Milton Friedman, Silver, and China

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Source: *Journal of Political Economy*, Aug., 1993, Vol. 101, No. 4 (Aug., 1993), pp. 755-758

Published by: The University of Chicago Press

Stable URL: https://www.jstor.org/stable/2138747

Comment

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Thirty years ago, Milton Friedman and Anna Jacobson Schwartz asserted that the U.S. silver purchase policy of the 1930s "impose[d] several years of drastic deflation on China" (1963, p. 699). Friedman's (1992) recent effort to maintain this view in the face of new data and interpretations contains assertions about China's economic history that conflict with available evidence.

Friedman states that China's "modern domestic and foreign banks . . . served primarily the transactions activities and liquidity desires of the financial community" (1992, p. 77). This is not true. Domestic banks developed nationwide branch networks extending in 1936 to 1,695 branches in 526 locations (Yearbook 1937). Their involvement was never limited to the financial community. Domestic banks devoted substantial resources to the finance of commodity trade, manufacturing, government, and even farming (Rawski 1989, chap. 3). The memoirs of Chang Chia-ao, a prominent Chinese banker, illustrate the point: offices of the Shanghai and Commercial Savings Bank "were established near the railway depots in Shanghai and Nanking in 1917 to attend to mortgage of goods in transit" (Rawski 1989, p. 147). Nor were foreign banks involved exclusively with the financial community. Japanese banks, for instance, financed the development of Manchuria's agricultural exports, transport infrastructure, and industrial base (*Manshû kaihatsu yonjû nenshi,* 1964).

Including the deposits of these institutions in China's domestic money supply produces ratios of currency outside of banks to the

I gratefully acknowledge financial support from the Woodrow Wilson International Center for Scholars and the American Council of Learned Societies as well as comments by Robert E. Lucas, Jr., on an initial draft.

[*Journal of Political Economy,* 1993, vol. 101, no. 4]

TABLE 1

Share of Currency in M2 for Several East Asian Economies (%)

	China*				
	A	B	Japan	Taiwan	Korea
1885			80.1		
1890			76.4		
1895			60.5		
1900			35.6		
1905			31.0		
1910	63.7	75.6	26.6	45.2	62.6
1915	67.2	77.5	20.1	37.8	60.0
1920	60.3	70.9	18.0	31.7	49.1
1925	55.1	64.6	16.1	30.5	37.4
1930	48.5	56.1	13.8	23.2	24.9
1935	33.4	41.3	14.2	22.1	29.2

Source.—China: Rawski (1989), p. 394; Japan: Emi, Ito, and Eguchi (1988), pp. 218–19, 301; Taiwan: Mizoguchi and Umemura (1988), pp. 301–2; Korea: Mizoguchi and Umemura (1988), pp. 304–5.

* China A and China B are separate time series for China's money stock (M2) based on different estimates of China's stock of monetary silver (see Rawski 1989, pp. 365–66, 371).

total money supply (M2) that, according to Friedman (1992, p. 77), are so low as to be "hardly credible" or "literally incredible." He proposes to adjust this ratio by dropping the deposits of modern institutions (but apparently not their bank notes!) from the money supply.

But what is a "credible" composition for national monetary aggregates? Although the Chinese ratio of currency to M2 for the 1930s is lower than the figures that Friedman cites for a grab bag of nations (Nepal, Chad, Yemen, Zaire, etc. [p. 77]), it is hardly remarkable in the East Asian context. Table 1 indicates that each of four East Asian economies experienced a transition from primary reliance on currency to more sophisticated financial arrangements during the half century before World War II, with Japan well in advance of the others. Are all these data "incredible"? Or should we conclude that the development of financial institutions, and with it a rising share of deposits in monetary aggregates, occurred at an earlier stage of the industrialization process in East Asia than elsewhere?

While conceding that he and others "may well have overestimated the real effects of the nominal deflation" (p. 76) in China during the 1930s, Friedman continues to maintain, without empirical evidence, that "the U.S. silver policy imposed a major deflation on China in 1934–36" (p. 63). Data assembled in table 2 show that, if anything, Chinese domestic prices *increased* after the implementation of the U.S. silver purchase policy, which, according to Friedman and Schwartz (1963, p. 483), effectively started in December 1933.

Although China did experience deflation during the early 1930s,

TABLE 2

CHINA: SELECTED PRICE INDEXES, 1928–36 (1929 = 100)

	Urban Wages	Urban Price Data: Retail Prices	Urban Price Data: Wholesale Prices	Farm Gate Prices
1928			96.2	86.3
1929	100.0	100.0	100.0	100.0
1930	116.8	114.0	107.8	111.9
1931	112.7	114.8	115.6	91.8
1932	111.9	115.0	101.9	85.3
1933	112.4	100.0	93.3	65.1
1934	107.7	93.4	93.8	78.8
1935	105.8	100.4	97.9	88.9
1936	103.7	106.0	112.6	92.6

SOURCE.—Calculated from Rawski (1989), table 3.10.

sharp price declines had a rather brief duration and were confined for the most part to the farm sector (table 2). Historical materials relating to manufacturing output (which never "drew to a halt" as claimed by Friedman [1992, p. 73]), railway activity, investment volume, and other business cycle indicators confirm that, contrary to Friedman's unsubstantiated assertions, the world depression caused no significant or protracted decline in China's real output (Yeh 1979; Rawski 1989, p. 175).

These observations about Chinese banking, prices, and output rest on abundant documentary and statistical evidence. This evidence undercuts Friedman's insistence that China's economy experienced sharp and protracted reductions in money supply, prices, and output during the 1930s. Ironically, the realities of Chinese economic life during the 1930s demonstrate the resilience of an unregulated market system in which households and businesses were genuinely "free to choose."

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