was a significant increase in the Bank of China's account at the Hong Kong branch of the Hongkong Bank from HK$5.5 million at the end of 1949[81] to HK$176 million in June 1950[82] and HK$190 in August.[83] The Hongkong Bank chose to keep these deposits in the form of HK$500 notes in their Cash Balance, believing that

> Some day the People's Government will want to do something with this money, most probably they will use it to buy much needed commodities and machinery from the sterling area . . . On the other hand, if there should be another collapse in their currency they would want to draw large amounts from us in notes to provide a stable medium of exchange within their own territory.[84]

In anticipation of further trouble, Adamson of the Hongkong Bank enquired at the same time how long it would take to get 10 million HK$10 notes and one million HK$100 notes printed and sent from London should the HK$ begin to replace the RMB. These smaller denominations suggest that the Bank anticipated the use of the HK$ primarily as a medium of exchange rather than a store of value.

There was close consultation between the note issuing banks and the Hong Kong Government in order to control potential demands to exchange HK$ for sterling. In October 1950, Governor Grantham assured the Bank of England that

> I have been in close touch with the Hongkong & Shanghai Bank in particular, which is primarily affected by large fluctuations in the bank note circulation outside the Colony, and I have been assured that although the inactive issue is high at present no substantial drawings of sterling are

[81] Telegram from Grantham (Hong Kong) to Secretary of State for the Colonies, 9 Dec. 1949. PRO T236/5111.

[82] Adamson (Hong Kong) to S. A. Gray (London), 23 June 1950. HSBC GHO179. Only part of the total repatriation would have gone through the Central Bank of China. A further proportion would have been repatriated directly. It is estimated that private capital flight from China to Hong Kong amounted to HK$500 million between 1947–49. Chang, *Inflationary Spiral*, p. 320.

[83] Telegram from Grantham (Hong Kong) to Secretary of State for the Colonies, 28 Aug. 1950. BE OV104/46.

[84] Adamson (Hong Kong) to S. A. Gray (London), 23 June 1950. HSBC GHO179.

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anticipated . . . it will be seen, therefore, that the local sterling exchange mechanism permits arrangements with the banks so as to avoid an inconveniently sudden realisation of investments.[85]

The accumulation of notes caused some local difficulties since they posed a danger if Hong Kong should be over-run by a foreign power. In July and August 1951 HK$153.5 million worth of unissued notes was sent for storage in Singapore.[86] It was not until April 1954 that the Bank of China's account with the Hongkong Bank was substantially reduced (from $277m in February to $87m) and the Bank's note issue was decreased by HK$80 million from HK$725.7m to HK$645.7m where it remained until 1957.[87]

Events, therefore, confirmed the confidence of the Hong Kong authorities that the redemption of HK$ notes would happen in an orderly way and would not disrupt the Hong Kong economy. The note issuer in this case was able to 'sterilize' the inflow by accumulating the cash and eventually eliminating the excess supply. This is reflected in the stability of the currency in circulation through 1950 shown in Figure 3.

Despite the sanguine attitude of those in Hong Kong, the threat which the external circulation of HK$ posed to the monetary stability of the Colony (and to the sterling area generally) greatly exercised British officials during the Communist take-over of China. The major concern was that the Chinese Government might gain control of these HK$ and exchange them for sterling, gold, or US$ in the free markets in Hong Kong.[88] Conversion to $US or gold on a large scale threatened to distort the floating exchange rate with the $US in the free exchange market to such an extent that it would attract speculators from elsewhere in the Sterling Area, further pushing down the cross rate of £/$US. At this time the UK was working hard to maintain the official fixed exchange rate of sterling to the $US through exchange controls in the UK and costly intervention in the exchange market.[89] The

[85] Grantham (Hong Kong) to Secretary of State for the Colonies, 12 Oct. 1950. BE OV104/46.

[86] Correspondence between Adamson (Hong Kong) and Edwards (Singapore), July–August 1951. HSBC GHO179.

[87] S. W. P. Perry (Hong Kong) to S. A. Gray (London), 23 April 1954. HSBC GHO179. A year later the Bank of China's balance had risen to HK$180m. Moodie (Hong Kong) to Gray, 18 April 1955.

[88] See, for example, memo by Portsmore (Bank of England), 2 Dec. 1949. BE OV104/46.

[89] Sterling was devalued from US$4.03 to US$2.80 in September 1949.

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potential that Hong Kong would allow a leak in this system prompted a search for ways to insulate China and Hong Kong from the rest of the international monetary system. No direct action could be taken to block HK$ accounts of Chinese residents because there was no way to distinguish Chinese residents from Hong Kong resident.[90] Other steps were taken, however, to limit the potential leak from the sterling area through Hong Kong's free gold market and the floating exchange market.

The Hong Kong gold market was an important aspect of Hong Kong's traditional role as a regional trading centre, but the British authorities eventually forced the Governor of Hong Kong to agree to close it in April 1949. The legislation, however, merely made transactions in pure gold illegal, while leaving the market free to operate in 0.945 gold.[91] The Ministry of Food Representative in Southeast Asia described this amendment as a measure 'which to the onlooker might appear to disallow a glass of gin unless angostura had been added'.[92]

The threat that China would exchange their HK$ directly into US$ (and so put pressure on the £/$US cross rate) prompted a vigorous investigation into closing the free currency market in Hong Kong. In November 1949, however, the Bank of England and Treasury agreed that the possibility that the new Communist Government would requisition HK$ from private holders in China and dump them on the free market for US$ was not enough reason to close the free market in Hong Kong.[93] There were four possibilities: that hoarders of HK$ would be able to keep them away from the authorities; that the market could stand the gradual pressure of conversion to US$; that the Communist Government might negotiate with the British Government to exchange them for sterling goods; or that the Communists would be unwilling to dump HK$ on a falling US$ market and would buy goods gradually instead. Closing the Hong Kong free market would merely drive it underground and might

[90] The possibility of China engaging in Cheap Sterling transactions prompted the Bank of England to control debits from Chinese sterling accounts in December 1949. This was to ensure that all sterling used by China had been earned or purchased at the official exchange rate.

[91] For a discussion of the Hong Kong gold market see, Schenk, 'Hong Kong Gold Market'.

[92] A. R. Pratt to G. A. Haig (Ministry of Food, London), 20 May 1949. PRO T236/5111.

[93] Portsmore (Bank of England) to N. E. Young (Treasury), Note of a meeting at the Treasury on 8 November, 10 Nov. 1949. PRO T236/5111.

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cause panic in Hong Kong.[94] In the event, the US embargo on exports to China and the freezing of Communist dollar assets in December 1950 meant that there was little incentive for the Chinese government to hold US$. The impact on the free dollar market, therefore, was minimal.

In summary, currency substitution prompted different reactions from the various players. Hong Kong was confident in the security of the currency board system and welcomed the benefits which the international use of the HK$ provided. Both the Nationalist and Communist authorities resented the circulation of HK$ as an infringement on their sovereignty.[95] The British had less confidence in the Hongkong Bank's ability to contain an inflow of notes, and feared for the impact on the exchange rate for sterling through the free market. In the end, Hong Kong's interests prevailed; exchange controls were not introduced despite pressure from China and from Britain.

IV

In November 1947, J. S. Beale of the Bank of England noted that 'Hong Kong currency circulates in South China and therefore, from a financial and monetary point of view—particularly in the foreign exchange field—Hong Kong should be considered as a part of China rather than a part of the sterling area'.[96] Politically, of course, this was impossible for another fifty years, but it is useful to remember that the financial integration of this region has a lengthy history. In the 1940s, the circulation of HK$ outside Hong Kong posed a political and economic dilemma for Chinese, Hong Kong and British interests which was resolved by a combination of deliberate preventative mechanisms and good fortune. The monetary system in Hong Kong allowed the domestic economy to be insulated from the repatriation of HK$, and the controls on China's US$ transactions prevented the repatriation from affecting the international exchanges. In the process, the financial relationship between China and Hong Kong for the post-war period was forged.

[94] *Ibid*. For a discussion of the Hong Kong free market see Schenk, 'Closing the Hong Kong Gap'.

[95] This contrasts with the passive acceptance of currency substitution in the 1990s.

[96] Memorandum by J. S. Beale, 11 Nov. 1947. BE OV104/87.

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Financial relations between Hong Kong and China were complex and problematic in the late 1940s and continue to be so today. Since the 1980s, the establishment of production plants by Hong Kong companies in South China has greatly increased the integration of this region compared with the 1940s. Although Hong Kong was returned to China in 1997, exchange controls are maintained between Hong Kong and the mainland, and separate currencies continue to circulate. In the 1990s, about 30% of Hong Kong's currency issue circulated in China. The One Country—Two Currencies system allows the Chinese to benefit from domestic monetary controls and relative sovereignty while enjoying the benefits of open international economic relations through Hong Kong.

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