

SPECIAL REPORT NO. S-36

Shanghai, China, January 30, 1939.

Subject: "CHINA ANNUAL ECONOMIC REPORT FOR 1938"

Submitted by: A. Blend Celder, Acting Commercial Attache.

(Required Report - Manual of Instructions, Part One - III)

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General: At the end of the year, hostilities had been under way for 18 months with continued dislocations to trade, industry, finance and general economy, further disruption to transportation facilities, additional wide scale destruction of property, and appalling human suffering as tens of millions of people were directly affected by war conditions. The devastation was especially great at two additional important industrial and trade centers - Canton and Hankow - which fell in October.

The territory "occupied" since the commencement of hostilities is estimated at about 390,000 square miles, which, together with the previously affected areas including Manchuria, totals 976,000 square miles, or 22.6% of the area of China, embracing an estimated 180 million people with possibly 270 million people in the territory remaining under Chinese control. "Occupied" areas of the country embrace not only an important portion of the rich agricultural and mining resources, but also those sections in which the major part of modernized industry had been developed. The area remaining under Chinese control, however, contains vast agricultural and extensive mineral resources, both of which are capable of considerable expansion. There has been an important migration of technical talent and capital to that area which is now active in developmental work. There has also been a limited migration of the general populace and educational and student class to the Chinese controlled areas. This movement is bound to have permanent effects in the development of the latent resources of hitherto neglected sections in West and Southwest China.

Agriculture and Rural Economy: During 1938 China generally enjoyed the third successive year of good crop production at about average levels. Wheat, cotton and flue-cured leaf tobacco production was much below average, but the 1938 rice crop was a bumper or record one. Miscellaneous food crops were also good. The carryovers of cotton and tobacco were larger than usual, offsetting in part this year's short crops. The cotton supply was about sufficient for domestic needs, but large takings by Japan will necessitate imports from India and America for Shanghai mills. The wheat supplies are insufficient for the large coastal consuming centers and hence important wheat or flour imports are necessary.

Despite the large rice production, restrictions on the movement of the crop from the growing areas and transportation problems are likely to make imports of rice necessary during 1939. Prices received by farmers, especially in "occupied" areas, averaged low compared with those for the years prior to the hostilities, hence rural buying power for the products of industry has been reduced. Besides this, the inaccessibility and high prices of these products have tended further to reduce the farmers' purchases.

Farm economy has generally reverted to a more self-sufficient basis both in the "occupied" areas and Chinese controlled territory. However, the Chinese Government, in the areas under its control, has aimed at the production of food crops adequate for self-sufficiency while at the same time it has encouraged the production of export crops. It has introduced specially grown cotton seed in West and Southwest China in efforts to offset the loss of cotton growing regions.

Transportation and Communications: At the end of the year about two-thirds of China's railway mileage was in Japanese "occupied" territory and one-third in Chinese controlled areas. There was an acute shortage of rolling stock in both Manchuria and North China, but a virtual glut of railway equipment on the Chinese controlled lines due to the removal of same prior to the Chinese withdrawal from the now "occupied" areas. Some portions of railways in the eastern areas were decommissioned and the rails and equipment were transferred to Central China for the construction of new lines westward and southwestward from the Canton-Hankow Line. Besides the completion of the Hengyang-Kweilin Railway (also known as the Hunan-Kwangsi Line) in September, its extension across Kwangsi Province to French Indo-China was actively under construction during the year, as was the Hunan-Kweichow Line. Plans for the early construction of the projected Yunnan-Burma and Yunnan-Szechwan Railways were under way at the end of the year.

The loss of rail communications and waterways, particularly the terminals of the Canton-Hankow Line and the Yangtze River between Kiukiang and Yochow (above Hankow) during the year, made Chinese areas more dependent upon highway transportation. Road construction was actively furthered, the outstanding development being the completion of the Yunnan-Burma highway. This 650 mile road opened up to motorized traffic an ancient trade route hitherto confined to pack animals or human carriers and connected with rail and river routes to the port of Rangoon in Burma. The situation has also made necessary the importation of large numbers of motor trucks for augmenting highway transport facilities over the numerous new trunk lines which have been completed in recent years and which now connect the new centers of Chinese Government activity.

(Transportation and Communications Cont'd)

The Japan Air Transport Company maintained fairly regular air mail service for the general public and passenger service, by military permit only and chiefly for Japanese passengers, thrice weekly between Japan, Shanghai and Nanking. Similar services were also developed between Japan, Tsingtao, Tientsin and Peiping in the latter half of the year. In Chinese controlled territory, commercial air services were active with several planes per day between Hankow and Hong Kong up to August when attacks on the services resulted in their curtailment and in resorting to night flying. After the fall of Hankow, services were mainly between West China cities and Hong Kong and Hanoi, in French Indo-China. Hong Kong assumed more importance as an air terminus with the extension of Air France services to the Colony, via Hanoi, and with the increased frequency of Imperial Airways services between the Colony, Australia and London. All first class mail between London and Hong Kong and vice versa is now carried by air. Trans-Pacific Clipper services to Hong Kong operated thrice monthly during the latter part of the year. Kunming, the capital of Yunnan Province, is to be included as a stop on the Hong Kong-India-London service of Imperial Airways under recently concluded arrangements. The China National Aviation Corporation (Sino-American) is to be permitted to operate between Yunnan and Burma and Yunnan and Hong Kong. Plans for air services between Chungking, Urumchi and Soviet Russia with connections for western Europe were being furthered at the end of the year.

Telecommunications were restored to some degree in the Japanese "occupied" areas and the Japan-Shanghai radio-telephone service has lately been restored. Telecommunications were also furthered in Chinese controlled territory with radio-telephone service established between Chungking and

(Transportation and Communications Cont'd)

Moscow late in the year. The most powerful broadcasting station in the Far East is at Chungking operating under Chinese Government auspices. Radio-telephone connections between Shanghai and the United States have remained cut off since the destruction of the stations in the neighborhood of Shanghai early in the hostilities. At the end of 1938, the Hong Kong Government was making plans for radio-telephone connections with countries abroad.

Industry: In Manchuria early in the year it appeared that the diversion of available Japanese capital to North China threatened the furtherance of the Government's five year developmental scheme for heavy industry and basic resources. However, by the end of the year it was evident that ample capital is forthcoming for amplification and speeding up of all projects necessary to war production economy. The nationalization of industry in Manchuria has proceeded rapidly with only a few minor industries remaining in private hands. The Government's plans include increases in the production quotas originally aimed at for iron, steel, synthetic fuel oil, coal, hydro-electric power, pulp, salt, gold, light metals, lead and copper to high levels by 1941. Total investment in Manchurian state commercial enterprises at the end of the year was estimated at yen 1.5 billion.

In North China, Japanese interests took over the principal Chinese enterprises including 12 flour mills, 14 electric power plants, 6 cotton mills and numerous miscellaneous factories. At Tsingtao, the rehabilitation of the Japanese textile mills was expedited by Japanese Government grants in aid, but Chinese industrialists felt no inducement to return to that area.

Shanghai industrial production has returned to possibly 45% or 50% of pre-hostilities capacity, but any further recovery will be dependent upon the opening up of the Yangtze Valley to normal trade. The present degree of recovery is due to the fact that many small and medium sized Chinese enterprises have been resuming production in temporarily improvised premises on leased land in the International Settlement and French Concession with equipment salvaged from the Chinese municipal areas prior to their occupation by the Japanese forces. The recovery is also due to the fact that an outlet is found in the immediate hinterland of Shanghai where supplies were cut off for many months and where stocks are abnormally low, and in Shanghai itself where consumptive capacity has risen materially with the large influx of well-to-do refugees from other parts of the country. Undamaged or slightly damaged Chinese plants in the "occupied" part of the International Settlement have, for the most part, been recommissioned under Japanese auspices.

While some of Shanghai's industrial output is shipped to Chinese controlled areas under special arrangements for a refund of the Consolidated Tax at Shanghai on goods obliged to pay such a Tax on entering Chinese territory, the policy of the Chinese Government has been to frown on the use in its territory of products of Japanese controlled Chinese mills in the "occupied" areas and to encourage industrial self-sufficiency in its areas by the promotion of so-called "industrial cooperatives", using available machines and expanding handicraft industry, Government banks aiding in the financing of these developments. The Chinese Government has endeavored further to provide essential industrial goods for the populace in its areas by encouraging the dismantling of large numbers of plants in threatened areas prior to their occupation, moving the machinery to new locations in West and Southwest China. This is calculated to have

(Industry Cont'd)

permanent effects in decentralizing industry, which was previously concentrated largely at the coastal ports and Hankow, and in scattering it to less vulnerable points throughout the consumptive areas. At Hankow and Canton, at both of which points industrial developments have been increasing rapidly in recent years, there was considerable destruction of industrial equipment by bombing and upon the Chinese evacuation from these districts.

The Chinese authorities have also been directing their attention increasingly to plans for speeding up the development of mineral resources in Central, West and Southwest China, particularly coal, copper, tin, tungsten and antimony, as well as to the establishment of additional power plants, machine shops, textile mills and installations for the production of defensive equipment.

Japanese effort in North China during the year has been directed toward increasing coal and salt production for export to Japan, besides laying plans for tapping iron ore resources in Chahar and Shansi Provinces and for developing blast furnaces for the supply of pig-iron for expanded Manchurian and Japanese steel plants, also toward installing iron foundries adequate to meet the needs of the area. The program envisions self-sufficiency in these products by the countries in the economic bloc.

Finance: The issuance of fiat currency in North China under the auspices of the Japanese sponsored Peiping regime to the extent of yuan 150 million during the year and efforts to tie the "occupied" regions into the yen-bloc constituted the greatest threat to China's monetary system. These developments necessitated the departure by the Chinese authorities from the foreign exchange management basis to exchange rationing. The latter was done at the stabilized rates in force prior to the hostilities, but in such a restricted quantity that open market trading at declining rates developed, the yuan suffering a 45% drop in exchange value. However, in Chinese controlled territory exchange control was enforced on specified exports at former stabilization rates. The open market rates naturally restricted imports and the Government acquired a goodly portion of remittances from Chinese abroad. All of these were offsetting advantages. While a fairly healthy balance of international payments thus obtains and this tends to support the open market rates for the yuan, there are adverse factors pointing toward ultimate lower rates, especially in the "occupied" territory where control measures are becoming more difficult for the Chinese authorities and where efforts to support the open market rates work to the advantage of the North China regime and others seeking to establish foreign currency balances abroad.

The Chinese authorities met all foreign obligations secured on the Customs revenues in 1933, besides a considerable portion of the payments secured on other revenues, thus making inroads on reserves held abroad. However, the loss of principal areas yielding Customs, Consolidated Tax and Salt revenues, together with the drain of war financing, has forced the Ministry of Finance to announce that beginning with January, payments on foreign and

(Finance Cont'd)

domestic obligations will have to be on a deferred and partial basis limited to the proportion of revenues collected in the Chinese controlled areas (possibly 10% to 15% of the total) unless arrangements can be made for the Customs and other collections in the "occupied" areas to be applied to payments secured thereon. While the Chinese authorities can probably secure a larger portion of the remittances from Chinese abroad through the new branch banks opened in Southeastern Asiatic countries and can develop a considerable degree of self-contained economy, thus restricting ordinary imports, the export movement is seriously obstructed by cutting off of the main ports and trade routes. Hence it appears probable that any considerable financing of required imports for the Chinese controlled areas will sooner or later be dependent upon foreign credits.

Foreign Trade: Despite the most widespread disturbances in China's history, China's recorded foreign trade for 1938 was but 10% in gold values under last year and very slightly under 1936, the last normal year. The fact demonstrates again that despite temporary disruption here and there, the Chinese people of necessity quickly revert to their basic economic life.

Factors which held up the trade volume to only slightly below the normal level included: (1) Controlled takings of export commodities by Japan in much larger than normal volume, notably salt, coal, cotton, wool, scrap iron and pig iron from North China. (Raw cotton exports accounted for one-seventh of China's total exports during the year, 90% of same being taken by the Japanese Empire). (2) The success of the Chinese Government in moving out a large volume of export commodities from Central and West China over the Hankow-Hong Kong rail route up to mid-October, despite the continual

(Foreign Trade Cont'd)

bombing of the line, especially exports of tung oil, tungsten, antimony, bristles and tea. (3) Egg products, which move principally to Europe and which constituted 6 $\frac{1}{2}$ % of the total value of exports, despite forebodings early in the year due to a shortage of chickens and disrupted transportation conditions in the region of Shanghai and Tsingtao, were three-quarters normal in quantity with the value greater than in 1936 and only 6.6% under 1937. (4) Cotton yarn exports, apparently mostly from Japanese mills in Shanghai, to India and other Asiatic areas increased and cotton piece goods exports held up to normal value. (5) Linen embroidery, drawn thread and cross-stitch work exports, which go mainly to America, held up to near normal volume. These items accounted for nearly 5% of the total exports for the year.

Factors accounting for the nearly normal import value included: (1) The fact that in North China "occupied" regions the large takings of exports by Japan were to a large extent replaced by Japanese consumer goods, mainly cotton and woollen piece goods and rayon, in what is tantamount to barter trade, due to purchases and sales in the same currency, (farmers fear reprisals by guerrillas for having "Federal Reserve Bank" or yen notes in their possession and quickly convert cash receipts for crops into virtually the only available merchandize, viz. Japanese goods); (2) Large flour imports into North China which were occasioned by the short wheat crop; (3) Imports of machinery from Japan, which were recorded but largely duty free, for the rehabilitation of Japanese plants; (4) Some flight of capital into commodities such as indigo and dyes, imports of which held up fairly well despite the much lower consumption; (5) Some items of chemicals held up despite the decreased consumption for the reason that domestic plants were destroyed or out of production; (6) The fact that the Hong Kong-Hankow rail

(Foreign Trade Cont'd)

route was open most of the year, permitting ready ingress to Chinese controlled areas of essential imports including a large increase in imports of unspecified goods under the heading of "sundries" believed to be Chinese Government purchases partly secured from Europe on a barter basis; (7) The large volume of import cargo diverted to various Far Eastern ports at the commencement of hostilities in 1937 was gradually brought to Shanghai or disposed of in Chinese controlled areas or elsewhere being mostly cleared up during the year, much of it at a loss; (8) Rice imports into Chinese controlled areas increased partly due to the restrictions on the movement of rice from the Lower Yangtze Valley to South China, which necessitated imports from abroad to the latter area.

Indications are strong that there was a large unrecorded trade outward and some inward. An analysis of the monthly foreign trade statistics shows that imports from Japan, which were very small in January, gradually rose to 73% of the imports into North China in December and 46% of the imports for that month into all China, surpassing all other nations and supplanting the United States, hitherto in first position. Hence, evidences are that the yen-bloc system, together with various restrictions, monopolies and control of exchange and transportation in the "occupied" areas is showing results in rapidly augmenting imports from Japan and in directing more and more export trade into Japanese hands to the gradual exclusion of others. The trend presents a very unpromising outlook for American, British and other non-Japanese trade interests.

Manchuria and North China are being tied more and more into the emergency economy of Japan and the restrictive policies enforced in Manchuria are gradually being extended farther south.

(Foreign Trade Cont'd)

While imports into China from the United States and its possessions in 1938 dropped off only about 20% as compared with each of the two previous years, a more accurate index of the trend is shown by comparing the position for December last with the last normal month prior to the hostilities, imports for December, 1938, from the United States being nearly 60% below July, 1937. Exports to the United States last year were 46% below the previous year and nearly 30% below 1936, whereas December, 1938, exports to the United States were 51% below July, 1937.

Exchange and trade control in Manchuria limit the imports almost exclusively to equipment from abroad which is necessary to the augmented five year development scheme for war industries, as much as possible of the required capital goods being obtained from Germany and Italy under the new barter deals for beans and vegetable oils. However, the capacity of the latter countries is apparently largely taken up with emergency demands at home hence the United States may be a temporary leading source of supply to Manchuria of this equipment providing exchange can continue to be found for the payment therefor. Other categories of imports into Manchuria are expected to continue heavily restricted. For example, it is announced that no import permits will be granted for leaf tobacco for Manchuria in 1939 from sources abroad other than Japan, Korea and North China.

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Conclusions and Outlook (Import and Export Trade Outlook): The 1939

outlook for general import trade from the United States is dark, the adverse factors being:

- (1) The Chinese authorities, for war economy reasons, are likely to restrict increasingly all non-essential imports into their territory, besides which, the now limited and circuitous facilities are likely to be used almost exclusively for Government requirements;
- (2) Imports into Japanese "occupied" areas may be affected by further tariff revisions favoring Japan;
- (3) The present low exchange value of the yuan and the prospective further decline in the open market exchange rates will be a heavy deterrent;
- (4) The likelihood of further implementation and extension of the fiat currency scheme, on the yen-bloc basis, in "occupied" territory, will tend to preclude any large imports from sources other than Japan.

The outlook for export trade for 1939 also has some unpromising aspects, as follows:

- (1) It is quite possible that because of unpropitious weather conditions in East Central China this winter, crop production may suffer;
- (2) From Chinese banking contacts it is learned, confidentially, that in such centers as Shanghai and Tientsin, as well as at other North China ports, they are hesitant to finance the movement of cash crops to export points, fearing that the Japanese authorities may enforce, as at Tsingtao and Chefoo, export exchange control, thus causing banks the loss of the difference between controlled and open market rates of exchange on any goods financed but still unshipped at such time as regulations of the sort might be enforced;
- (3) There are also apprehensions that additional commodities may be monopolized by the Japanese military authorities, thus making them unavailable for ordinary export trade, or that the areas where restrictions or monopoly handling of cotton, wool, and other commodities are in force, may be extended;

(Import and Export Trade Outlook Cont'd)

- (4) The chances are that the usual cash export crops in "occupied" areas may be smaller due to discouragingly low prices paid to farmers in the past two seasons (by the Japanese who have in many cases monopolized buying activity at the purchasing centers along the railways);
- (5) Some curtailment may be expected in agricultural production, especially of cotton and tobacco, in pursuance of the policies of economic resistance directed by the Chinese guerrilla forces and designed to prevent the Japanese from obtaining economic gains by exploiting Chinese agriculture;
- (6) While the Chinese authorities will naturally do everything possible to move export commodities from the territory under their control, it is obvious that the greater dependence upon highway transportation with longer hauls at greatly increased costs will tend to restrict the traffic to the more highly priced and less bulky commodities and it is likely that the movement will be much below 1938.

(Aims and Effects of Currency Control): Suspicions are entertained that the Japanese authorities are not only disposing of the Customs collections from the "occupied" areas in the open exchange market, but are using export exchange control and other methods to circumvent the functioning of non-Japanese exporters. The purpose is to use the foreign credits acquired in this manner to finance war needs, particularly the necessary purchases of heavy basic industrial equipment from abroad for Manchuria and North China. Thus, Chinese export trade is apparently being made to finance the Japanese expansion program, the methods involving the virtual ousting of non-Japanese traders, even for direct exports to America and Europe. It is believed that these are the combined objectives of Japanese currency manipulation and trade control in the "occupied" areas rather than the supposed purpose of building up a foreign currency or gold reserve for the North China fiat currency which is as yet inconvertible. Thus the anticipations held abroad with regard to the establishment of

(Aims and Effects of Currency Control Cont'd)

a new and workable North China currency which would facilitate the general trade of all countries with North China are apparently poorly founded.

(General Conclusions and Outlook): Therefore, observations of developments already well under way indicate that a relatively speedy success of the Japanese design may henceforth be realized to an increasing extent. This success is predicated, however, upon the acquiescence of the powers, chiefly the United States and the British Empire, in being thus preempted from their former position and upon their continuing to be the chief cash customers (thus financing the Japanese aims) for the monopolized products of Japan, Manchuria and a Japanese controlled China, at prices which will undoubtedly be boosted for those commodities not readily obtainable elsewhere. On the other hand, even if economic sanctions were to be applied (too late, as would likely be the case), the probabilities still would appear great (unless Chinese resistance can be made more effective) that Japan will be able, in the course of time, gradually to subdue the Chinese populace and to integrate resources and man power in the yen-bloc areas into a self-contained but expanding East Asiatic economic empire.

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SOURCES OF INFORMATION

In the preparation of the foregoing summary, the following sources of information have been freely drawn upon:

1. Regional Consular Reports, monthly and for the year, and our own monthly summaries for East Central China.
2. Letters and comments summarizing 1938 trade conditions from about three score American business men.
3. Chinese Maritime Customs Monthly and Annual Trade Statistics
4. Reports of the American Agricultural Commissioner at Shanghai.
5. Our own economic and financial radios giving highlights of the developments week by week.
6. Various Chinese statistical and banking publications, and local periodicals.