Note by the Chancellor of the Exchequer and the President of the Board of Trade.

We circulate for the consideration of our colleagues a report which Sir Frederick Leith-Ross has prepared at our request summarising his impressions and suggestions in regard to China.

N.C.
W.R.

16th September, 1936.
The primary object of my mission to China was to seek a solution of the acute currency crisis caused by the American silver-purchasing policy. This object was achieved as the result of the abandonment by China of the pure silver standard and the adoption of a managed currency last November. The currency reform then introduced has up to the present proved unexpectedly successful and no serious difficulty has been experienced in maintaining the exchange at the level fixed. The Chinese Government have still to complete the programme of reform by re-organising the Central Bank as an independent reserve Bank and by balancing the Budget; but the main danger to the currency is the constant menace of Japanese intervention and if a better understanding could be reached between Japan and China, there would be every reason for feeling confidence in the Chinese currency and for anticipating a definite revival in Chinese trade generally. Mr. Rogers, of the Bank of England, who accompanied me to China, is returning there, on the invitation of the Chinese Government, to advise the Central Bank, in which capacity he will be able to render valuable assistance in the completion of the banking re-organisation contemplated. I have circulated to the Departments interested more detailed notes setting out my impressions of the situation in China generally and the present memorandum is directed to formulating such suggestions as I have in regard to British policy and British trade. It should be borne in mind that,
although during my stay in China, I studied the situation as well as I could, these suggestions are based on personal impressions derived from the data at my disposal and they must be correlated with information available from other sources.

(1) **Publicity.**

First and foremost, if we desire to maintain our interests in the Far East, every suitable opportunity should be taken to emphasize that this is our policy. At present British prestige in China stands high; but there is a widespread feeling, both in Chinese and in British circles, that in the stress of European preoccupations, His Majesty's Government take little interest in China or in our trade with China; and that our policy is to abandon our position or at least not to make any effort to maintain it. This impression affects the Chinese attitude to British proposals and discourages our merchants from initiating new ventures. It can to some extent be counteracted by arranging more publicity both in China and here. Occasional articles in the Press reviewing the situation in China, such as those written by the Secretary of the China Association and published in the Times last year are useful. The publication of an annual report from the Ambassador summarising developments in China, and commenting upon them from the point of view of British interests and policy, would be of greater value. Still more important are Ministerial statements. These are cabled fully to China, are eagerly studied and commented on at length in the local Press. If Ministers would from time to time introduce
into statements on foreign affairs a few well-chosen sentences emphasising His Majesty's Government's sympathy with the rehabilitation of China and our desire to maintain and develop our trade there it would greatly encourage our traders and help to maintain our influence with the Chinese Government.

But, of course, in the end our continued interest in China can be proved only by the adoption of an active policy on the part of His Majesty's Government, e.g. in pursuing diplomatic representations to the Japanese Government and in working out appropriate financial assistance to China.

(2) Policy towards Japan.

It is very difficult to formulate any very definite recommendations in regard to Japan. The Japanese military undoubtedly aim at the domination of China, or at least of North China, through a subservient Chinese administration and they will do all they can to weaken the Nanking Government so long as it opposes this policy. There are many shades of difference in Japan as regards the extent to which, and the pace at which, this policy should be pursued, but in the absence of joint military pressure by the Great Powers, or intervention by the U.S.S.R. alone, no Government in Japan is likely to renounce it entirely and the main check on its pursuit will probably be the degree of resistance met with from the Chinese. On the other hand, we could use our influence with the Japanese Government to urge upon them a more reasonable policy towards China. At the present time, both the Japanese Government and the Japanese military authorities are definitely anxious to maintain
good relations with the United Kingdom; and they repeatedly assured me that they had no desire to prejudice British interests in China. We should make the most of these assurances and our Embassy in Tokyo should not hesitate to emphasise to the Japanese authorities, in a most friendly but quite firm manner, that they cannot expect the relations between the two countries to improve unless these verbal assurances are carried into practical effect. In particular, we should press tirelessly for the abandonment of the Japanese campaign for "autonomy" in North China, which, involving as it does the wholesale smuggling of Japanese goods, and the disruption of the Customs service, threatens both our trading and our financial interests in China, and which, if allowed to continue, will undermine both the political and financial stability of China.

(3) Personnel of Chinese Customs.

As the result of numerous discussions with Japanese representatives, the Japanese Government offered to agree that the successor to the present Inspector-General of Customs should be British provided that we were willing to agree that a Japanese national should be appointed Deputy Inspector-General and that he should be succeeded in this post by another Japanese national. No commitment would be made as to the more remote future but this arrangement would, it seems to me, meet the immediate necessities. The Japanese, more hesitatingly, asked that there should be some consultation between the two Governments as to the individuals
to be nominated to these posts. This may create some difficulty as the appointment of the chief Customs officials rests, and must rest, with the Chinese Government who would gravely resent any arrangement which gave the Japanese a deciding voice in their selection; but some informal consultation might be arranged by which the officers recommended for appointment might be mutually notified.

The Japanese Government are also pressing for an increase in the number of Japanese officials in the customs service and they appear to aim at securing at least as many Japanese as there are British officials employed. This is perhaps not unreasonable from their point of view, but we also wish to secure fresh recruitment of British officials, no new appointments having been made for over ten years. The Japanese oppose this on the ground that it will render more difficult the additional recruitment of Japanese officials which they desire. But if we agreed in principle to their desiderata, no doubt some compromise could be arranged, by which, say, one new British official would be appointed to every two additional Japanese officials, until the two nationalities were equally represented. (At the same time, a certain number of appointments would also have to be made of other nationalities.)

I have suggested that advantage should be taken of Sir H. Knatchbull Hugessen's visit to Tokyo to secure an agreement between us and the Japanese authorities on the above lines. There would still remain the question how the Chinese Government could be persuaded to give effect to such an arrangement.
The Chinese Government will, as stated above, resent any agreement made between us and Japan for distributing appointments in the Chinese customs service and the Japanese representatives at Hankow may well present the proposals in such a form as to foment friction. I am inclined to think that we and the Japanese should each approach the Chinese Government separately, with our agreed requests, but in the first instance, the method of approach to the Chinese Government should be discussed with the Japanese Foreign Office at Tokyo.

(4) Customs Tariff.

The Chinese Customs tariff has been increased in recent years, particularly as regards textiles, to a prohibitive point. The Japanese have frequently protested against these tariff increases; unfortunately they have linked their demands on this point up with the question of smuggling and have urged sweeping reductions of the tariff so as to make smuggling unprofitable. This is not a practicable proposal as the native industries of China need a considerable measure of protection against Japanese goods. But I believe that a careful revision of the Chinese tariff could be undertaken which would give some satisfaction to the Japanese demands, help our trade and increase the Customs revenues on which Chinese financial stability largely depends, and I think that we should continue to press the Chinese Government to undertake such a revision.

(5) Export Credits.

The main opening in China for British exports, in present conditions, lies in the supply of capital goods and particularly machinery for power plants and
other public utilities. To obtain such contracts with the public authorities concerned the arrangement of extended credit facilities is essential. The Export Credits Guarantee Department should be in a position to assist our exporters in this way: but up to the present it has not been possible to arrange, through the Export Credits Guarantee Department, terms such as our German and American competitors are in a position to offer and the credits arranged have been undertaken by the British firms concerned on the basis of their own resources. The extent to which they can do this is naturally limited and Government assistance would materially help to secure further orders. Conditions in China are substantially different from those prevailing in more organised countries and it may be that a special scheme will have to be devised to meet these conditions. I would recommend that the Export Credits Guarantee Department should undertake to cover a proportion, say 40% or preferably 50%, of the risk of any public utility contract in the Yangtze Provinces, and perhaps even in other parts of China, at a premium not exceeding 5% and without priority, provided the bankers, merchants or manufacturers are willing to carry the remainder of the risk. I believe that the risks involved will not prove, in fact, so great as they appear on paper; and the commercial houses, which will be responsible for 60% of the risk, can be left to obtain such security as is available. If the above proposal is not feasible, the possibility should be examined of guaranteeing a credit to the Chinese
Government, on the lines of the recent credit to the Soviet Government, for financing railway equipment or public utility contracts entered into with British firms. Such a credit would be of special value in regard to railway equipment orders. Apart from large contracts, the possibility should be explored of export credits facilities being made available for ordinary trade goods, e.g. textiles, and also of guarantees being granted to British Merchants in China, instead of only to exporters here. I cannot emphasise too strongly the importance which I attach to the question of export credits on which depends the main possibility of expanding our export trade to China. I am very glad to hear that the Export Credits Guarantee Department has arranged to send out a special representative to China and I hope that he, working in conjunction with the Commercial Counsellor at Shanghai, will be able to frame a satisfactory system which will enable guarantees to be arranged locally and promptly for all suitable projects.

(6) **Railway Loans.**

China also needs long-term capital for development purposes, particularly Railway construction. Until recently, any such loans were out of the question owing to the defaults on many of the existing loans. During my stay in China, the Chinese Government arrived at settlements of several of the British Loans in default and made offers, in the other cases, which in my opinion were reasonable and should be accepted. The door, is therefore, open for new financing and a small loan, for the completion of the Hangchow - Ningpo
Railway, was issued while I was in China. But a larger scheme is justified and would, I believe, prove very helpful, both in improving internal trade in China and in promoting exports of railway materials from the United Kingdom. I think that the Consortium Banks should be induced to examine the possibility of a loan of, say, £10,000,000 - £15,000,000 for financing the import of railway materials for the new construction which is now being undertaken by the Chinese Government on the basis of internal loans supplemented by barter transactions. The loan should, if possible be of an international character and it would require to be secured on the Customs surplus. For this purpose the Chinese Government would have to arrange with the domestic bondholders to give the new loan priority over domestic loan charges; but this could, I believe, be arranged. It would also be necessary for the Chinese Government to arrive at an understanding with Japan in regard to the smuggling situation; but subject to this, the Japanese Minister of Finance assured me that such a loan would not be opposed by the Japanese Government so long as Japan obtained orders for materials in proportion to her participation in the loan. A similar proviso would no doubt be insisted upon by all the other participants in the loan: indeed, the only possible basis for any such operation at present would be that each country should obtain orders in proportion to the capital subscribed. The Consortium is at present bound by an understanding in favour of "open tender" and the first step is for the British members of the Consortium to request a revision of this understanding. It should not be diffi­cult to secure agreement on this point but in the
absence of agreement, it is for consideration whether we should not free ourselves from our Consortium obligations and frame a proposal for a joint loan on the above basis with any other national group interested. The Japanese and Belgians would, I believe, be willing to co-operate.

If it appears that market conditions make the issue of any market loan impossible, it is for serious consideration whether a guaranteed loan or credit to China, for the purchase of railway equipment in this country, should not be made. Apart from the useful orders which our manufacturers would thus obtain, such a loan would greatly increase our prestige, would help us to obtain the agreement of the Chinese Government to our requirements (e.g. in regard to the Customs personnel) and would contribute to the financial and economic rehabilitation of China, on which our trade depends. It would be particularly helpful to Hong Kong if such a loan could be arranged for financing extensions of the railway system in Kwangtung (including a loop-line joining the Canton-Kowloon and Canton-Hankow Railways) and the re-establishment of the authority of the Central Government over Kwangtung gives a favourable opportunity of which advantage ought to be taken.

One other factor in connexion with railway orders should be mentioned. It is important to secure the appointment of British engineers, wherever possible, on the Chinese Railway system. The German and American engineers make every effort to secure orders for their countries and it would help to secure orders for British manufacturers if British engineers, of the right type, were in key positions. The position is different to-day from what it was in 1925. The foreign staff now in question would not be representatives of the bondholders but would be appointed by the Chinese Railway administration with a view to increasing
the efficiency of the service. In the recent settlement of the Tientsin Pukow Railway default, such an appointment was provided for and I am sorry to learn that no interest has been taken in this proposal by the Departments and the banks concerned at home and that difficulty is being experienced in finding any candidate for the post. I think that the British and Chinese Companies should take steps to compile a list of possible candidates for such appointments.

(7) **Boxer Indemnity Agreement.**

The Anglo-Chinese Indemnity Agreement of 1930 has enabled us to secure some very valuable orders for railway equipment. But I found considerable, and apparently justifiable, complaint both as to the prices charged and as to the serviceability of the goods supplied. This latter complaint related particularly to the large order for Vulcan locomotives for the Canton-Hankow Railway. Full details have, I understand, been reported to the Department of Overseas Trade and the complaints should be carefully investigated with a view to securing a tightening up of the system, so as to obviate similar difficulties in the future.

The China Indemnity Fund also provides for a number of Chinese students to be sent to British Universities for education. This is a most valuable use of the fund as every Chinese returned student tends to be a propagandist for the country in which he has studied and the majority of Chinese students are at present trained in the United States of America, Germany or Japan. The British Council should be invited to consider, with the organisations of British Manufacturers, whether they can arrange facilities for more students to study here, particularly in the various branches of engineering, or if that is not possible, whether they could endow British lecturers or provide engineering equipment for Chinese Universities. Such
assistance by training the young Chinese engineers in British methods, would be of great potential value in securing future orders.


In present conditions in China, it seems to me essential that British officials and traders should establish as wide contacts as possible with the Chinese. So far as I could judge from my own experience it is far easier to get difficulties settled, or proposals amended to meet our views, by unofficial discussions than by formal representations. From this point of view, it is most desirable that business firms should encourage their permanent staffs to learn Chinese; and the same thing applies of course, to the Official Services in China. The Chinese authorities seem not only willing but anxious to obtain advice from persons in whom they have confidence. British traders have in the past had the reputation of standing rather aloof from the Chinese, but the best firms are now fully alive to the necessity of working as closely as possible with the Chinese and securing their co-operation. While I was in China, unofficial Sino-British Trade Councils were established by the local British and Chinese Chambers of Commerce at Shanghai and Hankow to promote friendly discussion of all questions of mutual interest. The Chinese Government also agreed, in principle, to the establishment of an official Committee atNanking to which difficulties of British traders resulting from action of the Chinese authorities could be referred. It was arranged that the Commercial Counsellor should prepare a definite project for the
organisation of this Committee and I hope that it will be successfully carried into effect.

(9) British Banks in China.

The policy of the British Banks in China, and particularly of the Hongkong and Shanghai Bank, appears to me to need a radical revision if they are to maintain their position there. Their main business hitherto has been that of pure exchange banks and their prosperity has depended on the constant fluctuations in the value of silver. With the stabilisation of the Chinese exchange, this business should cease and they will be compelled to give greater attention to the financing of trade. At present they do a moderate amount of business with British merchants but the facilities they offer to these might well be extended; and their relations to the Chinese must be improved. On this latter point, the policy of the Chartered Bank compares favourably with that of the Hongkong and Shanghai Bank, which appears to prefer nursing its frozen assets in China rather than co-operating with the Chinese banks to re-organise the concerns affected. The Hongkong and Shanghai Bank's policy is directed by the Hongkong office and it is not likely to be altered save as the result of experience. But the Governor of the Bank of England might be asked to discuss the whole position with the London Committee of the Hongkong and Shanghai Bank and with the Chartered Bank.

(10) Relations of Diplomatic and Consular Officers to Trade.

I heard a number of complaints from British traders as to the attitude of H.M. Embassy and Consular Service to their difficulties. As regards the Embassy,
these complaints related mainly to the lack of access to the Ambassador, and they should be remedied by the arrangement made under which the Ambassador will reside for considerable periods at Nanking. He should also arrange to pay frequent visits to Shanghai; indeed, from many points of view, it would be preferable if the Embassy was located in Shanghai. The present division of the Embassy Services between Peking, Nanking and Shanghai constitutes a real handicap to efficiency and the more they can be concentrated either at Nanking or at Shanghai the better. As regards the Consular Services, the complaints appeared to be more substantial and to merit close investigation. I have no means of judging the official work of these officers; but the unofficial contacts which I had with them left me with the impression that something is wrong. Some of the officers - in particular the Consuls-General at Canton and Tientsin - appeared to me admirable; but in other places there was evidence of staleness, discouragement and indifference. Moreover, the Consular Service, as a whole, seemed to have inadequate contact with local Chinese banking and business leaders. I suggest that the Consular Services in China and Japan should be carefully investigated by one of the Inspector-Generals of the Consular Service and that the personnel should be reviewed in the light of his Report. I also suggest that the Head of the Mission should convene conferences with the local Consular officers at the Embassy or at other centres, when he is on tour, so as to give them more opportunities of exchanging views both with him and with one another.
(11) **British Position in Shanghai.**

Shanghai is not China, and some of the characteristics of Shanghai are not altogether creditable to the British merchant community there. All the same, Shanghai is a remarkable monument to British enterprise in the development of China and it remains the centre of British interests in that country. The position of the Settlement should be maintained as fully as possible. Provided that the administration gives due consideration to the reasonable demands of Japanese residents in the Settlement, our predominant position there is not likely to be challenged by Japan; and the difficulties between China and Japan elsewhere have for the time being made the Chinese less anxious to press for a radical change in the position of the Settlement whose existence is helpful to them in many respects. The administration should however be improved and the Settlement authorities should be ready to examine complaints, both from the Japanese (e.g. on provision of schools) and from the Chinese (e.g. on tax privileges) and to meet reasonable requests.

(12) **Position of Hong Kong.**

The present position of Hong Kong is not a happy one. Economically, a part of China, the colony is faced by an ever-growing tariff wall and is feeling more and more the competition of ports like Shanghai which are inside that wall. The difficulty was accentuated by the currency policy followed by Hong Kong in 1935 and 1936; and some improvement has taken place since the currency change made last December. But the permanent future of the colony depends on the possibility of trade with China and the question should be considered whether it would be possible
for Hong Kong to enter into a Customs Union with China. One of the Chinese Ministers suggested to me that the Chinese Government would welcome a proposal of this kind: while the Governor of Hong Kong recognised that it would be greatly to the advantage of Hong Kong. I did not pursue the question, as it obviously involves important political issues, but it appears to be well worthy of exploration. Whether this is possible or not, every effort should be made, now that the Chinese Government has re-established its authority over Kwangtung, to secure better relations between Hong Kong and the Chinese authorities in the mainland, who are, I believe anxious to establish closer co-operation with the Colony.

(13) Another question, raising political issues of a different kind, is the question of linking up the Indian and Burmese Railways with China by the construction of a new line from the present terminus in Burmah to Yunnan Fu. The Chinese Minister of Railways has a scheme on hand for building a line to Yunnan Fu from Kweiyang, with a link to the Canton-Hankow Railway, and expressed the desire to interest His Majesty's Government in the extension of this line to Burmah. It would obviously open an important new trade route to China overland and I submit it for investigation by the Departments concerned.

To sum up, my suggestions are that:

(1) Every suitable opportunity should be taken, especially in Ministerial statements, to emphasise our continued interest in China and our intention to maintain our position there.

(2) The Japanese Government should be told in a friendly but firm manner that the prospect of better relations with the United Kingdom depends on their respecting our interests in China, which are threatened by their present policy of disruption and particularly by the smuggling in East Hopei.
(3) We should seek an agreement with the Japanese Government as to the foreign personnel of the Customs Service.

(4) We should urge the Chinese to undertake a revision of the Customs tariff, with a view to reducing prohibitive rates and increasing the revenue.

(5) Export credits are essential for the encouragement of British trade with China and the Export Credits Guarantee Department should be invited to devise a scheme, suitable to conditions in China, and to put it into force as rapidly as possible.

(6) The Bondholders Committee should be urged to expedite a settlement of existing defaults on the basis of the offers made by the Chinese Government.

(7) The British banks in the Consortium should be requested to work out a proposal for an international Railway Loan, on the basis that orders for materials should be allocated to the countries participating in the loan in proportion to their respective participations: for this purpose the present understanding that all orders should be placed by open tender should be abrogated. If a market loan is not possible, the grant of a guaranteed loan or credit for the purchase of railway equipment in the United Kingdom should be seriously considered.

(8) Every effort should be made to secure the appointment of British engineers on the management of Chinese Railways and a list should be prepared of suitable candidates for such appointments.

(9) The arrangements for the placing of orders by the Boxer Purchasing Commission should be overhauled so as to ensure that the materials supplied are suitable and the prices charged reasonable.
(10) Every effort should be made to help Chinese students (particularly engineering students) to come to British Universities and to send British lecturers and/or equipment to Chinese Universities.

(11) Co-operation with the Chinese is essential for modern trade with China. Support should be given to the unofficial Sino-British Trade Councils formed at Shanghai and Hankow, and every effort made to secure the establishment of an official Sino-British Trade Council at Nanking.

(12) The Governor of the Bank of England should be asked to consult with the Hong Kong and Shanghai Bank and with the Chartered Bank as to the possibility of improving facilities for British trade in China and as to the policy of these banks generally.

(13) The Embassy and Consular Services should be urged to pay more attention to British trade: and the Consular Service should, in particular, be overhauled.

(14) The position of the International Settlement at Shanghai does not appear at the moment to be in any danger: but every effort should be made to maintain it and to improve its administration.

(15) The possibility of Hong Kong joining in a Customs Union with China should be examined.

(16) The advisability of linking up the Indian and Burmese railway systems with China by the construction of a line to Yunnan Fu should be examined.

(Signed) F.W. LEITH-ROSS.

4th September, 1935.