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# Exporting hyperinflation: The long arm of Chiang Kai-shek

Richard C.K. BURDEKIN*, Hsin-hui I.H. WHITED

*Claremont McKenna College, 500 E. Ninth Street, Claremont, CA 91711-6400, USA*
*Colorado State University-Pueblo, 2200 Bonforte Boulevard, Pueblo, CO 81001, USA*

**Abstract**

As mainland China's inflationary spiral accelerated in 1947–1949 there was a massive outflow of funds to the island of Taiwan. The exporting of China's hyperinflation was augmented by the fixed, overvalued, exchange rate for the mainland Chinese currency against the Taiwanese currency that was adopted in August 1948. Empirical tests offer support for the importance of the 1948 monetary policy reform and suggest a substantial role for capital inflows and excess money growth in mainland China in accounting for Taiwan's own hyperinflation. We find no independent role for Taiwanese money growth in the inflation process.


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> For two decades, Chiang held the advantage.... Rather than the inescapability of Communist victory, it was the weakness of the Nationalists, Chiang's failure as a military leader, and economic disintegration that sent the one-time man of destiny fleeing to Taiwan. (Fenby, 2004, pp. 503–504)

* Corresponding author. Claremont McKenna College, 500 E. Ninth Street, Claremont, CA 91711-6400, USA. Tel.: +1 909 607 2884; fax: +1 909 621 8249.

*E-mail address:* richard.burdekin@claremontmckenna.edu (R.C.K. Burdekin).

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## 1. Introduction

It is well known that small open economies are highly vulnerable to the importing of foreign inflation when, faced with excess money supply growth abroad, funds flow out of the foreign economy into the initially more stable domestic currency. If the pressure for appreciation of the domestic currency is resisted under a fixed exchange rate system, even larger economies can face significant imported inflationary pressures. In this case undervaluation of the domestic currency triggers capital inflows that drive up the money supply unless the domestic monetary authorities can somehow sterilize this effect.[1] The potential for importing inflation under a fixed, undervalued exchange rate has perhaps never been more vividly demonstrated than during the twilight of Nationalist rule in mainland China. The 1947–1949 period was marked by a large outflow of funds to Taiwan that reached mammoth proportions in 1948 following the adoption of a fixed rate of exchange between Taiwan's currency and the newly issued gold yuan on the mainland. In this way, excess money supply growth in mainland China was translated into excess money growth in Taiwan that the Bank of Taiwan was essentially powerless to prevent under the fixed exchange rate arrangement imposed in August 1948.

The combination of the fixed exchange rate and Nationalist control over both the Central Bank of China and the Bank of Taiwan created an almost ideal vehicle for massive capital flight from mainland China to Taiwan. Indeed, the worse conditions became on the mainland, the greater the incentive to capitalize on the fixed exchange rate and move funds into Taiwan and the Taiwanese currency. The existence of a causal link between capital inflows from mainland China and Taiwanese inflation receives strong support from the data presented in this paper. These capital inflows are, however, mainly a proximate factor in the inflation process. While exogenous from the point of view of the Bank of Taiwan, these capital inflows were themselves the endogenous product of deteriorating conditions on the mainland coupled with excess money growth that had, as a major outlet, the exit strategy offered by the fixed exchange rate imposed on both central banks by Chiang Kai-shek's Nationalist regime. Holders of gold yuan naturally took advantage of the de facto currency arrangements that forced the Bank of Taiwan to accept the depreciating Nationalist currency and exchange it for the separate Taiwanese currency at an overvalued rate.

One way of assessing the magnitude of the overvaluation of the gold yuan against the Taiwanese currency is to consider how the gold yuan fared in black market trading. On October 15, 1948, the US Ambassador to China, John Leighton Stuart, observed that the US dollar was exchanging for 16 gold yuan in Beijing even though the official rate was only 4:1 – while an ounce of gold was selling for 1000 gold yuan, up

[1] Such rising capital inflows began putting pressure on Chinese inflation and money growth rates in the early 2000s, albeit nowhere near the extent of the 1948–1949 experience documented in this paper. On the recent controversy about renminbi undervaluation, and its consequences, see, for example, Cargill, Guerrero and Parker (2004).