History of Economic Theory

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Lecture No. #13

Birth of Political Economy: Mercantilism

We are going to talk about mercantilism today. Does anybody have any idea, what mercantilism is about? I know you have not studied it in this course yet, but have you heard of mercantilism in any other course that you studied either too?

Student: (( ))

The nasty things, he said about mercantilist.

We shall be saying nasty things about them today, because you know, it is difficult to say nasty things about people, who said lots of things over 250 years, here from 1600 to 1600 to middle of 18 century is the period, when you think mercantilists were saying a lot of interesting things, in fact about 1550 is more like it. You do not have any group of people at any point of time in Europe, who said we are mercantilists, you know like we are sociologists, we are economists, no we did not have anybody even articulating a very precise ideology of something called mercantilism. Now, we did not have that, but quite a lot of peoples staying among things during this period also seem to favor certain ideas, this ideas seem to be coming up again and again among these people. And post script is that such people should be called mercantilists, which is what happened really.

You can think of two points or two periods of time when mercantilists could be referred to as having being dominant in Europe, one is the period up to the end of the 16th century, precisely towards the end of the rein of queen Elizabeth the first in England, when a lot of mercantilists ideas were spoken, that is what is called early mercantilism. And subsequently from the middle of the 17 th century onwards right up to middle of 18 th century you find mercantilism of another variety coming up, and that is what a want of other words I shall say mature mercantilism. No as persons intended towards the early mercantilists, but this is just ideas seem to have gelled in greater detail about this time.

The early mercantilists are people who are identified also with the notion of bullinism, what is bullion?

Bullion is gold, it is not even unit just gold is bullion, large quantities of gold is called bullion. And if you wore a little ring in your hand made of gold you won't call it a bullion ring, it is just a gold ring. So, bullion is basically referring to a substantial quantity of precious metal gold particularly is called bullion. People about this time the mercantilists or people who were called mercantilists about this time had an obsession with bullion.

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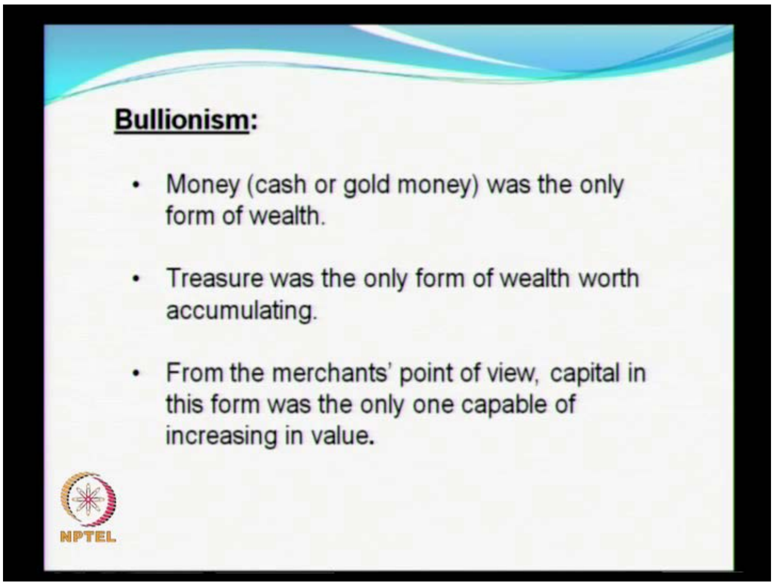

They taught that bullion was good for a nation, for the simple reason that money was a major form of wealth, money was a major form of wealth and the only form of wealth which could sort of multiply itself through time was money, and finally it is money in the form of capital, at least in the view of the traders and merchants money as capital was what really reproduced itself time and time again through different business ventures. Smith was to point out to them that this was, but one's they mistaken smith taught in thinking that money is the only form of wealth, and that was wealth taken too. Because bullionists were at least people who believe that is nothing worth accumulating, is nothing worth going for all the time except more and more and bullion, and of course money as representing bullion.

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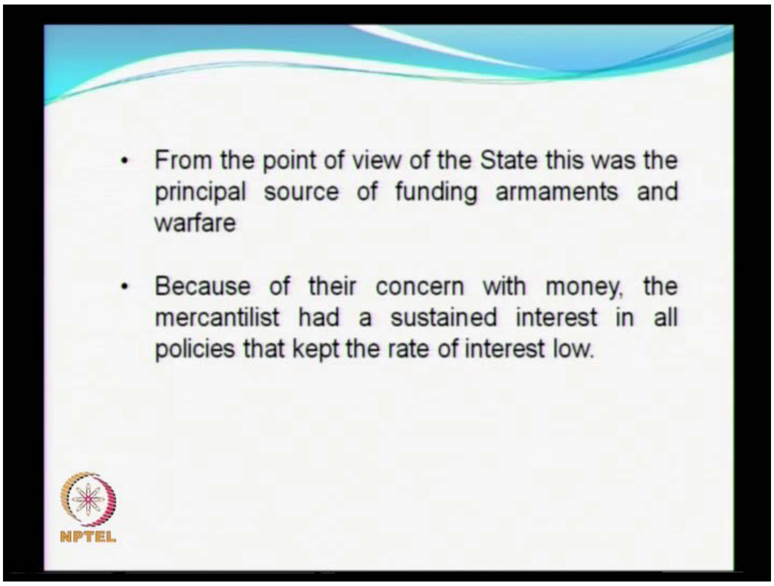

Now, how was bullion to be accumulated and where is the source of multiplying this, the source of multiplying money is by putting into trade and working towards a favorable balance of trade, what is a favorable balance of trade?

Super what do we have for lunch today? Good yeah that did not produce a very cheerful face from you when I said what did you have for lunch, probably your happy because you dint eat or what you were supposed to eat today. Anyways so yes trade surplus trade surplus simply means to export more you earn more through exports, than you pay for your imports, so when you have a favorable balance of trade what it does is that it ensures that more money comes into the country than the money which leaves the country. Now, this provides a basis for sustain growth.

How it does is more money coming into the country making it more cash rich a more cash rich country would mean, there is a lot more spending going on when there is a lot of spending going on there is more business more manufacturing, when there is more business more manufacturing there is more employment, in short there is prosperity. So, they key to prosperity in the bullionist argument was simply getting hold of more bullion through a favorable balance of trade.

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So, as we can see extensive circulation of money within the national boundaries leads to growth. Secondly making sure that there is gold this precious metal this money does not leave the country, what is the point of having earned money through a trade surplus only to find a leaking out across the boundaries on other, so prevention of money crossing national boundaries going out if need be stringent measures prohibiting and penalizing people who transferred money across the boundaries, so keeping the hold in.

Another interesting way to this prosperity is by inducing foreign currency into moving into this country and being spent in this country, you could do it legally by offering higher rates of exchange for foreign currency, so that it comes into this country on a premium and gets spent in this country. What it does is that it preserves your stock of gold, it preserves your own domestic currency and creates a bonus of funds coming in across the border which creates more spending in this country and sets off the process of prosperity.

Not all in flow of foreign currency could be done through legal incentives, very often even governments in those days used various artificial by artificial I mean the governments would think of immediate to be implemented today kind of schemes, whereby you could get Florence, gold Florence from Florence into England, let us say by getting people from Florence, people from Italy to spend that money here for some specific reason, in short the idea was that foreign currency should be spent in this country one way or other, and the governments wants particular about how this was done. Sometimes for instance the government themselves engage in policy of it is called clipping.

Clipping is to reduce the intrinsic metal worth of domestic currency deliberately, but without announcing it, for instance if 1 pound was such an such a fraction of an ounce of gold, then clipping would mean officially keeping this weight in gold, but unofficially tripping off some edge from the pound so that the pound is actually carrying less precious metal in weight. Now, when it is known that clipped money, domestic money is going around then automatically what happens is good domestic money goes out of circulation and in it is place foreign currency slips in.

So, as I said expanding the levels of circulation of money, and expenditure of money domestically, making sure that there are not significant out close of precious metals and gold from the country.

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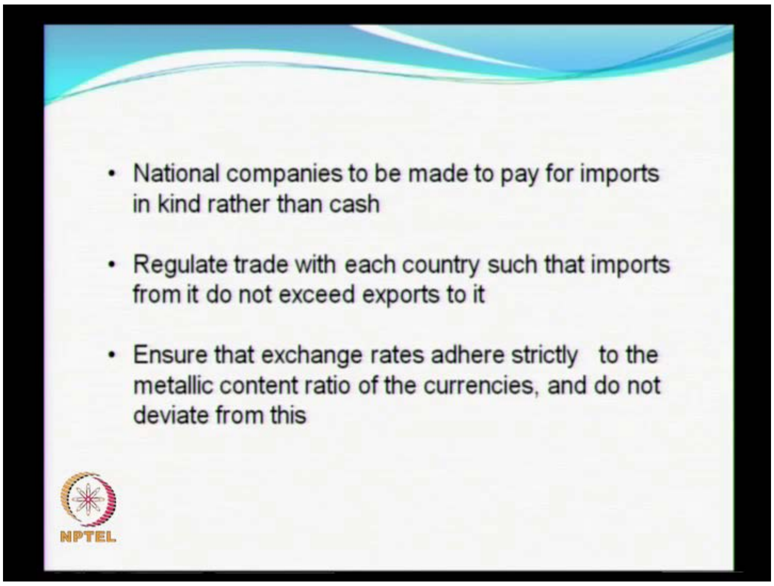

And then third encouraging the coming in of foreign currency to be spent in this country. Then companies which are doing within this country are very often told that it would be better that they paid for their imports not in cash, but as a kind of a barter in kind, so your importing let us say your importing let us say raw cotton or flax and instead of paying for it in pounds sterling you may like to pay for it say through some wool, pay through some domestic manufacturer, whatever but pay for it in kind so that your ensuring that you earned foreign money and gold for your exports and you do not pay your money for your imports and in that fashion commodity trading tends to help you preserve the stock of cash, and the money supplied domestically and perhaps even enhance it a little bit.

And then this is a policy which all the countries dint adopt, but Spain was pretty good at adopting this. A county by country kind of a list checking to see whether a minimum balance of trade was maintained with all the countries at least this was ensured that you do not import more than what you exported to that particular country, so that across the board when you add it all up you end up getting a favorable balance of trade. This is a kind of aggregation process you make sure that every time you trade with the country you trade with it in such a manner that you have a favorable balance of trade and then you aggregate it across for all countries you end up getting in general a favorable balance of trade.

The other thing was a continuous fear in most governments and particularly the assessed governments, that always somebody was going to do a little bit of mischief about the money, in short would there be counterfeiting, would there be clipping done by the governments, in short there was always a fear that the intrinsic value of domestic currency would always be lower than the value at which it exchanged. During those days a fluctuation in the early days of bullionism fluctuating exchange in exchange rate was not understood to be something coming out of balance of payments, problems you end up owning more than your domestic currency depreciates in exchange rate, foreign countries ended up buying more from you ended up having a domestic currency which appreciated, in other words exchange rate fluctuations where not understood strictly as consequences of balance of payment problems, exchange rate fluctuations were taught as having their sources in corruption, in the government through clipping, and mischievous manipulations by bankers across the countries, and finally forgery.

It was believed that currencies with high intrinsic value had a tendency to go underground, and would be replaced by currencies which do not have as much intrinsic value in precious metals as they are advertised to be. So, it was believed that these manipulations forgeries and so forth were the real reasons underlying fluctuation in exchange rates, and some early mercantilists even suggested that these fluctuations can be counted through balance of payment adjustments by simply exporting more or importing less and so on and so forth.

In short what is understood today as a corsal chain was put on the reverse by early mercantilist, who said exchange rate fluctuations did occur and to set that right you work on balance of payments adjustments, whereas you know today and later mercantilists too understood that exchange rate fluctuation were actually the consequence of balance payments adjustment problems rather than the other way round.

Anyway, one rule which mercantilists were following all the time very strictly is to make sure that different currencies that they came across stayed very close to their intrinsic values, so the ratio of exchange rates ratios of currencies in terms of intrinsic values was a genuine exchange rate, and the exchange rate which was market induced; induced by demand and supply was something that existed at this point in time. So, there was an attempt in this process to try and ensure stable exchange rates, but stable exchange rates not in terms of manipulating the market towards ability, but ensuring that all currencies try to stay as close as possible to their intrinsic value.

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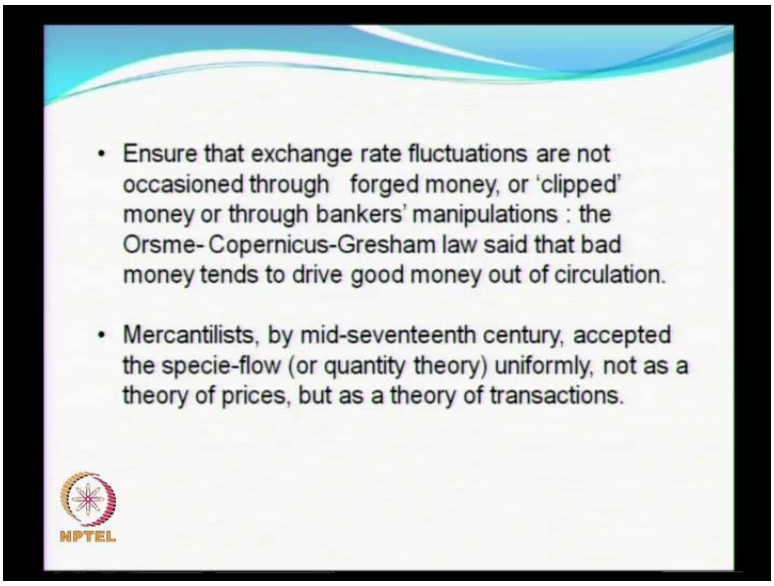

By the middle of the 18th century, this attempt to ensure that currency stayed as close as possible to the intrinsic worth became a kind of a standard norm across all countries, and by early 19th century almost all major European countries were trying to follow a norm of evaluating each other's currency in terms of the gold worth of that currency, and it came to be called the gold standard. So, these early attempts by mercantilists to ensure stable intrinsic value ratios of currencies later turned out to be the precursor to the gold standard which became the international monetary system from the 19th century onwards right up to the end of the First World War, which was about 1920.

This whole concern about money which stayed close to it is intrinsic worth was a concern with what was called good money. This money which was not chipped, money which was not eroded or money which was not for some reason or other through friction, whatever reason lost its value, or money which was simply forged all of it was bad money, there was a law which came to be roughly called Gresham's law attributed to a financial advisor to queen Elizabeth the first towards the end of the 16th century, Thomas Gresham wrote a letter to queen Elizabeth the first telling her that good money always is driven out of circulation by bad money. And so as a monetary regulation it is important always to keep an eye on where bad money is, where good money is and what is happening to money.

Although it is attributed to Thomas Gresham it goes back much further to early 16th century to Copernicus of all the persons, 1519 Copernicus is the one who says good money is driven out of circulation by bad money. You know Copernicus had great many other interests including trying to find out whether it is the earth which went around the sun or it is the sun which went around the earth, right he was the one who propounded the Helios centric solar system. So, but then Copernicus also had little to something to say about money as you can see be that as it may.

There was a great concern about maintaining good money, there was another argument which mercantilists accepted quiet comfortably, but which was put to tremendous use against mercantilism by the critics of mercantilism, this was called the specie-flow mechanism. specie-flow what is specie-flow?

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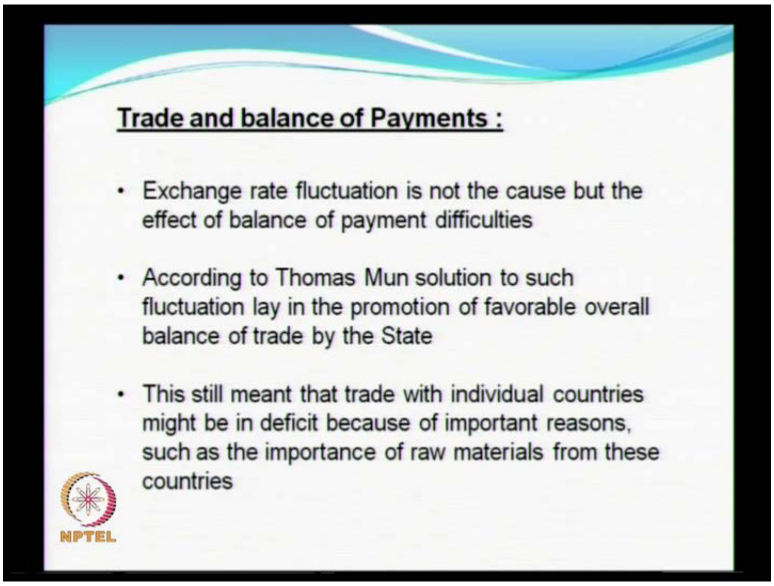

Can somebody tell me what specie-flow is?

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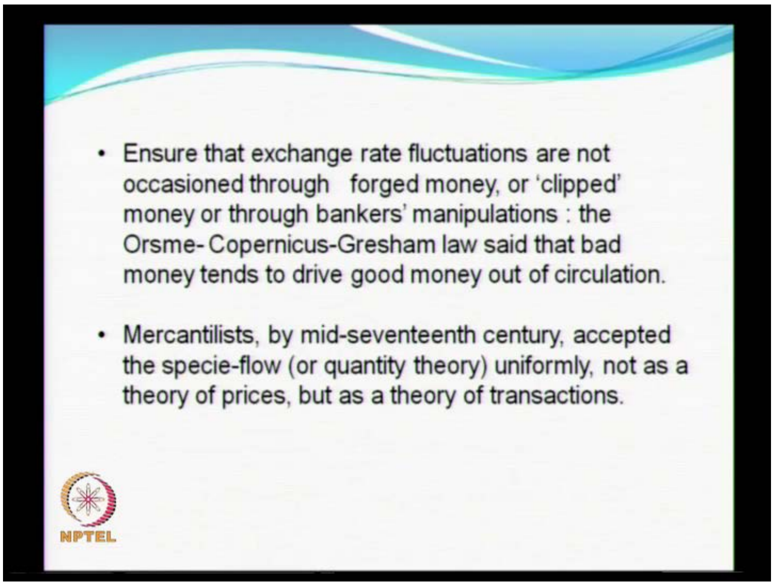

It is common English word not in use today, but specie-flow is gold, bullion, precious metal. So, specie-flow basically money flow because most money was in those days were tied up to precious metal, have you heard of it in its modern avatar have you heard something called quantity theory, what is a the quantity theory?

Student: Velocity of money is the relation between consecutive money and existing money.

py is I

Student: Py

Py y is output and p is rupees price so product of price and output will be it will be equal too it is an identity it will always be equal to the money value and money supply.

I thought you are going to say money demand, what is PT? Or PY

It demands for money aggregate demand for money, and M V is nothing but, the total supply of money in the system. So, this identity is basically a money market equilibrium, you know it as a quantity equation, in the old days this was roughly known as a specie-flow mechanism how money flowed, now the critics of mercantilism actually talked of this process in trying to tell mercantilists that any increase in money supply will simply hike the prices up, and nothing else, so their argument is useless that is what the critic said, but the mercantilists were aware of this specie-flow mechanism argument, long before people like home were actually using it as a critic, what mercantilists used this is as an argument to explain how the volume of transactions in the economy can be increased. If you hold price as constant you increase the money supply then the number of transactions in the economy has to increase.

Which is the way in which the mercantilists thought progress could be achieved, you pump money to the economy people transact more and more with that money as a result of which there is more money manufacture, more employment and the economy seems starts growing. So, the specie-flow argument was used by mercantilists to justify their belief in bullionism.

The other side of mercantilist argument was trade and balance of payments. As I said already there were all the time concerned at least the bullionists were very directly concerned about favorable balance of trade, as a key instrument for bringing in more and more money into the country gold bullion into the country. Early mercantilists as I said used to think of exterior fluctuations as some things which cause balance of payments difficulties. It was Thomas Mann one of the most powerful thinkers among the mercantilists, who said the fluctuations in exchange rate could be only tackled not by trying to prevent forgery and other things which early mercantilists were talking about, he said no you just make sure that your exports grow and your imports are kept under control in other words you work towards a favorable balance of trade right. So, favorable balance of trade became virtually an official slogan of all mercantilists by the middle of 17th century.

Of course, the mercantilists were not insisting that they should have had a favorable balance of trade with every country. They also saw that with certain countries you had to have an unfavorable balance of trade, in short with respect to some countries your imports might be higher than the exports to them, for example these countries could be selling crucial raw materials to you, which you need for your manufacturing. So, with these countries they might buy less from you than what they sell to you, in short you might have an unfavorable balance of trade with them, but still you have to have that because you need it, but what you do is on the aggregate you make sure that this gets cancelled out. So, on the whole if you look at all the exports and all the your imports you make sure that the sum of your exports is higher than the sum of imports. So, balance of trade being favorable was not in the stringent sense of a deal which you enforce with every country, but more like a guideline which a country follows to ensure that it stays on the road to prosperity, not more than that.

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The most important way of ensuring favorable balance of trade, of course is to persistently be protectionist, make sure that you have a tariff barrier which ensures that the imports are costlier than domestic manufacture, and thereby they are discouraged in the market. At the same time you are ensured that your exports are attractive either by creating export subsidies or giving concessional terms to exporters, and such other matters which ensure that you have a favorable balance of trade. Now, in 1644 in France the finance minister of France started a series of aggressive protectionist policies, which came to acquire his name; his name was called Ban. And therefore, Colbertism became a standard reference to any country which went very aggressively ensuring favorable balance of trade and protectionism.

In 1641, 1651 the English passed an act called the navigation act, which simply meant that all shipments which English merchants were making from any part of the world should be shipped only in English ships. On the face of it seems to be a gesture in nationalism, which of course it was but more importantly it was to make sure that the margins of transportation costs also went to your merchants. So, your shipping companies earned the transportation fees, your insurance companies thereby earned the insurance on shipping, in short not only do you make sure that you have a trading margin by bringing things from rest of the world and selling it to say Europe. You also ensured that you earned margin in all kinds of ways including transportation. This was also a way in which you prevented competition because, if you are large in a fleet then you end up getting most transportation done by your own fleet, this was particularly a policy which favored British shipping as supposed to Dutch shipping, Because other than the British the Dutch had the largest fleet for marketing and trading overseas. So, when the British passed the navigation act it simply meant that they were taking a short at Dutch fleet and making sure that the profits went to the British fleet.

Well British soon after that a couple of decades after this the English also passed a law which said that anything which you were importing from anywhere in the world to be sold in Europe, bring something from West Indies to be sold in Europe, you bring something from India to be sold in Europe etc. You make sure that it lands and it is offloaded in an English port first. So, your selling something to France previously you might have shipped it directly to mass sales, let us say but, now after this enactment of this law you make sure that they are offloaded in London or Manchester or York or wherever some English port, and then ship from there to mass sales, which simply means that dam raj holding the goods, the charges for holding the goods, charges of you know managing and handling the goods and the charges of offloading and reloading from all these went to British merchants, and more importantly as England became more and more and more of an entrepod trader entrepod; E N T R E P O D means retarding. England became more and more and more for retarder, bringing in things from the rest of the world selling it to another set of countries and so London in fact became the very center of retreading across the world by the end of the 17th century, and this meant both the navigation act and the act which ensured the things are offloaded in England helped considerably in bringing England into the status of a large retarder.

And more importantly almost all European countries taught it is wise to encourage monopolies while trading with foreign countries. For instance the English East India Company was started in 1600, and the Dutch started their east India Company in 1602, and then very soon the French followed suit. So, granting trading monopolies to single companies who did trading overseas was taught of as the best way to protect your interests instead of creating competition.

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The mercantilists were also very keen that manufacture within the nation grew much faster, so that you had to import less. So, all kinds of technology upgrades, all kinds of new technologies were constantly focused upon as matters worth importing. So, that domestic competitiveness grew. Likewise they also believed that if a nation had skilled skilled weavers, it is preferable to encourage these weavers to migrate to England, rather than import the products woven by these weavers in the country. So, there was considerable amount of taught about encouraging skill workers to migrate towards the domestic country, not only in England but all them countries which believed in mercantilism.

The mercantilists were also acutely conscious that most of the cost of production involved labor cost. So, that the best way to lower cost of production was to ensure high productivity for labor. Now in this lay the colonel of an idea which became one of the most central theoretical ideas from the time of Adam smith onwards called the labor theory of value. So, this idea about labor which the mercantilists had is the colonel of labor theory of value which came later.

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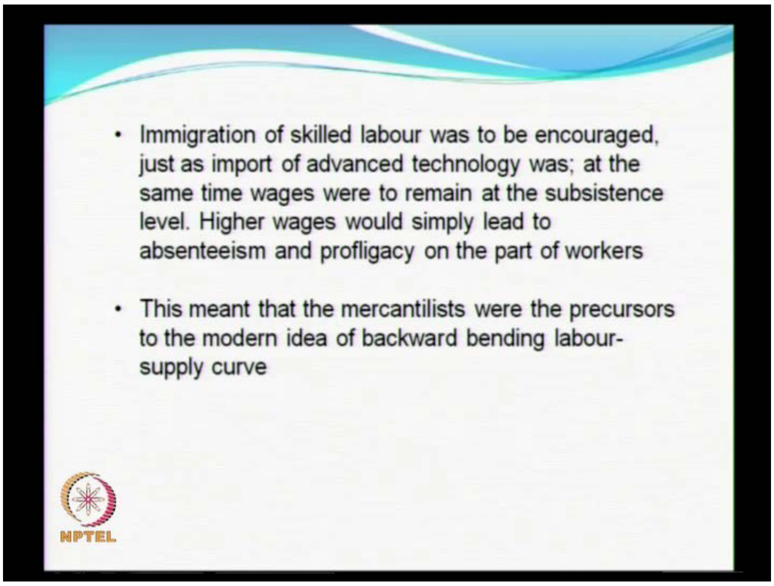

While the mercantilists were eager to admit how important skilled labor was for the manufacturing process within the economy, and therefore for the profitability of domestic industry visa foreign competition, and while they were also eager to admit that labor was the crucial element in having such an advantage, the mercantilists also sincerely believed that labor was mostly and out to be mostly paid only subsistence wage. So, what would happen if labor got something more than subsistence, what is subsistence wage? Who can tell me, Sharon what is subsistence wage?

Student: Average wage might be subsistent wage might not too. Basically it is enough for them to sustain themselves.

Pardon me.

Student: It is enough for them to sustain themselves.

Subsistence simply means; where leaving so labor wage which ensured their living a subsistence wage. Almost all mercantilists believe that labor actually got around subsistence wage and it was also good to make sure that they only get that, because they had a low opinion of labor as a class. They believed that laborers were profligate, drunkards, spent thefts they dint know how to use the money, in short they were like not very far from the oxen who worked on the farms. The bullocks which pull the plow had 4 legs, and the laborers were taught to have 2 legs, but the mercantilists had a pretty low opinion of laborers, so they were good to have good to have but, it is also good to see that if they got more than subsistence wage they drank themselves fully, they threw the money around wasted it and more important and most important, if they got more than subsistence wage they dint turn up for work, because they would have enough to eat. So, the next 3 days they won't come because they earned money today, and then when this money gets finished and then they come back to work and then they say alright what is there for me to do. Mercantilists believe therefore, that you give them a lot of money you are encouraging absenteeism.

So, they believe that buy in large as far as labor supply goes, the long run labor supply function will be close to subsistence wage, in the short run for some reason or other especially due to demand labor you might find wages going up above the subsistence level, immediately the quantum of labor offered in the market is withdrawn. Labor supply shrinks so the higher the wage is above subsistence wage the more the labor supply shrinks. So, here you have the early version of a labor supplier theory which became very popular from late 18th century onwards and right into the 19th century. This is the idea of a backward bending labor supply curve that is beyond a point if you increase wages labor supply diminishes, so labor supply increases with labor supply as a positive correlation with wages only up to a point, then the whole thing switches around and becomes an inverse correlation. So, this idea of a back bending supply curve had its genesis in the mercantilist's idea about subsistence wage and labor supply.

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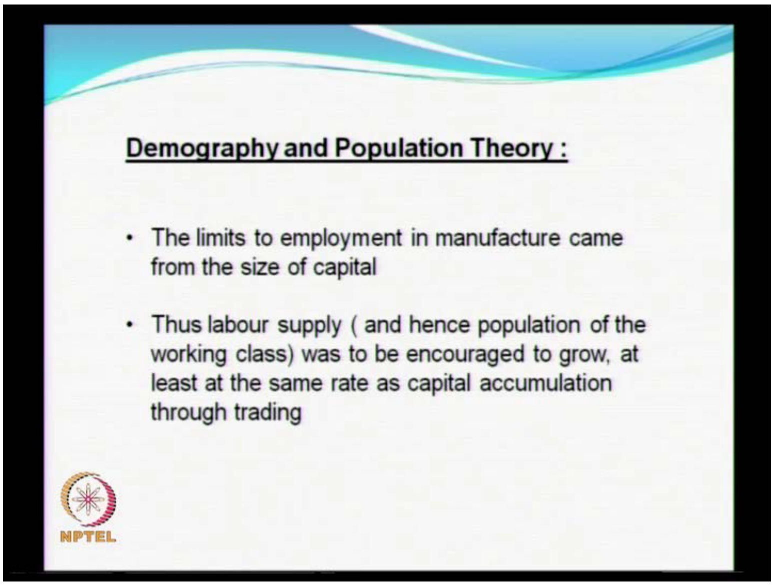

So, what causes manufacture to grow more workers, because you followed a theory which said most of it was done by labor, people earned money so that they could start manufacturing, and who did the manufacturing the workers, so he employed more workers if you wanted more manufacture, that was very clearly understood. So, there limit to how much you can manufacture is governed by the labor supply, and how many laborers you could employ is given by how much capital you have with which you could employ them, so the mercantilists were had a very interesting theory of democracy, they said that the population of the working class population in general, but population in the working class in particular should be encouraged to grow, because the higher the number of workers available the higher the possibility of manufacturing, but what is the limit they said it should grow at least at the same rate as that of capital accumulation.

So, that as you earn more and more money you could work I mean you could put more and more workers to work, so labor supply should increase at least at the rate which capital was accumulated, it is very interesting theory quite in contrast with demographic theories which came up in the 18th century especially after the psychographs. We will talk about it when we are taking them, a couple of weeks from now but at this point in time it is important to see that the mercantilists were one of the few people who talked about the need to have a growing population, growing working class has the key to prosperity. So, it is just not trade balance, it is not just positive trade balance, but that positive trade balance could be realized only if domestic manufacture grew and domestic manufacture couldn't grow unless you had sufficient hands to manufacture, and therefore they said the number of hands available to manufacture domestic goods should constantly be on the growth, how much growth as fast as you accumulated capital the population should be available for you to work. So, this was in theory of democracy, which is nothing be like what can be later 100 years later right.

It is almost as such the mercantilists are saying if you want to make too many lot of shirts then I must grow a lot of cotton, unless the cotton fields grow in size you do not get enough cotton to make shirts. In the same way and as the population grew you do not get enough workers to make the shirts. So, the mercantilists demographic theory is a very interesting very important theory which we must keep in mind. Now, what do you find is happening amongst the mercantilists here, you find in shear contrast with what was happening at the time of saint Thomas Aquinas in, so forth at the time of the scholastics you found that the whole attitude towards trade, hole attitude towards profiting, to one attitudes towards business was if nothing moralistic, restricted and suspicious, and we also saw that about the time when saint Thomas was writing actually business was prospering across Europe merchants were growing in size and the volume of trade and this was becoming a source of suspicion for the church.

A because it is a new source of political power coming up in the system, but more important people with a lot of money will learn the art of doing whatever they want of getting away with it because they can pay for it. And if that is the case the world would might become a world full of sinners, people might become immoral, this was a basic fear which the church had which gets reflected in the way in which saint Thomas Aquinas was writing.

By the time when saint Thomas Aquinas was writing evidently it dint matter if he suspected the merchants or not because the merchants were not in commanded that time, but by the middle of the 16th century towards the end of 16th century. As I told you 2 or 3 things had happened which changed things around, one the discovery of the Americas and the in flax of gold and precious metals from the Americas into Europe particularly via Spain. And Portugal this suddenly meant that the volume of money available for transactions is growing and the volume of precious metals out of which the money supply came was also growing, which mean's that there was a slow inflation across Europe for instance between 1500 and 1650 it was believed that the price has troubled across Europe, which means there was a slow creeping inflation which is good for business. If the prices are increasing dramatically then it is not good for business because conditions are too insecure for business, whereas if there is a slow creeping inflation across the board then it is good for business because the businessmen can you know how to manipulate and push business around so that they could maximize their business profits.

So, by the time the mercantilists ideas were in to the 4, merchants were to the 4 were in Europe as in an interest group as a major interest group and this was also the time when nations states had come into existence strongly, positively and aggressively so which is why it is a collusion of interests, the interest of the states coincides with the well being of the merchant class, everybody stands to gain with a favorable balance of trade when money comes into the country, the state benefits because it has money to buy arms with make more arms with and to fight more wars. And the merchant tells them how to get that way tells them this is the policy which you adopt to get there favorable balance of trade protectionism and so on and so forth.

So, for the first time the policy of the government becomes very important Europe in history, monetary policy, trade policy, policy towards manufacture business you name it in other words the government has a major macroeconomic actor comes to the 4 in European mind. And this pre eminence of the government as a major economic factor comes about with the government in collusion with the trading class, the merchant class.

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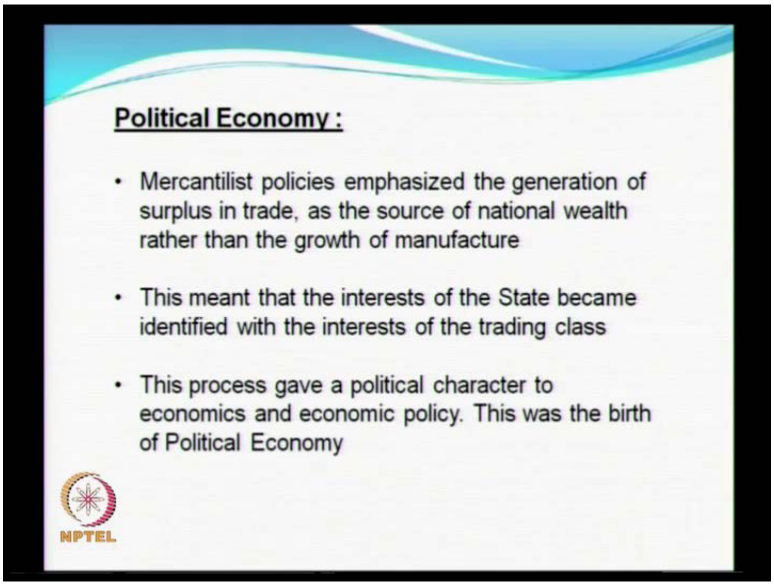

So, perhaps a person like Karl Marx writing in the 19th century, when he said the state is always articulating the will of the dominant class of people. The first evidence which Marx could probably find was with mercantilists. He argued while under feudalism the rural aristocracy was powerful and therefore, the interest of the state coincided with the interest of the aristocracy, but however the decline of aristocracy is the right of rise of the town the trading classes, the merchant, businessmen made sure that their balance of power act of the state enabled the state to support the merchants against the feudal aristocracy, because the states the kings, the monarchs dint want to get under the control of anybody least of the all the feudal aristocrats.

So, you found that the states were encouraging the merchants, businessmen as a new source of economic power on which they could depend, for example the mercantilists repeatedly argued that an economy where money is circulating far and wide is economy also which has a rich tax base, so you encourage money circulation in the economy, you encourage vast volume of trading and transactions, you are also encouraging the tax base of the economy to grow and a good tax base is always good for the government. It builds the power of the government so this collusion between the class of merchant capitalists and the state became absolutely pronounced at the time of the mercantilists; it is therefore at this point in time that was born the idea in European mind the idea of political economy.

Economics was not just policy economics was not just agriculture, not just manufacture, not just trading, but it was a collusion of the state with the specific class group in the economy so that particular types of policies become highlighted, particular types of economic policies became significant, so economics is not just economics, it is political too so the word political economy comes into vogue with this collusion of the merchant class with the state.

You have any questions up till now; we have covered a big ground actually today's class you have any questions which you would like to ask and clarify, while you do not have any questions at this point so what we will do is we will close this particular session and go on into the next session.

To start with the critic of mercantilism, I mean and then to go into a very interesting exercise as to how mercantilists were taught to be bad guys, for 200 years from 1750s right on to 1930's, when suddenly somebody comes up in 1930's who conducts a major revolution in economics, he says hey actually the smart guys were the mercantilists, they said a lot of things which all of you missed out on. So, let us look at mercantilists again the person who said this was John Mainer Kane's, so let us look at what happened and why Kane's taught mercantilists were actually sensible people, but for the present well call off the class now.