



Who let the paper money out?

By CK Wong 2005.11.20

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Introduction

Paper money appeared in China in the Song Dynasty (10th to 13th Century). Since then the function, characteristics, usage, planning and performance have changed. Bush asks the country which invented paper money to appreciate. This could cause the bankruptcy of the US Government.

Paper Money in China

Through my study of the money system, I am amazed how easily and naturally gold standard was established among all ancient civilizations. There were alternative such as salt appeared in the ancient East and West. However the virtually non-destructive nature of gold allows the transfer and transmission of wealth through time and space. The advantage and the short coming of it is the weight. The weight prevents the payment over distance easily. If you need to settle a payment that worth 100 tons of gold, the logistic is extreme heavy in comparison with a cheque.

During the ancient time, Chinese government as well as merchants had to do settlement through the real McCoy. The result was a very specialized force established for the transfer of gold and silver. Gold is a good tender but its value is too high for small change. So silver is used for small denomination. The lowest denomination is copper coin. Copper is more common than silver and gold. The way to prevent copper coin forgery is done by fear as well as technology. The legal implication for coin forgery is capital punishment. In many periods, the implicated village would all be slaughtered. The technological prevention was that the coins were poured not stamped.

The gold and silver bullion was also poured. On top of that it bore the stamp of authentication. However, the stamp served as proof of material but the weight counted the value. Gold and silver were counted at face value; unlike copper coin there were no mark up.

Government as well as civilian could make bullions. There were no limitations. Of course, like all government, people prefer the government issued bullion because 'they trust the government'.

Since the government had to send out salaries and collect tax from all over the place, a special delivery system was established. The system consisted of army for protection, a highway, canal, and sea route system for fast delivery, a postal system that takes advantage of the highway and the traffic and a logistic department that look after the delivery.

The trade route in China was highly developed. The settlement created a trade for secured delivery for civilians. The secured delivery also delivered various objects: from prisoner (yes as overflow), women and children, precious cargo and documents. This demanded a delivery system like the government. This system had its toll way. Sometime, they could pay toll and use the government's transport system.

As time go by, the population of China was increasing rapidly for the last one thousand year. The traffic to move the bullion became a burden. It was first appeared in the civilian bank that issued deposit note of gold or silver for trader so that they could trade without carrying the bullion. Trader could pay the banker and received a deposit note which could withdraw the gold or silver he deposited in another city on demand. At the beginning, only the bearer of the note could with drawn. Later, when the note became very popular, some could be withdrawn by anyone.

The deposit note was state of the art at that time. Its authentication was guarantied by high tech. The note itself was made of extreme thin paper that could have the strength to be handled but delicate enough could not be physically altered. The thin paper also had another purpose: authentication. The note was covered by stamps over multiple locations. These stamps were recognized by the bankers of different cities. To certify it, the thin note and a sheet of thin paper with the stamp would be reviewed against light for an exact match.

One thing for sure was that no moisture was allowed to get near to the deposit note. These notes were frequently wrapped in oil clothe to prevent any mishap.

The civilian system caught the government's eye and the government copied it without paying any royalty. It was the time of no civilian intellectual property right. So there were two types of note: government and civilian. Again, the government note became more popular. It is interesting enough that the government note had the same function like the Federal Reserve Board. They could issue the government note (cheque) and the civilian banker would pay out. May be some smart American read Macro Polo's book well.

Yet there is difference. The bi-metal standard existed until the end of Qin dynasty and replaced it by the silver standard. Silver coin became the currency with the influence of the Spanish and Portuguese who established the silver coin payment standard.

Deterioration of the Note

Originally, the Chinese central government had the reserve to issue the note. As time went on, the army became the reserve. The more brutal military government, the less reserve. This cycle did not just repeated once. It repeated many times that reflected the boom and bust of period in a single dynasty. When the note was note backed by the gold/silver, inflation mushroom. Riots started from the farmer and spread to the upper echelon. History just repeats itself; the pattern never changes.

The most ironic event was the *monetary reform* introduced by the National Party just before the Second World War. Corruption emptied the central bank's reserve. Civilians

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were forbidden to keep gold. All civilians were forced to exchange their gold and silver to the new paper currency called *Gold Dollar Note*. Within a few years, the inflation was so serious that you have to buy any staple food used paper money that was 100 times in weight of the food. In fact the paper note was worth more than the face value.

Will China Devalue RMB?

Chinese Communist Party rose during the 1930's. They knew the inflation lesson well. Since the founding of the Communist China, there was a very long period of time that inflation was bound by the central planned economy. With the open door policy, inflation escaped from the ball and chain. The problem is far more severe than the West could envision due to the uneven distribution of wealth. I do not mean some entrepreneurs became billionaire. The problem lies on the uneven distribution of wealth among regions. The wealth accumulation happens mainly at the east around the coast. The further you go to the west, the boom gets less.

Inflation is a national phenomenon. It is not localized in a single city or province. While the average income increases to counter balanced by the living standard, the pain does not hurt much. If the income does not increase, it hurts a lot. This will brew dissatisfaction and develops undercurrent and social unrest.

To solve this, it relies on increasing export by the western region. Since they have a late start, high tech or big ticket item will not be accessible.

China has up-valued the RMB about 3% since July. It sets the daily floating rate to 0.3%. If she pushes the RMB higher, this will jeopardize the economic development of the western region. As the result, the wealth differentiation between east and west could create an irreconcilable gap that may cause the eruption of social unrest. It would be dangerous for the Chinese government to further up value the RMB. A strong currency will hurt export. Canada is a prime example. Strong currency should be the result of strong economy but not the other order.

There is another important factor that RMB could not appreciate. Japan has just finished its deflation period. It is logical for the American to find another country who is willing to buy the treasury while the US devalue. This means the new debtor's currency must appreciate. China is now becoming the new leading debtor of American. To continue to buy the US treasury, it must have a strong economy that is competitive in pricing which must keep the currency value low. If China up-value RMB, the economy will be less competitive. There will be less money for China to buy the treasury. American also wants to have slow debt building by enjoying cheaper goods from China. Buying treasury and appreciate RMB are two contradicting request. If China does up value RMB, she will earn less US\$ to finance the US debt. Bush's wish could cause US government to bankrupt.