History of Economic Theory

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Module No. # 01
Lecture No. # 15
A Postscript to Mercantilism: Hume and James Stewart

So, in the last class we were talking about mercantilism and the debates surrounding the mercantilist claims, about money supply in the economy and how it was a stimulant and how after a couple of 100 years of facing criticism the mercantilist argument eventually got its very powerful revival in the hands of John Menard Canes.

What I shall do now is to wind up the debate on mercantilism by concluding with the positions taken by, on the one hand Hume as a critique and on the other hand the defence of mercantilism, probably the best defence by James Stewart. So, we will do the Hume, Stewart debate which I am looking at as a kind of a postscript to what we have studied about mercantilism earlier.

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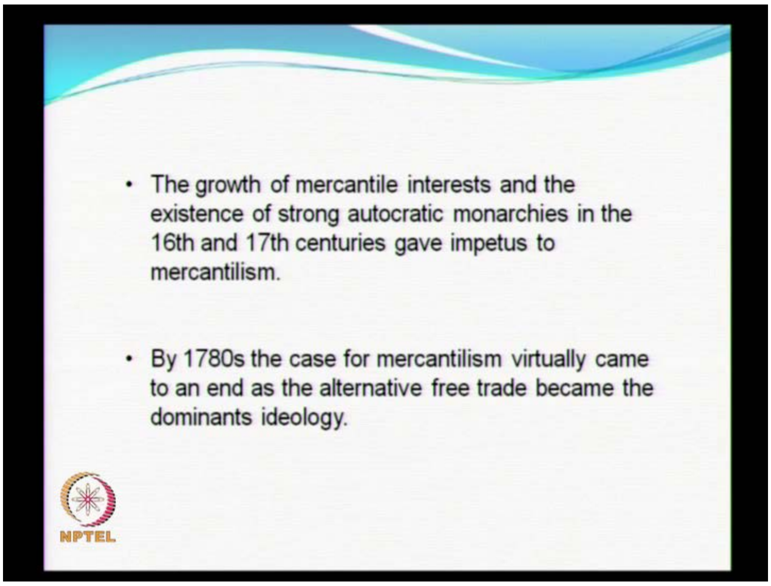

Now, as we have seen the period of mercantilism was between the middle of 16th, between the middle of the 16th century to the middle of 18th century. This is a period when two things happened in Europe; one thing is strong nations states have been formed. All of which had been controlled and all of which had been ruled by autocratic strong monarchies, and these monarchies had the backing of the mercantile interests of these economies which are growing stronger and stronger through this period. So, there was a kind of class collusion between the ruling class of the monarchies and the economically powerful boosvasies in the towns, the traders and their manufactures exporters mainly.

So, it is this collusion, it is this collaboration between these two groups that eventually led to the dominance of mercantilist for about 300 years. The second thing is that we have the argument for free trade breaking out open by the middle of the 18 century very strongly very aggressively as a part of an overall stimulation for the whole society to think in terms of different kinds of freedoms.

This is a period when the idea of political freedom and liberties took stronghold after the writings of John Lock and also a number of French interest groups French intellectuals over all in favour of intellectual freedom and the freedom of thought. So, you had an environment and ethos, virtually in this period which was talking about freedom. It was a part of this, that the ideas grow up as we shall see in the next section, about free trading economies as some kind of natural order. So, as the argument for natural order of free trade grew stronger and stronger through the eighteenth century by the 1780s virtually mercantilism of all forms had become history.

A period of 30 years really put paid to three 100 years of varied and a sorted mercantilist argument. So, what we are seeing today is a kind of postscript in the sense the finest criticism of mercantilism as it came through Hume and the finest defence of mercantilism about 15 years after Hume through, the writings of James Stewart.

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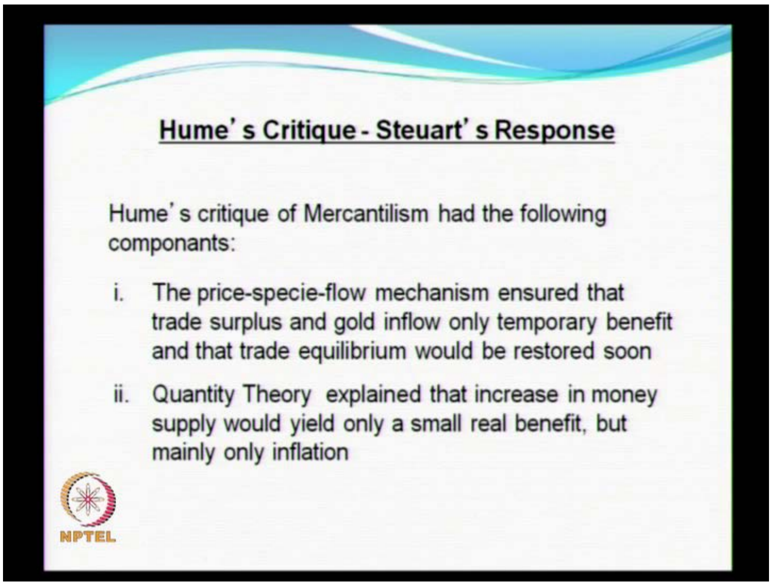

We already know, that there were four broad fronts through which Hume made his critique. What we will do now is to quickly sum it up and see what these argument are. Can somebody tell me what this price-specie-flow mechanism is? Krishna. Sorry you got to go off to the mute mode

Student: Am not able to recall it properly like.

So, your define for that.

Student: Specie specie refers to metal or gold

Beautiful and specie flow.

Student: Specie flow their will be money flow like

Excellent So, what is it all about?

Student: So this is related to what, what the mercantilists believes, that they believe it at all cause you should keep the wealth with you and at at all cause you should keep money with you. So, when your trading say with another country, you should, you should encourage your traders to pay them in kind and take payments in.

Gold

Student: Gold from them

That is lovely. So, in other words, conserve the bullion in your hands, if possible add to it through trade surplus gains. Am I right. So, Humes critique against this was simply that, importation of gold will increase the volume of money in supply and it might lead to a small amount of real gain, but fundamentally it will only reverse the whole thing because what will happen is the cost of domestic manufactures would rise with more money in circulation. Which would mean that domestic industry would lose its competitive advantage with which it is been making trade surplus and when this competitive advantage is lost. In other words, when the price of domestic manufactures are rising to equal the price of imports or sometimes cross the price of imports when all that happens is that the entire advantage in trade is lost.

So specie flow at best is a short term palliative which seems to stimulate money supply in the economy and it might have a real benefit in the sense, a little bit of real benefits to occur when money supply increases, but eventually what will happen is this will end up pushing up the prices and inflation which in turn would make the domestic industry lose its comparative or competitive advantage vice versa imports so Humes argument was specie flow mechanism ensured that basically bullionism is not really a gain. Addition to bullion in the economy is not really a gain. There is a tendency for balance of trade to be continuously equilibrated through gold transfers.

This is this criticism of Hume is in conformity with modern notions of balance of payments, where transfer of not so much liquidity, but transfer of assets is set to compensate for trade deficit or surplus. For instance, if I have a trade deficit with an another country, then the other country has an option of buying up assets in my country. In place of the money which I vow the other person. In other words, a transfer of assets takes place.

So, one flow in balance of trade statement, which is a trade deficit, I am importing more than I am exporting, is compensated by a counter flow in the capital account of balance of payments, whereby there is an inflow from abroad into this country. So, eventually this offsets the other and balance of payment remains as it was before in balance. However, a current account flow is counted by a capital account flow within the balance of payment. This is the modern technique and in order to ensure that this process this mechanism is working properly the united nations not so much united nations, but international monitory fund which is part of the Briton Woods agreement was established precisely in order to finance these short term flows of funds to offset balance of payments disequilibrium.

So, you can see that there is considerable modernity in the idea of Hume. The flow of gold or assets or cash as the case may be is only an offsetting flow which offsets balance of trade disequilibria and restore balance of payments equilibrium this was basically the power of the price specie flow mechanism argument. Should like you can make a note of this.

Now, the quantity theory is a further development of this basic argument in specie flow mechanism, whereby, it is argued that in the quantity equation, you remember the quantity equation is m v equals p t, p being price, t being the number of transactions. So, p t is a total or systems aggregate demand for money, c it. M is the stock of money and v is the velocity with which this money is doing its rounds. So, together a constitute the flow and stock definition of money supply.

So, m v is the aggregate money supply and in the identity form the money market is set to be in equilibrium or tending to equilibrium most of the time because the stocks and flows of money are adjusting to the aggregate demand all the time. Now, this is broadly the quantity theory and therefore, what happens in this case according to Hume any addition to money supply will have a short term real benefit, in the sense that it will stimulate domestic production because more money supply comes into the system and it means more spending is possible and people spend more so, far the he goes with the mercantilist argument of bullionism, but he says this is only short lived.

Because, after a while the prices start rising and benefit in terms of expanded production vanishes. So, eventually the money market is in equilibrium, once again at higher prices right. So, this is the quantity theory argument and therefore, while the specie flow argument dealt especially with the balance of payments side of the problem, the quantity theory dealt with the money market in the economy as a whole, the affect of both of them were to say that the real sector of the economy only needed real stimulants. It could not work in the long run on the basis of monitory stimulants and that was the thrust of humes argument through the specie flow and quantity theory arguments.

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Now, the area where Hume really struck hard at the mercantilist argument is there assumption that the possibilities of global trade expansion were only finite. They thought that you know the world is a pretty small place, so in which for somebody to become a big cat here to shoulder out the smaller cats. In other words, some kind of predatory attitude is necessary for you to prosper through trade. This was the mercantilist argument, essentially because of their assumption that the possibilities of expansion of global trade were finite.

This was the heart of it know, remember this. So, Hume says, who said the possibilities are finite because when there is free trade every country has a growth impetus set into it. So, as countries have free trade there is greater exchange activity going on, there is greater production in all the countries and therefore, greater exchange activity. So, it is a kind of a spiral which enables economies to move up on a growth path.

Which basically means the mercantilist were faulty in their first assumptions namely that the total trade possibilities in the world economy are finite. Hume says that who says that they are finite. So, given free trade there is growth and when there is growth production possibilities grow and therefore, trade possibilities grow and more production possibilities and a spiral which takes you upwards. So, this was Hume's argument, third argument about fundamentally unlimited possibilities of expansion of the world market through free trade.

Here again Hume was a prick as a to a lots of arguments made since nineteen eighties across the world market, where its been argued that if trade is liberalised if countries across the world liberalise the trade as a part of a deregulation programme which means you cut down tariff across the board, stimulate imports from one another, this stimulates cheaper cost of production across the world and this intent stimulates growth and more exports in short growth, based trade based growth is what has been argued across the world since nineteen eighty as a part of the global economic reform programme.

You can see that this argument goes right back to Hume. He was the earliest one to make this argument. The last of the four major arguments of Hume related to rate of interest. This was a counter by him to ever so many mercantilist arguments about the governments, the need for government policy to keep interest rate slow. The common sense argument, why they wanted this is as follows; glowing growing trade which leads to surplus and then to growth. So, growing trade needs to be financed, and if the money for growing trade across the world is viable cheaper and cheaper to that extent it is an incentive for trade to grow even more.

So, it was a basically a mercantile argument cheaper interest breeds, cheaper financing of trade and cheaper financing of trade would mean faster growth in trade this was basically the common sense of it. Now, Hume said money supply has nothing to do with interest rates. After all the mercantilist believed that if the government through policy kept the interest rates low then it would been cheaper and plenty of money supply would be available to the trading community.

Now, Hume says this is not true. He says interest rates cannot be artificially regulated by the government to enable increase in money supply because he says interest rates are a real phenomena. In the sense that as growth occurs investment expands, as investment expands return on capital comes down simply because there is more and more and more investment return on capital comes down, which means people are willing to pay less and less to borrow funds which is the reason interest rates come down. So, he says the coming down of interest rates it is a real phenomenon, it is not a monitory phenomenon it happens due to real growth in the economy and it is coming down does not mean that money supply is going to increase because he said this is a demand related factor, that is in the market for investable funds.

There is less and less demand for investments because the return on investment is coming down because the investments are growing the capital structure is expanding capital accumulation is going on. So, for all these reasons interest rates, interest rates drop and that is, it is got nothing to do with government policy keeping interest rates low, is that governments do not have to do that at the growth process and the market mechanism ensure this.

Now, there is a major argument here which later became the heart of classical and neoclassical economics, write up to Canes. It is always been argued up to Canes that interest rate is a real phenomenon it is not got anything to do with money, that is, nominal interest rates were not really the heart of the problem in economics according to classical and neoclassical economics. It is a real rate of interest which makes the different because this real rate of interest which is influenced by such factors as waiting, you see, you give the money to somebody to make an investment, you wait for the period of gestation of investment to start yielding.

So, its waiting and the Austrian argument was there was a time preference involved that is you give money to somebody and you take money back at a later stage. So, there is some discount involved here and the compensation which you get for lending the money should be at least equal to the rate of discount. So, there are number of factors in classical and neoclassical economics which were strongly urging that interest rate are real phenomenon and not monetary. This argument that interest rates are real and not monetary again appear to have their origins in this argument of Hume about interest rate and the capital market.

Would you like me to clarify something on that? So, can I go on. Now, about fifteen years after Hume had published what he published on this issue, James Stewart made a response. Now, James Stewart is acknowledged as a mercantilist, but it seems to me that he was a visionary that he was a lot more than simply a mercantilist because as we shall see in about twenty minutes time James Stewart was actually also a growth theorist, one of the earliest ones. He was trying to explain different stages in the economic growth of an economy, I do not think anybody did that before him. So, he was a visionary who used to mercantilist analysis to make a policy recommend or make a series of policy recommendations so let us look at what James Stewart had to say.

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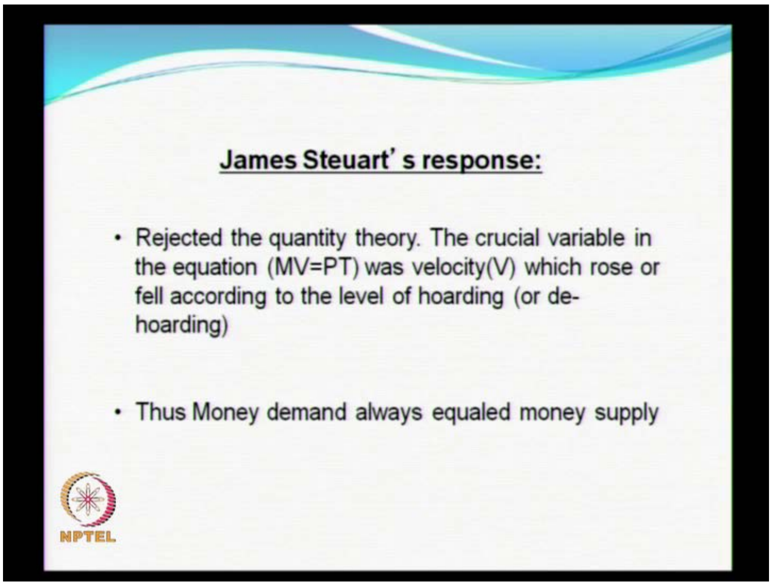

The first thing he did was to reject quantity theory and he along with others made the following contention, in the quantity equation which is MV equals PT according to Hume M and P became crucial independent and dependant variables now those as m moves the dependant variable list P variable list P and P goes up and down on an inverse relationship between M and P.

Now, what Stewart said is the quantity theory argument, forgets the fact that there is something else which is happening in the economy. Every pound or dollar or rupee which is a stock of money is not simply going around. Suppose, for an instance a dollar or a pound or a rupee changes hand 6 times, right. So, in terms of velocity you will say it changes hand 6 times during the day so velocity daily velocity 6. So, the total value of money is not just one pound but, 6 pounds, am I right.

Now, one thing which this argument over looks is this, that it does not do 6 rounds in a day it may do more it may do less, in between the time it moves from one hand to another, it stays unmoving in the hands of people. For instance 5 of the 6 transactions might be over by 10 o clock in the morning and they may sit in the hands of somebody till 7 o clock in the evening and at 7:15 this man performs the last or the sixth transaction.

So, in terms of velocity you say it did 6 rounds in the day its 6 rupees, but if you actually look at this between 10 in the morning till 6 in the evening the money was ideal, it was not moving, is it not? So, there is not only flowing money but there is also ideal money in this system. So, this ideal money which is not flowing it is an inverse of velocity, am I not right, it is called holding.

So, up to 10 o clock the velocity is 5, then from 10 o'clock to 6 o'clock the velocity is 0 and then at 6 o clock the velocity is one, am I not right, but between 10 and 6 the money was holded, am I right? So, how many rounds the money does during the day also depends upon the periodicity of stagnation of money in peoples hands, not flowing holding am I right.

So, Stewart was conscious of this factor of holding among other mercantilist. So, Stewart said if holding increases, velocity drops. If holding decreases that is people are removing money from their private stocks and releasing it into the circulation its deholding. Deholding happens, velocity increases. So, he says money market adjustments are happening all the time because people are constantly holding and deholding money in accordance with what they need at that time whether they whether they need cash which they need to release from the holding or whether they want whether they have extra cash which they want to just hold and keep away. In other words, the behaviour with respect to holding is a crucial factor which determines the velocity of money supply.

So, he says if this is the case, then how can you correlate money supply with just price because the adjustments in between money supply and demand is actually happening with holding and deholding, and there is an excess money supply according to quantity theory prices should rise, but according to Stewart it is simply lead to more holding. If there is too much money on hand people will simply put it away, instead of spending it on goods. So, he says that just because people have more money in hand, it does not mean they spend, it does not mean that it leads to a price increase, it may simply go into pockets for a for another day spending. So, holding increases.

So, according to Stewart velocity of money supply in the M V equals P T is a crucial variable, and that goes upper down according to whether there is holding happening or disholding happening, and holding or disholding happening, happen when there is a discrepancy between money supply and money demand in the economy. So, when money supply money demand discrepancy happens according to Stewart it does not simply lead to price increase or decrease as the quantity theory. He says it simply leads to more holding or less holding or holding or disholding, in which case he says there is no reason why you should accept quanity theory at all.

This was the probably the most strong case ever made against quantity theory, ever in the history of economics. I am not saying that people like Canes did not make a strong claim against quantity theory, it is true that Canes had a much wider and much more complex description of the money market than quantity theory could ever do, but till the time of Canes one thing which happened, which questioned the quantity theory strongly was this argument of Stewart and other mercantilism like him, against the assumption that any increase in M could increase could lead to increase in P because he said any increase in M could simply mean a decrease in V so that the money market removes in the equilibrium.

So, bringing in of holding as a crucial variable and therefore, as a variable which determines the size of V is a major contribution by mercantilist as a critic of quantity theory. If you want you can make a note of this. Now, one further extension of this argument of holding, later on classical and in large measure of new classical economic theory accepted holding as an important factor. so, quantity theory itself was given two version subsequently, one version which looks at money demand and money supply, purely as a function of M V and P T and other looks upon the total output in the system in place of P T it looks at the output in the system and the money supply is looked upon as a function of some kind of a cash balance which people hold.

So, the total value of transactions in the Cambridge equation which came later was equal not to velocity times stock, but was determined purely by the stock of money which people held. So, they said if your income is one thousand rupees you have tendency to hold say 200 rupees in cash all the time. So, the total demand for money you have in the system is only centring around this two hundred rupees you keep this two hundred precisely because you need to spend money. So, any point of time as you spend some money out of this stock which you are having you inject more money into the stock, so that you maintain it is like having money in the purse, know.

So, this version of quantity theory which talks about cash balances rather than velocities was called the Cambridge equation, which recognised the holding behaviour alluded to by Stewart and his friends.

Now, the Cambridge equation is simply some k times, small k times, k is a fraction line between 0 and 1. So, some small k times the income. If I have an income of thousand rupees then k fraction of that income is what I hold as cash balance, and the total money supply in the economy is only this cash balance, isn't it. So, the Cambridge equation looks at the whole thing from the point of view of cash balance which is nothing, but a variation of the holding which Stewart and others had earlier referred to.

So, because of these arguments, because holing is the one which is the cushion, in the money market, Stewart could argue that money market never went into disequilibrium. It was always in equilibrium because any changes in the value of, because P T is the constant according to him. The volume of transactions is a function of what was happening in the production conditions of the economy and P is the price at which the transaction are happening that is it period. So, adjustments are all taking place not between M and P as quantity say argued, but between V and holding the volume of v increased or decreased as M changed. So, that one side of money market remained unchanged. So, they could argue that money market is all always a equilibrium. It can never be disequilibrium; this was Stewart argument, a very powerful argument.

The next argument of Stewart was on the level of employment. The aggregate demand for the goods and services in the economy, could be such that they need not employ every worker who is available in the economy. It might not provide employment for everybody. In other words, what Stewart was arguing was that aggregate demand might be such that it might be below the aggregate supply of goods in the economy. There might be an excess supply, there might be an over production of goods know and this happens unemployment, right.

If you have simple production function where you say Q is a function of L where L is employment for any increase in Q you need to increase employment or better still as a demand for Q increase L will increase and it can go on happening some L cap or L bar which would be full employment, know yes. You want me to write this down. So, What Stewart argues says that any level of aggregate demand in the system which exist at any point in time need not be necessarily ensure that there will be full employment, and to have full employment we have to have policies oriented towards the wages right, and like other mercantilist Stewart also argued that the labour market does not ensure some kind of automatic adjustment of wages according to availability or demand or supply of labour.

Here government intervention is necessary. So, how does Stewart looks at the system, he says in a economy which is growing any change in technology which leads to mechanisation, which leads to bringing in of more capital tends to displays labour. Now, when labour is displaced automatically there is supply, excess supply of workers, wage rates fall. At the same time the labour market is not by itself adequate to have automatic adjustments which will ensure some kind of an equilibrium wage rate. So, on the one hand you need technological progress, on the other hand you need to ensure that there is no mass poverty or destitution. So, you need a government which is active in this direction which ensures that subsistence wage is paid to workers in the economy.

Now, the big difference is the new classical or classical economy would have said any increase in labour supply will go on pushing the wages down till it reaches subsistence right, but Stewart says the labour market does not work like that. He for instance would accept earlier mercantilist arguments, you remember backward bending supply curve right, because if wages are slightly above subsistence there is absenteeism people do not turn up for work they earn money in one day, they will not work for 2 days because they say I have got enough stock of food for two days why should I work.

So, labour market at the critical point around subsistence wage is a bit indeterminate. You do not know when the fellow is going to turn off from work when he will return to work there is a indeterminate space there, above subsistence wage where the supply curve bends upwards. know so, he says its one reason why you need an active intervention of government in this situation to ensure that subsistence wage prevails.

Like many other mercantilists for instance he argued that we should not have poor laws, which gives some kind of in social security to workers during unemployment. He said you should scrap all the poor laws so that labour participation in the production process is more complete. So, this as far as labour is concern, do you have any questions on this?

On the question of subsistence wage, it might be interesting to look at Stewart and his successors among the classical economist. They were all talking of subsistence wage and towards the end of 18th century in fact there was even a theory which was kind of notorious in terms of implication of justice it had for workers. It was a theory which said the total funds designated for the subsistence and living of workers in the economy as a whole must fixed and finite, it was called wage fund. Not because somebody was fixing that so much money should go, it is just that in any production process a particular proportion of the revenues went for the subsistence of workers.

So, according to this theory the wage funds in the economy are in the long run constant and they provide around subsistence wage rate, but in the short run demand and supply in the labour market cost the wage rates at any point in time to be above or below the subsistence wage rate, but in the long run the total funds revolving around so many workers subsistence in the economy had a constant population assumption is constant. So, population is increasing at a fixed percentage, then wage fund also increase at a fixed percentage.

So, statics and dynamics of subsistence wage theory imply that there is something called wage fund, which sustains workers which is a part of a national income as a whole and this wage fund is constant. it was a bit, it is a bit of a harsh theory which came under fire in the nineteenth century considerably from a lot of people who saw the evils of capitalism has been very awesome gruesome. So, lot of socialist criticism was against wage fund lot of non socialist criticism of capitalism, liberal criticism of capitalism was also focused substantially on the wage fund theory, but most importantly, probably the most, one of the most brilliant of nineteenth century followers of Adam Smith namely John Stewart mill his defence of wage fund theory was extremely uncomfortable.

He dint have any definitive statement to make on wage funds, he appears to support wage fund sometimes and other times he appeared to agree with the questioning of wage funds. It is basically because the moral and ethical implication of this wage fund theory was very strong. Much more than the theoretical implication for economics, the moral implications become very crucial and in the nineteenth century one moral question on capitalism were asked again and again and again even by Karl Marks, who could not separate the moral argument about capitalism from the theoretical argument about capitalism. Which is why in this manifesto of communist party, Mark says workers of the world unite you have nothing to lose, but your chains.

So, workers of the world unite could be a theoretical proposition propositions saying that capitalism is falling, so worker should unite and get together and form a new government as one. One the other is the moral exaltation saying do not worry. There is nothing for you to lose you are already chained and shackled in capitalism, so you will only get your freedom when capitalism dies. So, you see this combination of moral and scientific argument as far as the subsistence wage, wage fund theory goes even goes into Marks, who I am saying even into Marks because Marks tends to look down upon other socialist as been emotional utopian and so on so forth.

Well that is as far as Stewart's argument on wage fund and subsistence are concerned. Now, Stewart backed all this with the very interesting theory of economic growth. Stewart's economic theory of growth assumes that the landed class with the prosperity in agriculture, the landed class would be spending more and also the prosperity in manufacture growing in economy.

The manufacturing class will also spend more, but according to Stewart the spending propensity of the landed class is much more than the manufacturing class because he believed that the manufacturing class would devote its surplus earning to more production. Whereas, this argument goes later on after Stewart to when they say, the landed class does not have the motivation to grow bigger than what it is. They have got the land they are earning the rent from land and all they need to do is to spend the earnings from rent and enjoy their life.

So, that being the case the real spenders in the economy or the landed class, so they as the level of agricultural performance grows as agricultural prosperity starts really happening it is a landed class who become the big time spenders, which in turn stimulates growth process in the economy, yes. So, the first phase of economic growth in the arguments of Stewart is a domestic market based growth.

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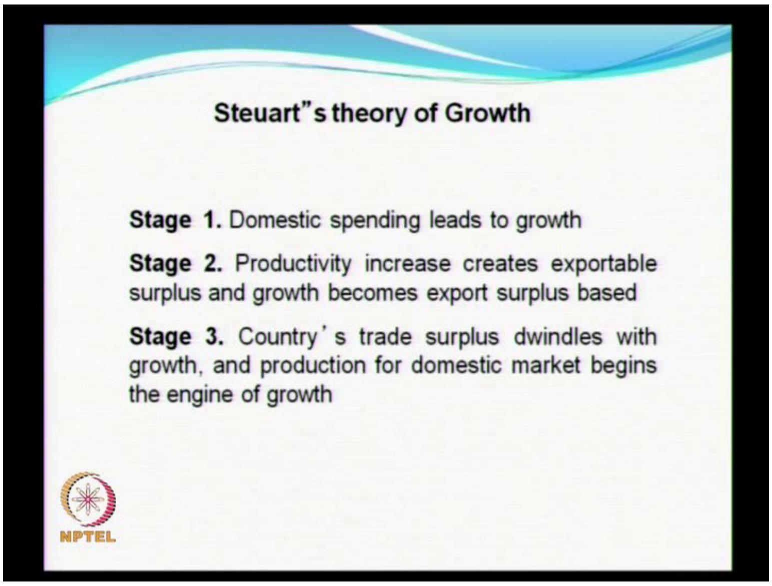

This growth leads to growth of manufactures and competitiveness among manufactures, and then this competitiveness enables a moment into a second stage where your now growth, your growth is now based on trade surplus. You might import goods for raw materials purposes, you might import labour for skill purposes, but you do all this to ensure that your surplus in trade by using these resources is growing.

So, in this second phase it is a trade based growth and as this trade based growth goes on and on and on. Globally other countries in the world also start getting to the competitive. Gradually, you lose competitive edge in a large number of things which you are exporting. It is simply that people are catching up with your technology; people are catching up with your investments capacities and resources. In short people are getting to be competitive with you. As a result your trade surplus starts coming down and then you go to the third stage where the big spurt of growth occurs, but entirely based on a very prosperous domestic market.

So, than you do not need trade surpluses to grow as you did in the second stage. You probably will still have trade surpluses, but your engine of growth is your domestic market due to domestic opulence domestic wellbeing and domestic spending capacity. So, Stewart had these three phased theory of growth. If you look at this comparison with some modern theories of growth, it resembles some of the modern theories of trade and growth, there is a theory called product cycle theory.

Which says that the initial spurt of growth happens in a technology, in a product domestically, and then this technology enables this country to export this product, so this country starts earning money by exporting this product and the product grows really fast because now it has found an export market been sent all over the world, and in the third stage it is cheaper to set up a factory abroad to manufacture this product then to export it. So, you make foreign investments, of course this part is not in considered at all in Stewart’s model, but what happens in the Stewart model in what happens in the product cycle theory comes at times when almost everybody is setting up factories to manufacture this product across the world that is when your intellectual property rights comes to an end.

Twenty years you hold a patent on it, you initially export the product, then you setup factory all over manufacturing patented product, then finally everybody start making it you lose all competitive edge on that. So, you come back to dependency on domestic market for the product. So, there is similarity between the product cycle theory of trade and Stewart’s arguments about stages of growth. By this we come to an end to this section which we have called a postscript to mercantilism. After the break we shall return and discuss theories of natural order which led to free trade.