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Revaluating Chinese Currency

Greg's Note: Fred Sheehan returns to discuss the recent attempts by "weaker minds in the U.S. Senate" to force China to revalue its currency. Apparently, this has happened before! The U.S. tried to force a *de facto* revaluation of China's silver-backed currency in the early 1930s by a concerted effort to jack up the silver price. Did that forced revaluation turn out well? Not exactly…so please read on and send any responses to your managing editor right here: greg@whiskeyandgunpowder.com

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By Frederick J. Sheehan

America's Beggar-Thy-Neighbor Policy

Weaker minds in the U.S. Senate are determined that China revalue its currency. Up, up it must go, in relation to the dollar. Leaving aside the abysmal logic employed by Sens. Schumer and Graham, the historical precedent of America's revaluation of the Chinese currency is a sorry episode of U.S. foreign policy. The earlier generation of weak minds caused nothing short of starvation across the Chinese Republic.

By 1930, China and Mexico were the two notable countries that still employed a silver standard. (There is a long history of silver standards. The pound sterling is one legacy. By the late 19th century, though, most countries had attached themselves to the gold standard.) Silver traded more like a commodity than it might have if it still circulated as money. In step with most raw materials the price of silver fell 52% between 1928-1932.

That was an unpleasant period in the United States, but not so much in China. This is a relative comparison. China had not escaped the worldwide depression. Between the high of 1929 and September 1931, wholesale prices had fallen 29.5% in the U.S., roughly the same across Europe, but only 20% in China. In the words of Roy Jastram, author of *Silver: The Restless Metal:* "The Senate Foreign Relations Committee wanted to raise the price of silver so that China could buy foreign goods." The motivation is no different today. Substitute "Senate Finance Committee" and the match is exact.

A higher silver price — in theory — would increase the Chinese capacity to buy more American goods and pull the U.S. out of the depression. Economists buttressed the politicians' yearnings. John Maynard Keynes wrote a letter to a House of Representatives' committee. Keynes believed there "was good reason to suppose that higher silver prices would boost Chinese imports and diminish exports by raising costs of production in world terms. This would cause China to stop buying silver and to export it instead, to make up for her unfavorable balance of trade."

Jastram's blood boils at this hallucination: "What China really needed was a *stabilized* price of silver, because rapidly fluctuating exchange rates could do real harm. Predictability of exchange rates was what the businessman needed. The prospect of silver prices rising arbitrarily at the hands of the United States meant further instability — the last thing the commercial world needed to add to its internal turmoil from war, flood, and famine."

"War, flood, and famine" ravaged China for a quarter century or more, culminating in the Communist Party's acquisition of national control in 1949. It is true the post-1928 slide allowed the Chinese to buy silver cheaply, thus, in greater quantities. In professor Jastram's words: "[China] could then apply [the greater quantity of silver] to her purchase of other goods and commodities. As a nation with an unfavorable balance of trade, mainly due to internal catastrophes, a low price of silver was important to her." A low price of silver – and what the economists and senators described as an undervalued Chinese currency – was exactly what the United States would banish. (Under a silver standard, China's business expanded with a greater quantity of silver reserves. Today, we have elevated the Fed to a godlike status since the means of expanding business is to print more dollars, which become bank reserves. Godlike figures always crash and burn, but that is another story.)

This analysis describes only the public debate and, regrettably, the more high-minded motivations. The man most responsible for currency manipulation was Sen. Key Pittman of Nevada. He was not in the least bit interested in the China trade but had long been an advocate of higher silver prices. Lyric Hale, CEO and publisher of the indispensable *China Online,* describes the motivations of the peoples' representative thusly: "Sen. Key Pittman of Nevada supported a bill to require the U.S. Treasury to purchase silver, in order to raise prices and 'do something' for the silver industry. Need I mention that Sen. Pittman was a major investor in silver mines? By 1934, he got his way, since FDR needed votes for his New Deal."

Pittman rode the fiat train as it gathered steam. (He had played an instrumental role in the decision to sell silver reserves on the open market and to replace them with Federal Reserve Notes during World War I.) In the confusion following the passage of the Gold Reserve Act in 1934 (which transferred title of gold from the Federal Reserve to the United States government) and the frantic pace of New Deal legislation, Pittman was able to remonetize silver, in a manner of speaking. His attachment to Roosevelt's Agricultural Adjustment Act (under the Thomas Amendment) required the U.S. government to buy silver on the world market until the price reached one-sixteenth that of gold: $1.29 per ounce. This was more than double the world's market price. In Charles Kindleberger's estimation, "Silver purchases abroad provide a brilliant example of world economic irresponsibility on the part of the United States."

Kindleberger continues: "[The silver program] represented a beggar-thy-neighbor policy, where the hurt to the neighbor was wanton and provided no domestic economic and little political benefit." It also ignored reality. American trade with China was the best thing going. Between 1930-1931, when the silver price declined 25%, the United States increased its exports to China by 1.2%, a period when American trade with all other countries fell by 38%. But Washington operated under a veil of ignorance. After driving up the price of silver, American exports to China collapsed.

The Chinese minister of finance, T.V. Soong, warned the rising prices of silver drained China of money. (There is no funny-money paper printing with a metal standard. The silver is either there or not. If the money has been sold and left the country, it simply does not exist. Businesses cannot borrow and jobs disappear.) Soong's sober warning went unheeded. Jastram laments, "It is sad to be reminded of popular American comments at the time. These seldom went beyond reiterating the conviction that doubling the world price of silver would double the exchange value of China's stocks of silver and thereby allow her to buy the United States out of the Depression. What it did was to drag China in…" The American-led program of purchasing silver (other countries bought upon American insistence) "added the final destructive touch in 1933…It could not have made the Chinese feel any happier to hear the American proposals advanced as a means of saving [China]." Following the 1934 Thomas Amendment, when the Mexicans and Chinese pleaded for relief, Secretary of the Treasury Henry Morgenthau reacted much as the bombastic political class today: He blamed the Mexicans and Chinese for creating difficulties. For good measure, Morgenthau cast doubt on their "standards of personal and public morality."

By the latter half of 1934, "Depression in China deepened as [silver appreciated] with American buying. Dislocation became severe with the great drain of silver from the country. This forced a contraction of credit leading to business failures everywhere, including some major banks." Unlike the U.S., China did not have a Federal Reserve System. It was a hard-money country. When bank reserves fell, and without the stimulus of fiat money printing, banks failed. (These explanations of the different money systems may look repetitive, but we are so far removed from a hard-money standard today, the redundancy may be useful.)

Silver continued to flee China since Pittman's handiwork bid prices above what the production from his Nevada silver mines would have earned, if not for mindless government buying. (Corn and ethanol might be a current parallel.) In Jastram's eulogy: "In [October] 1934, a record volume of silver left China in legal form. In an attempt to stem this vital outflow, a heavy export tax was put on the metal."

Order was disintegrating. Mao's Long March started the same month. Japan was encircling China. The Chinese people were starving to death. "At the close of October in 1935, the Chinese had reached their limit of patience — even endurance. They proposed the sale of a huge amount of silver in preparation for putting their money on a paper basis. On Nov. 3 they nationalized all domestic silver and ordered it exchanged for paper notes. China was the last major nation to abandon the silver standard." In Lyric Hale's words, "China was truly an accidental communist county."

In a sad re-enactment, the U.S. Senate drafted legislation in July 2007 to "boost pressure on China to let its currency rise in value." If passed, this will include heavy tariffs on imported goods. Wal-Mart shoppers may be surprised to see prices rise 30%. In a sad recreation of Morgenthau, current U.S. Treasury Secretary Henry Paulson flew to China the following week "to warn top Chinese leaders that Congress will move ahead with legislation unless the yuan appreciates in value." Paulson's mind seems to be a muddle. When he departed on an April trip to Beijing: "U.S. Treasury Secretary Henry Paulson said…he is 'a big believer in a strong dollar,' but reiterated that China's currency needs to appreciate more against the greenback." Paulson persisted: "As I think you know, I believe very strongly that a strong dollar is in our nation's interest, and I'm a big believer in currencies being set in a competitive, open marketplace." The Chinese negotiators may be left asking themselves, "If the head money-changer from Goldman Sachs thinks you can appreciate and depreciate a currency at the same time, what do Americans want?"

It only grows less comprehensible. The politicians want to devalue the dollar, yet it is on the verge of a collapse. In such circumstances it is a noble sentiment of presidential candidate Hillary Clinton to campaign for a bulletproof dollar. According to *The Daily Telegraph:* "[She] has called for restrictive legislation to prevent America being 'held hostage to economic decisions being made in Beijing, Shanghai, or Tokyo.' She said foreign control of over 44% of the U.S. national debt had left America acutely vulnerable." The second sentence is true; the first sentence is preposterous. A practical application of Clinton's proposal might ban the Chinese from buying American securities or demand all Americans pay off their mortgages immediately (thus retiring the billions of dollars worth of American mortgages the Chinese government was kind enough to mop up.)

The Communist Party of China has enough domestic woes of its own without this nonsensical blustering: The fragility of the Chinese banking system is comparable to that of 1934; the millions of unemployed Chinese might whip up their own Long March. Perhaps this is why the authorities issued their "nuclear option" on Aug. 8, 2007. He Fan, a government official, reminded the world's greatest spendthrift to bother someone else: "China has accumulated a large sum of U.S. dollars. Such a big sum, of which a considerable portion is in U.S. Treasury bonds, contributes a great deal to maintaining the position of the dollar as a reserve currency…China is unlikely to [sell dollars] as long as the yuan's exchange rate is stable against the dollar." If not, "The Chinese central bank will be forced to sell dollars once the yuan appreciates dramatically, which might lead to a mass depreciation of the dollar."

In response, Sen. Graham warned the Chinese "to work with us to achieve meaningful currency reform, rather than issuing draconian threats. Congress has been incredibly patient on this issue, and the consequences of inaction without real reform are too great to many sectors of our economy." This is populist rambling with no substance. Just how would the U.S. close the trade gap if the dollar were devalued by 30-50%? Ship 200 tons of socks to Shanghai Harbor?

In the wake of Graham's warning, President Bush told the Chinese they would be "foolhardy" to sell U.S. dollars. Bush expanded by describing his ambition to "encourage the Chinese to go from a savings economy to a consumer economy." This would seem to be for the Chinese to decide. Hank Paulson told CNBC selling dollars would be "absurd." Possibly so, but the debtor is not in a position for its head of state and chief currency negotiator to mock its primary dealer. Even the most arrogant, highly leveraged, insolvent hedge fund manager knows that. Well, maybe not.

Samuel Johnson best described the past 75 years of nonsense: "Knowledge without integrity is dangerous and dreadful."

Regards,
Fred Sheehan