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Milton Friedman Would Wince at China's Rise

By Dani Rodrik

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Next year will mark the 100th anniversary of Milton Friedman's birth. Friedman was one of the 20th century's leading economists, a Nobel Prize winner who made notable contributions to monetary policy and consumption theory. But he will be remembered primarily as the visionary who provided the intellectual firepower for free-market enthusiasts during the second half of the century, and as the eminence grise behind the dramatic shift in the economic policies after 1980.

At a time when skepticism about markets ran rampant, Friedman explained in clear, accessible language that private enterprise is the foundation of economic prosperity. All successful economies are built on thrift, hard work and individual initiative. He railed against government regulations that encumber entrepreneurship and restrict markets. What Adam Smith was to the 18th century, Milton Friedman was to the 20th.

As Friedman's landmark television series "Free to Choose" was being broadcast in 1980, the world economy stood in the throes of a singular transformation. Inspired by Friedman's ideas, former U.S. President Ronald Reagan, British Prime Minister Margaret Thatcher and many other government leaders began to dismantle the government restrictions and regulations that had been built up over the preceding decades.

China moved away from central planning and allowed markets to flourish — first in agricultural products and, eventually, in industrial goods. Latin America sharply reduced its trade barriers and privatized its state-owned firms. When the Berlin Wall fell in 1989, there was no doubt that the former command economies would embrace free markets.

But Friedman also produced a less felicitous legacy. In his zeal to promote the power of markets, he drew too sharp a distinction between the market and the state. In effect, he presented government as the enemy of the market. He therefore blinded us to the evident reality that all successful economies are, in fact, mixed. Unfortunately, the world economy is still contending with that blindness in the aftermath of a financial crisis that resulted in no small part from letting financial markets run too free.

The Friedmanite perspective greatly underestimates the institutional prerequisites of markets. Let the government simply enforce property rights and contracts, and — presto! — markets can work their magic. In fact, the kind of markets that modern economies need are not self-creating, self-regulating, self-stabilizing or self-legitimizing. Governments must invest in transport and communication networks; counteract asymmetric information, externalities and unequal bargaining power; moderate financial panics and recessions; and respond to popular demands for safety nets and social insurance.

Markets are the essence of a market economy in the same sense that lemons are the essence of lemonade. Pure lemon juice is barely drinkable. To make good lemonade, you need to mix it with water and sugar. Of course, if you put too much water in the mix, you ruin the lemonade, just as too much government meddling can make markets dysfunctional.

The trick is not to discard the water and the sugar, but to get the proportions right. Hong Kong, which Friedman held up as the exemplar of a free-market society, remains the exception to the mixed-economy rule — and even there the government has played a large role in providing land for housing.

The image most people will retain of Friedman is the smiling, diminutive, unassuming professor holding up a pencil in front of the cameras in "Free to Choose" to illustrate the power of markets. It took thousands of people all over the world to make this pencil to mine the graphite, cut the wood, assemble the components and market the final product. No single central authority coordinated their actions. That feat was accomplished by the magic of free markets and the price system.

A modern-day Friedman might ask how China has dominated the pencil industry, as it has so many others. There are better sources of graphite in Mexico and South Korea. Forest reserves are more plentiful in Indonesia and Brazil. Germany and the United States have better technology. China has lots of low-cost labor, but so does Bangladesh, Ethiopia and other populous low-income countries.

Undoubtedly, most of the credit belongs to the initiative and hard work of Chinese entrepreneurs and laborers. China's state-owned firms, which made the initial investments in technology and labor training, also played an important role, as did generous export subsidies and government intervention in currency markets, which gives Chinese producers a significant cost advantage. China's government has subsidized, protected and goaded its firms to ensure rapid industrialization, thereby altering the global division of labor in its favor.

Friedman himself would have rued these government policies. Yet the tens of thousands of workers that pencil factories in China employ would most likely have remained poor farmers if the government had not given market forces a nudge to get the industry off the ground. Given China's economic success, it is hard to deny the contribution made by the government's industrialization policies.

Free-market enthusiasts' place in the history of economic thought will remain secure. But thinkers like Friedman leave an ambiguous and puzzling legacy because it is the interventionists who have succeeded in economic history, where it really matters.

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