

# History of Economic Thought

## Ch 3: Late Pre-classical Economic Thought (1500 – 1750)

1. Mercantilists,
2. Precursors of classical economic thought,
3. Physiocrats.

# I. Mercantilism

2/8/2008

Late Pre-Classical Economic  
Thought

2

# I. Mercantilism

- ◆ The writers were merchants and businessmen.
- ◆ Analyzed questions of economic policies related to their own interest. Lobbied for government-granted monopolies for themselves (so the objectivity of their analysis is questionable).
- ◆ No attempt to synthesize the contributions into a general theory.

# I. Mercantilism

- ◆ Tried to determine which policies promote the power and wealth of nations.
- ◆ Early Mercantilists associated the wealth of nations with the amount of gold they had.
- ◆ Key assumption: **total wealth in the world is fixed**. Thus, an increase in the wealth and power of one nation occurs at the expense of other nations (trade is **zero sum game**).
- ◆ Advocated “favorable” trade balance (Exports > Imports).

# I. Mercantilism

- ◆ Advocated low wages, to give the nation competitive advantage in international trade.
- ◆ Advocated low consumption (high saving) and high production.
- ◆ Similar to the goals of Soviet Union, where the focus was on the power of the state and production, with no concern for increasing consumption of the masses.

# I. Mercantilism

- ◆ Mercantilists believed that increase in money supply leads to increase in economic activity.
- ◆ Jean Bodin (1569) however understood that increase in money supply leads mainly to rising prices.

# I. Mercantilism Main Contributions

- ◆ The idea that the laws of the economy could be discovered by the same scientific methods that revealed the laws of physics.
- ◆ Many mercantilists saw relationships of “cause and effect” in the economy.
- ◆ Understanding these rules of economics can help design legislation that can positively influence the economy.

# II. Precursors of Classical Thought

Philosophers/economists whose ideas anticipated or influenced the Classical thought.

# Thomas Mun (1571 – 1641)

- ◆ Typical Mercantilist (director of East India Company, promoted government policies that benefit particular business interest, confused the wealth of a nation with its stock of precious metals, encouraged exports of manufacturing goods and imports of raw materials).
- ◆ Adam Smith devoted much attention to refuting the mercantilist thought and Mun's ideas in particular.

# William Petty (1623 - 1687)



Late Pre-Classical Economic  
Thought

# William Petty (1623 - 1687)

- ◆ English economist, scientist and philosopher.
- ◆ Coming from poor family, mastered Latin, Greek, French, Arithmetic, geometry, and navigation by the age of 15. Later became sailor, doctor, surveyor and inventor.
- ◆ Was interested in taxes, politics, money and measurement.

# William Petty (1623 - 1687)

- ◆ **Contribution:** in his *“Political Arithmetic”* (1676), introduces a new method of economic research – **empirics**.
- ◆ “The method I take to do this is not very usual. For instead of using only comparative and superlative words and intellectual arguments, I have taken the course... to express myself in terms of number, weight, or measure; to use only arguments of sense, and to consider only such causes as have visible foundations in nature.”

# William Petty (1623 - 1687)

- ◆ Tried to measure population, national income, exports, imports, and capital stock.
- ◆ His statistical methods were crude, and his conclusions were typical mercantilists.
- ◆ Adam Smith found his contribution as not useful.
- ◆ The importance of his contribution is the idea that economic variables must be quantified (measured).
- ◆ Until the end of 19<sup>th</sup> century, the main tool of economic analysis is verbal arguments.

# Bernard Mandeville (1670 – 1733)

- ◆ Argued that selfishness is a moral vice but social good could result from selfish acts if these actions were properly channeled by the government.
- ◆ Today some interpret this as an argument in favor of **Laissez-faire** (“let it be” in French).

# David Hume (1711 – 1776)



Late Pre-Classical Economic  
Thought

2/8/2008

15

# David Hume (1711 – 1776)

- ◆ Scottish philosopher, historian and economist.
- ◆ Close friend of Adam Smith.
- ◆ At the age of 12 enrolled at University of Edinburgh to study philosophy and general learning. Left at 15 with no degree.

# David Hume (1711 – 1776)

- ◆ Influenced by John Lock (who introduced the term “velocity of money”), developed a quantity theory of money.
- ◆ Deviated from the Mercantilist view that an increase in money leads to increase in economic activity. He observed that after an increase in gold (money supply) there is increased economic activity **only in the short run**. In the long run however, the only effect of increased money supply is higher prices. (See Lucas Nobel lecture)

# David Hume (1711 – 1776)

- ◆ Pointed out that it is impossible to maintain “favorable” balance of trade forever. This is known as “*price-spice-flow theory*” or “*gold-flow theory*”. If exports > imports, there is an inflow of gold (money) into the economy, prices will go up, and the country’s goods will become more expensive. The terms of trade will change: exports go down, imports go up.

# David Hume (1711 – 1776)

- ◆ Attacked the mercantilist view that trading states are rivals, with one gaining only at the expense of the other.

# David Hume (1711 – 1776)

- ◆ “In opposition to this narrow and malignant opinion, I will venture to assert, that the increase of riches in any one nation, instead of hurting, commonly promotes the riches and commerce of all its neighbors; and that a state can scarcely carry its trade and industry very far, where all the surrounding states are buried in ignorance, sloth, and barbarism.”

# David Hume (1711 – 1776)

- ◆ In modern language, trade is a **positive sum game**, according to Hume, as opposed to **zero sum game** according to the mercantilists.
- ◆ Hume pointed out that economic freedom goes hand in hand with political freedom.
- ◆ Distinguished between **normative statements** and **positive statements**. Concluded that the former cannot be derived from that latter.

# David Hume and Religion

- ◆ “I have written on all sorts of subjects... yet I have no enemies; except indeed all the Whigs, all the Tories, and all the Christians.”
- ◆ “The Christian religion not only was at first attended with miracles, but even at this day cannot be believed by any reasonable person without one.”

# David Hume's Impact

- ◆ In Robert Lucas Nobel lecture on Monetary Neutrality (1995), the name of Hume is mentioned 35 times! Modern monetary economics is still struggling with understanding the impact of money on the economy.
- ◆ The link between political freedom and economic freedom is very relevant for some countries today.
- ◆ Trade policies, such as protectionism, are still relevant.

# Richard Cantillon (c. 1680 – 1734)

- ◆ Richard Cantillon, acknowledged by many historians as the first great economic "theorist", is an obscure character. This much is known: he was an Irishman with a Spanish name who lived in France and reputedly made a fortune of some twenty million livres under John Law's schemes before moving to England.

# Richard Cantillon (c. 1680 – 1734)

- ◆ “*Essai Sur la Nature du Commerce en Général*” was written in French circa 1732 and published anonymously in England some twenty years after his death.
- ◆ Was murdered by his servant whom he laid off ten days earlier, and his house was burnt. Maybe a lot of valuable work was destroyed in fire.
- ◆ In his views on trade he was Mercantilist.

# Richard Cantillon Contributions

- ◆ The first to develop the **General Equilibrium** view of the economy (markets are interconnected).
- ◆ Modern approach:
  - step 1 – establishing basic principles through process of reasoning (economic models)
  - Step 2 – collecting data to verify the principles

# Richard Cantillon Contributions

- ◆ The key actors are **entrepreneurs** motivated by their pursuit of profit, leading to social benefit far superior to the one produced by government intervention.
- ◆ Any element in the economy is **endogenous** (determined within the model). That includes population.

# Richard Cantillon Contributions

- ◆ Analyzed the price adjustment process, in response to **exogenous** changes.
- ◆ Developed **micro-foundations** approach to macroeconomics (the economy consists of individuals who make choices).
- ◆ Had an insight that monetary policy can affect different sectors differently, depending on where the new money is entering the economy.

# Richard Cantillon Impact

- ◆ Very little impact. His work was largely ignored.
- ◆ Cited by Adam Smith and some Physiocrats, but his work was fully appreciated much later.
- ◆ "The Essai is far more than a mere essay or even collection of disconnected essays like those of Hume. It is a systematic and connected treatise, going over in a concise manner nearly the whole field of economics, with the exception of taxation.. It is thus more than any other book I know, the first treatise on economics...Cantillon's essay is, more emphatically than any other single work, "the Cradle of Political Economy". (William Stanley Jevons, "Cantillon and the Nationality of Political Economy", 1881, Contemporary Review)

# III. Physiocrats

- ◆ A group of French economists who promoted the ideas of Francois Quesnay during 1750 – 1780.

# François Quesnay (1694 – 1774)

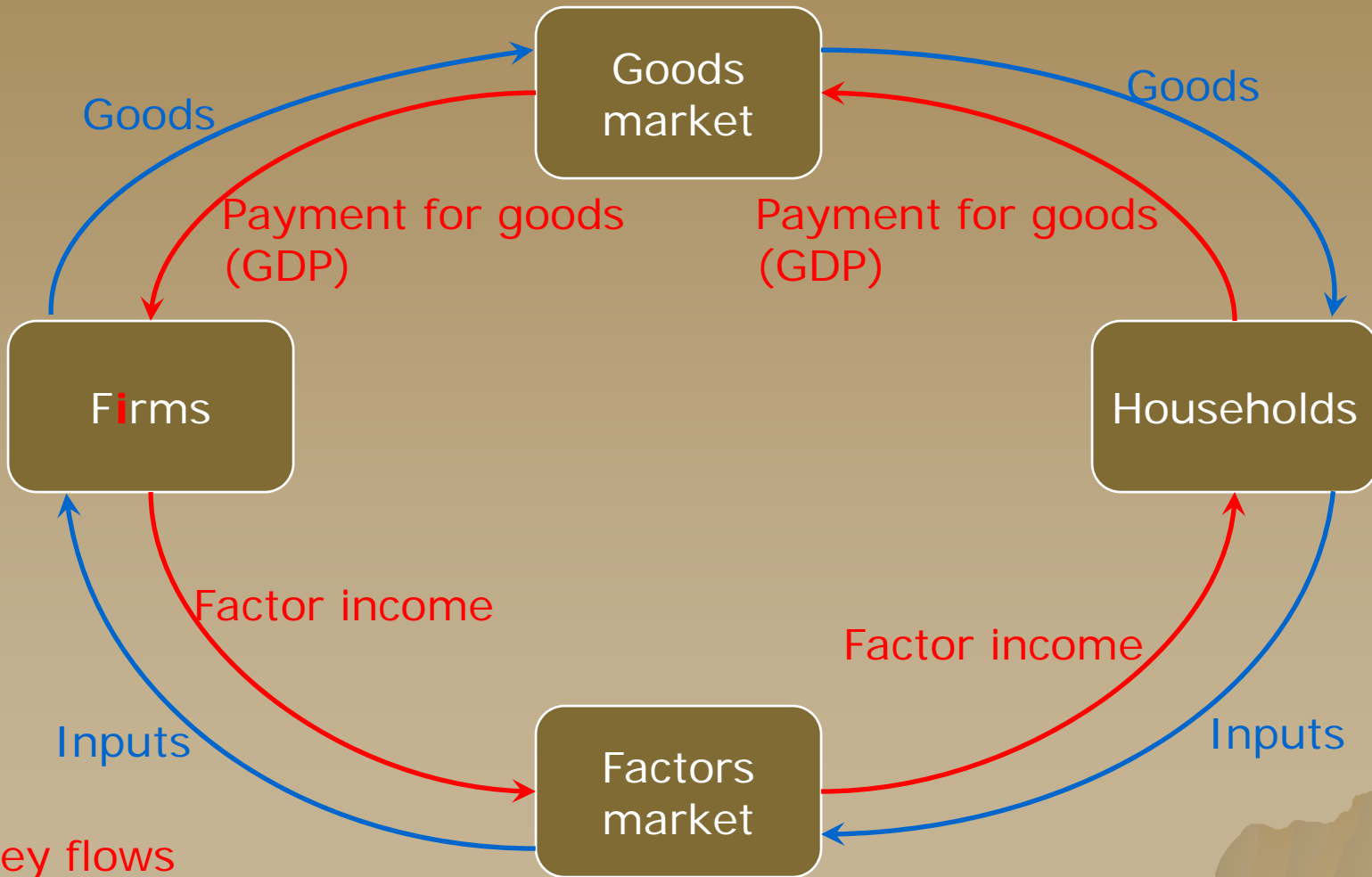
- ◆ Orphaned at thirteen
- ◆ Learned to read
- ◆ Became barber-surgeon
- ◆ Partly responsible to separation of surgeons from barbers and elevating the status of surgery into a medical science



# Quesnay Economic Table (*Tableau Économique*)

- ◆ Attempt at analyzing the entire economy by means of an abstract **model** (novelty at that time, but today the main analytical tool).
- ◆ Understood the **interdependence** of sectors and markets, but didn't know how to describe it.

# What did Quesnay try to develop?



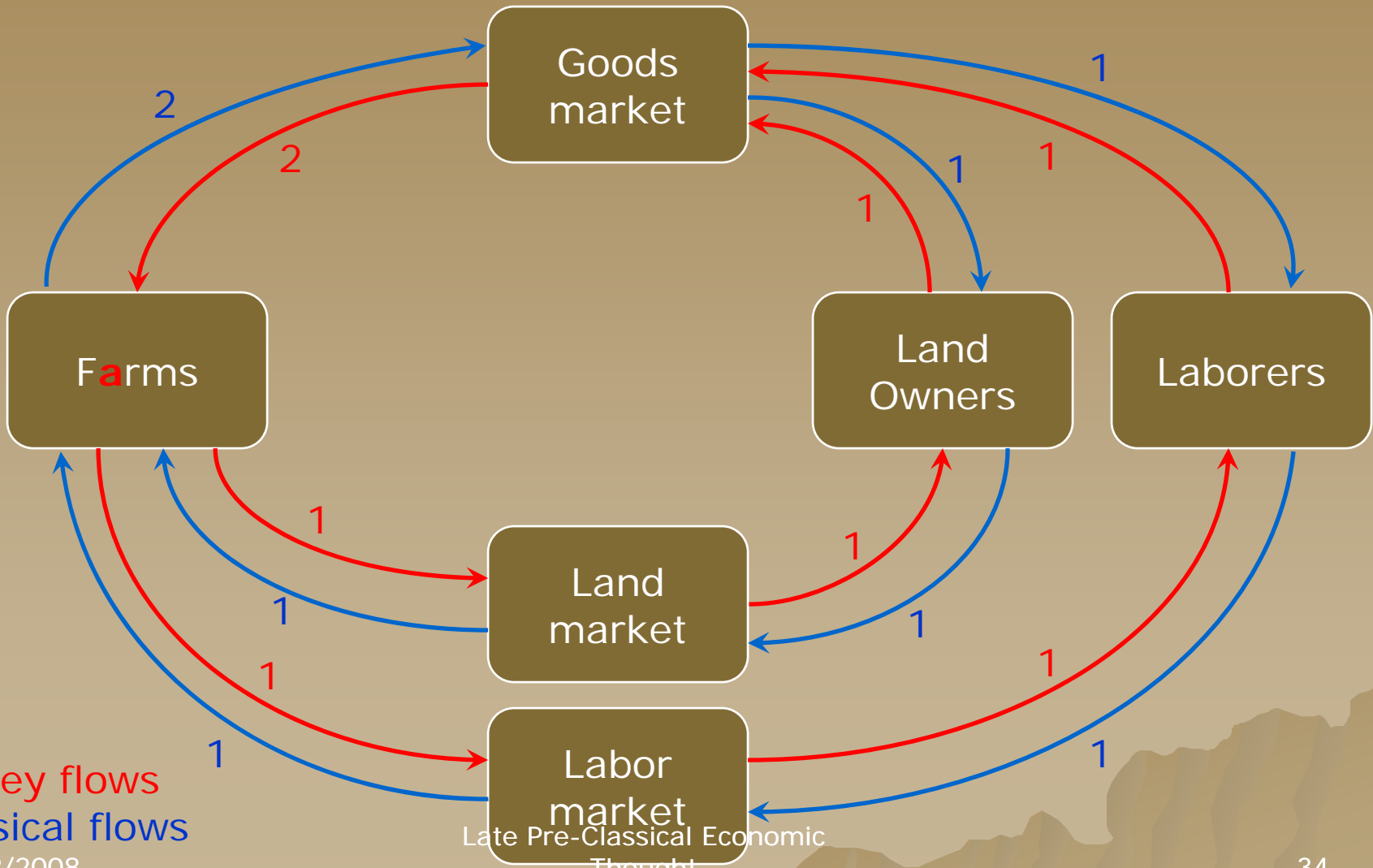
Money flows  
Physical flows

2/8/2008

Late Pre-Classical Economic  
Thought

33

# Or maybe?

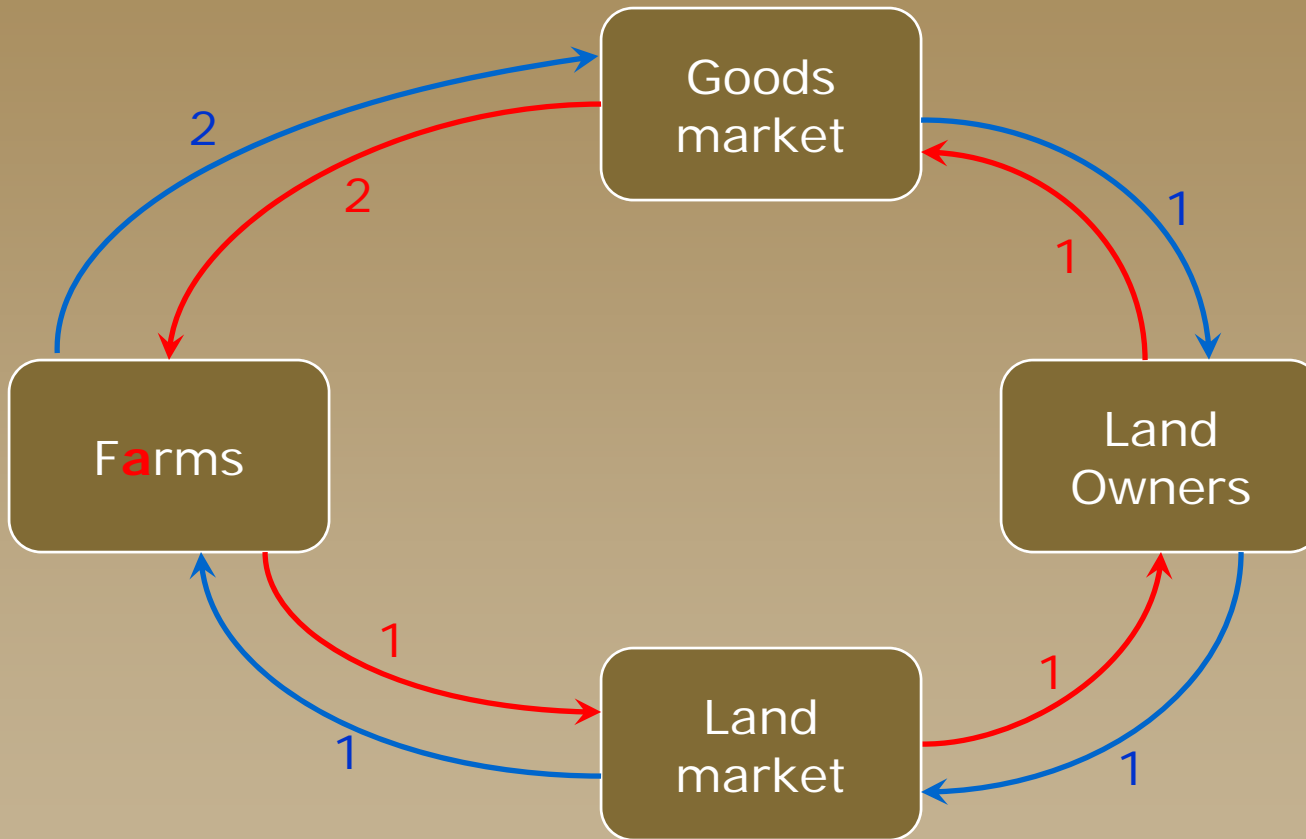


Money flows  
Physical flows

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Late Pre-Classical Economic Thought

# What if we omitted the labor market?



Money flows  
Physical flows  
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Late Pre-Classical Economic  
Thought

# Net Product

- ◆ Conclusion: agriculture generates **net product**; if landowners spend 1000 livres on farming products, the farm sector generates 2000 livres of income.
- ◆ Quesnay began with the axiom that agriculture is the only source of *produit net* (net product, or surplus of output above cost, **rent**).

# Quesnay Table Illustrated

Farmers

Landowners

Artisans

Net product from last year

→ **2000**

1000

Net product

→ **1000**

1000

500

Net product

→ **500**

500

250

Net product

→ **250**

250

125

Net product

→ **125**

125

# Quesnay Table Illustrated

- ◆ The landlord starts with 2000 “net product” from the last period. He pays 1000 to the farmer and 1000 to the artisan.
- ◆ The 1000 paid to the farmer generate income of 2000, i.e. net product of 1000.
- ◆ Next, the farmer spends half of its income (500) on purchases from artisans and artisans spend half of their income (500) on purchases from the farmers.
- ◆ This generates additional net product of 500.

# Quesnay Table Illustrated

$$1000 + 500 + 250 + 125 + \dots$$

$$= 1000 + 0.5 \cdot 1000 + 0.5^2 1000 + \dots$$

$$= 1000 \sum_{t=0}^{\infty} 0.5^t = 1000 \cdot \left( \frac{1}{1-0.5} \right) = 2000$$

# Quesnay Table Illustrated

- ◆ A "natural state" of the economy emerged when these income flows were in a state of "balance", i.e. where no sector expanded and none contracted. Once the "natural state" was achieved, the economy just continued humming along, reproducing itself indefinitely.

# Alternative Interpretation of Quesnay Table

- ◆ The table is a precursor to the Keynesian multiplier? Notice that when the artisans or the farmers receive some income, they spend only part of it. In this example, they spend 0.5 of income, which means that the Marginal Propensity to Consume (MPC) is 0.5.

# Contribution of Quesnay Table

- ◆ The theory and the table, although full of contradictions,
  1. Gave crude representation of flows of money and goods between different sectors in the economy,
  2. Stressed the **interdependence** of sectors and markets.
  3. Is an attempt at analyzing the entire economy by means of an abstract **model** (novelty at that time, but today is the main analytical tool).

# Physiocratic Economic Policy

- ◆ **Laissez-faire:** concluded that competition led to the best price and that society would benefit if individuals followed their best interests.
- ◆ Advocated a simple tax system: tax the land only since the land is the only source of “net product”.
- ◆ Free trade.

# The Origins of the Phrase “Laissez-faire”

- ◆ The French phrase “Laissez-faire” was coined by Vincent de Gournay (1712 – 1759).
- ◆ Quesnay was known as the European Confucius. The doctrine and even the name of “Laissez-faire” may have been inspired by the Chinese concept of **Wu Wei** (“without action”).



# Mercantilists vs. Physiocrats

	<b>Mercantilists</b>	<b>Physiocrats</b>
<b>Source of wealth of nations</b>	The gold and silver the nation possesses	Agricultural output
<b>International trade</b>	Emphasis on exports, import only raw materials	Free trade
<b>Role of government</b>	Strong government with lots of regulations, monopoly rights, tariffs and taxes.	"Laissez-faire" – the government should stay away, tax only land.
<b>Main impact on subsequent economic thought</b>	The idea that the economy could be formally studied	The idea that the economy could be formally studied, and that sectors and markets are interrelated.

# Spanish Economic Thought

2/8/2008

Late Pre-Classical Economic  
Thought

46

## Martin de Azpilcueta's (1492 - 1586)

- ◆ In 1556, thirteen years before Jean Bodin, developed a quantity theory of money. He observed that prices in Spain increased after the influx of gold from what is now Mexico and Central and South America.

# Luis de Molina (1535 – 1600)

- ◆ Had remarkable deep understanding of how markets operate, and what forces determine the prices of goods.
- ◆ For example, when war is imminent, the prices of horses go up.
- ◆ Applied his supply and demand ideas to money to develop a quantity theory of money.

## Pedro Rodríguez de Campomanes (1723 – 1802)

- ◆ Accepted the arguments of his predecessors and concluded that influx of gold into Spain had dire consequences for its development.
- ◆ As gold flows into Spain, prices in Spain rise, and it becomes cheaper to buy goods from France and England. As a result, Spain will not develop as much as the others.
- ◆ Advocated freedom of trade

# Summary

- ◆ Late mercantilists and physiocrats main contribution is the recognition that the economy can be formally studied.
- ◆ They were the first to use abstract economic models.
- ◆ Mercantilists achieved insight into the role of money.
- ◆ Physiocrats realized that sectors and markets are interrelated.

# Summary

- ◆ Mercantilists viewed markets as a conflict where some gain while others lose.
- ◆ Physiocrats viewed markets and trade as harmony, a way to reduce the conflict inherent in scarcity.
- ◆ William Petty, who was mercantilist, was significant in that he was the first who attempted to ground economics in empirical observation. Adam Smith, by rejecting this approach, delayed the movement towards quantitative economics by 100 years.

# Questions

- ◆ Why did so many economists develop the quantity theory of money around the 16<sup>th</sup> century?
- ◆ Explain what is the importance of statistical analysis in economics.
- ◆ What makes a claim scientific?
- ◆ What is science?
- ◆ Is economics a science?