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Monetary theory from a Chinese historical perspective

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While many commentators focus on China's future, this column draws economic theory insights from its past. It argues that Chinese monetary theory preceded Western thought and influenced the likes of Adam Smith and Karl Marx. Moreover, it says the Eastern emphasis on the pursuit of wisdom, as opposed to knowledge, has a role to play in today's economic debate.

The world is still learning about the multifaceted marvel which is China. China the rapidly growing giant (Mitchener and Yan 2010), China the super saver (Wei 2010), China the super-competitive exporter (Huang 2010), China the ancient culture, etc. One aspect that has been little appreciated is China as a source of economic theory.

In recent work we summarise pre-industrial revolution thinking on money and monetary policy (Xueyi et al. 2010)—the first in what we hope is a series of papers on ancient Chinese economic thought.

Money in China

The monetary structure of the economies of ancient China varied across dynasties. In some ways it was both more complex and less well-developed than Europe's.

- Three different forms of coinage typically circulated (gold, silver, and copper).
- The invention of paper money is usually credited to China, with its large scale use arriving in the late 8th or early 9th century.
- There were no financial institutions involved in credit creation or issuance of insurance contracts.
- There were, however, monetary depositories where merchants and others could deposit commodity money in exchange for a paper certificate, which in turn could be exchanged for goods in the various provinces.

Originally labelled "flying money" (it was so light the wind could blow it out of a holder's hand), this money began as a draft rather than bank issued money. Private merchant drafts were taken over by government in the early 9th century and this currency was used for forwarding local taxes and revenues to the imperial capital. Later, silk notes replaced paper, and older money had to be exchanged for silk.

Currency unification

A unified currency spread throughout China by the late 13th century, and Chinese notes were a monetary medium in Persia. Marco Polo was reportedly greatly impressed by Chinese money. In the Ming Dynasty (14th century) a new note named the "precious note of great rising" was issued but, inconveniently, only in one denomination. Copper coins were still allowed to circulate. Inflation occurred, and the precious note was progressively replaced by silver.

In the mid 17th century, the Ming Dynasty attempted to revive paper money after a 200 year hiatus, but with no success. Only under European occupation in more modern times did paper money return.

The older Chinese paper money profoundly influenced Western banking. The original Hamburg and Swedish banks were set up following a Chinese model. The first western paper money appeared in Sweden in 1661. America followed in 1690, France in 1720, England in 1797, and Germany in 1806.

Ancient Chinese monetary policy and theory

Imperial China was a politically integrated structure with regional segmentation of economic activities and hence with regional money. Monetary policy was conducted at regional level, but overseen nationally before countrywide integration under the Ming dynasty (14th century). There were regional differences in the forms of money circulated. Gold, silver, copper, and paper were all present at various times in various provinces.

The Imperial Chinese economy witnessed boom and bust, and inflation and deflation. Monetary policy was controlled, much as it was subsequently controlled in Europe. This policy was guided by monetary theory that included basic concepts such as the roles of monetary policy, the velocity of circulation, inflation, interest rate parity, and the quantity theory of money. In our paper, we argue that Chinese monetary thought thus seemingly preceded Western thought, and had remarkable similarities.

Chinese origins of economic thought

Modern Western economic theory is traditionally traced back to the late 18th century with the emergence of the so-called Physiocrats in France. As the New World Encyclopedia puts it: "Physiocracy is perhaps the first well developed theory of economics. It immediately preceded the first modern school, classical economics, which began with the publication of Adam Smith's The Wealth of Nations in 1776. Key thinkers were Anne-Robert-Jacques Turgot (1727–1781) and François Quesnay (1694–1774) both of whom had an important influence on Marie-Esprit-Léon Walras and Adam Smith."

Despite this, there are claims from the Chinese scholarly community that many of the key ideas later expressed in Western economic thought were found much earlier in Imperial China—although with different wording and different emphasis.

In Imperial China, great issues of the day were often passed to leading thinkers in the court who were given time and staff for reflection and advice. Young scholars (Westerners would call them students) affiliated with at least one of the commissions seemingly travelled the Silk Road and spent some years in Europe. It seems that they may have talked to Quesnay in France in the 1750's (who intellectually, in some people's opinion, was a forerunner of Walras).

Karl Marx in Das Kapital (1873) makes explicit reference to a specific old Chinese thinker (an economist). Thus, the intellectual heritage of modern economics (now global) may in some small way reside in China.

Western knowledge versus Eastern wisdom

There are large cultural differences between old Asia and the newer OECD which both divide and inspire contemporary policy debates globally, and specifically across the Pacific. Eastern philosophical tradition does not accept the notion of absolute truth—a notion that is at the heart of the Popperian tradition of Western science, and its Friedmanian corollary in modern economics.

In the West, science has as its goal identification of objective truth; progress means moving ever closer to the frontier of knowledge. Eastern philosophy, by contrast, argues that there is only "knowledge", which is embodied in deep thoughts of old and new texts. Old texts are held in particular reverence because they have passed the test of time.

This traditional distinction between "Western pursuit of knowledge" and "Eastern pursuit of wisdom" marks a difference that pervades far more than East-West differences on economic thought. Delving into the wisdom of the past from an Asian traditional perspective as a way of moving forward in decision making on today's problems thus seems a sensible way for Asians to proceed.

But modern economics is not really a hard science. It has been impressively formalised in maths and parts of it have been rigorously analysed econometrically, but it can never be a science in the way physics or chemistry is. There are no controlled and repeatable laboratory experiments for entire economies. Modern experimental economics is an important development, but economists can never really sort out causation on the biggest questions. It would be impossible to see, for example, what would have happened if the subprime crisis had coincided with stricter capital requirements on banks, or indeed whether such regulation would have prevented the crisis in the first place.

Economics remains, as Joan Robinson characterised it, a pseudoscience. It is more in the tradition of Durkheim's emphasis on development of chains of deductive logic to aid policymakers in reaching decisions on social action. In this sense, the Eastern approach is not so different when it comes to economics. When considering how to proceed in the modern discipline of economics, we would argue that old and new knowledge should perhaps to be given equal weight.

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CAGE's research analyses the reasons for economic outcomes both in developed economies such as the UK and emerging economies such as China and India. The Centre aims to develop a better understanding of how to promote institutions and policies that are conducive to successful economic performance and endeavours to draw lessons for policy-makers from economic history as well as the contemporary world.

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