

## Module 1

### Lecture 2

#### Topic

#### 1.2 Mercantilis

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- Mercantilism was another dominant school of economic thought prevailing in the seventeenth century. The mercantilist writings were scattered through 1500-1750, although the more sophisticated treatise appeared between 1650 and 1750. Unlike Physiocrats, Mercantilists did not have a systematic treatment of their doctrines. Mercantilist writing can mostly be found in the form of pamphlets.
- The term first acquired significance at the hands of Adam Smith who criticized the doctrines and that's how Mercantilism started to be called a coherent school of thought.
- The most famous doctrine of the Mercantilists is the doctrine of balance of trade. The main tenet of this doctrine is simple: in their view bullion and treasure are the essence of national wealth. A nation spends such treasure to make up for trade deficit viz. the value of export – the value of import. Hence, government should restrict imports to save bullion and treasure.
- Their rationale behind such policy prescription was simple: as must an individual, a country must spend less than its income (i.e. import less than it exports) so that its wealth will increase. In Mercantilist view, national wealth took the form of bullion and treasure.
- Did mercantilists really identify money with capital?
- A sophisticated version of mercantilism does not identify money with capital. Why do then they care about balanced trade?
- This is hard to say as Mercantilist writing lacked precise formulation. The idea of maintaining export surplus runs through the entire mercantilist literature.

- Whatever the mercantilists hoped to achieve by positive balance of trade has to be short lived. Thomas Mun writing as early as early seventeenth century understood the fallacy. He realized that inflow of bullion will raise the price of domestic goods and turn the balance of trade against a country. Hence, the specie (bullion) flow will be self-regulating. This theory was at hand in the seventeenth century but the contemporary writers failed to recognize it.
- Interestingly Smith did not put forward the argument of specie flow mechanism against the mercantilists even though he discusses this mechanism elsewhere.
- However, in later period protectionism got revived in Europe and simultaneously scholars came forward in defense of Mercantilism.
- Roscher, Schmoller and then their English disciples, Cunningham and Ashley rose to defend Mercantilism. Their main arguments was that the mercantilist policies were rational in achieving certain goals: national autarky and the expansion of state power.
- This defense was however unable to defend the intellectual fallacy of the mercantilist regarding the Balance of Trade doctrine until J.M.Keynes produced a full blown answers to the critique of mercantilism. Keynes argued that as soon as it is realized that the economy is not automatically gearing toward a state of full employment the whole of classical argument based upon the advantages of the international division of labor loses much of its force.
- He further argued that the preoccupation of the mercantilists with gold inflows was no "puerile obsession" but an intuitive recognition of the relationship between plenty of money and low rate on interest which in turn induces more investment. In his argument high prices (induced by export surplus) and low interest rate would encourage high investment.
- Were the mercantilists really pre cursors of Keynes?
- A lot of Keynesian elements could be seen in Mercantilist documents but that does not mean that they were concerned about the problem of effective demand.
- Hecksher criticized Keynes' defense on the ground that the nature of unemployment in 1930s was very different from that during the Mercantilist era. Most of the unemployment during that time was agricultural and therefore seasonal. Hence, in his view most of the unemployment during that time was

voluntary rather than involuntary and nothing to do with the problem of effective demand for investment goods which was emphasized in Keynesian writing.

- On a purely historical context, the Mercantilist doctrine can be rationalized on the basis of Britain's trade with East Indies and Baltics. Britain was net importer from these regions and had nothing to offer to these regions as export. Hence bullion was required to pay for these imports. However, the Mercantilists never explicitly mentioned this argument in their pamphlets. But this line of argument did form the basis of attacks on the East India Company in the British Parliament. Thomas Munn, who was a shareholder of the Company, attacked the mercantilists precisely for this reason.
- The fundamental problem with the Mercantilists doctrine was that they failed to recognize that more money in the system would lead to inflation. But why did not they see this?
- The reason that mercantilists did not pay attention to the possibility of inflation is that they interpreted the quantity theory of money differently. The quantity theory of money is the theory of money market adopted by the classical economists. This theory states that  $MV \equiv PT$  where  $M$  is the supply of money,  $V$  is the velocity of money – number of times one unit of money changes hand to support one unit of transaction,  $P$  is the price and  $T$  is the total volume of transaction. In the standard interpretation of the quantity theory of money,  $V$  is thought to be determined by institutional factors and  $T$  is being determined by real factors. Hence, the traditional interpretation of quantity theory only looks at the relation between  $M$  and  $P$ .
- But the mercantilists emphasized the effect of  $M$  on  $T$ . They perceived that an increase in money supply will result into increase in transaction which in turn signifies more income.
- By the end of the eighteenth century, Mercantilism lost its theoretical fervor as an analysis of economy. The mercantilist writers failed to provide an integrated analysis of the market economy. However, Mercantilism formed the basis of one of the most powerful argument in the favor of protectionism. It even inspired many future economists such as J.M Keynes to reinterpret Mercantilist doctrines to form supportive arguments against free trade. Even today, many arguments against free trade contain the essence of the mercantilist argument.