Compare the views of Smith, Ricardo and Keynes on the doctrines of the mercantilists. (4/5/12)

A. Mercantalism

First we must give a brief overview of mercantilism (what G.v. Schmoller retrospectively called 'state-craft'). Heilbronner (1999 [1953]) uses the metaphor from the cover of Hobbes's *Leviathan* which shows a benevolent monarch standing-watch over the population. Heilbronner further states this pre-Adam Smithian period is one when nations were seeking power, a rich monarch ("the Mercantilist monarch") means a powerful state. The way to riches was through foreign exploration and accumulating gold and silver from the New World and Africa into the national treasury. (The Pope and the Spanish and Portuguese monarchs signed a 1494 declaration which divided the non-Christian world between these two monarchies). As species-based foreign trade developed it was seen that exporting more than importing and holding down the living standards of the general populace was the way to national power. Monopolies were granted to ensure high export prices and bargaining power for raw materials abroad. The state used tariffs, subsidies, quotas and duties to regulate trade. Heilbronner thus calls mercantilism "kingly wealth and national stinginess". Exporting more, and therefore importing more gold than other nations, was seen as a way to gain power and wealth at the expense of other nations. [In fact it was often a capital crime to export gold.] Further, again retrospectively paraphrasing J. Robinson (1935) we can call mercantilism a policy of "beggary-thy-neighbor".

It should be noted that the "mercantilist period", which might be considered the period during the transition between feudalism and capitalism, lasted several centuries and took place in a diversity of locations, resulting in a diversity of thoughts and policies. It is not clear whether mercantilism was a coherent economic-social philosophy or a series of events as they unfolded. Was it indeed statecraft or was it what we would call today "rent-seeking".

I will use as examples two well-known mercantilists, Thomas Mun in England and J-B Colbert in France. Mun was a director of the East India Company which was given monopoly rights for the "development" of India. His most famous work is "England's Treasure by Foreign (sp) Trade" (1620s-1660s). Although like other mercantilists he called for England's exports to be greater than their imports, he also used causal logic to argue against the exportation of gold and silver as a capital crime. He used this reasoning to describe how gold exports to India allowed then greater (and lesser cost) exports from India to England, which then

England could use as inputs to production and re-export for more gold. Mun also believed in “kingly wealth” but also believed that if too much of the gold flow was held in the treasury deflation would occur, and, if the crown spent too much too quickly inflation would occur.

J-B Colbert was the finance minister for Louis XIV in the mid-late 1600s. Colbert prevented the export of most corn (agricultural products) in an attempt keep the cost of living in cities as low as possible to encourage the manufacturing sector. Manufacturing goods served as the base for French exports and very few imports were allowed to enter the country (“national stinginess”). Like other mercantilists he believed in “kingly wealth” and (for the Sun King) subsidized “manufactures royale” for consumption by the aristocrats. The difficulty in generalizing mercantilist policies can be seen in Colbert’s attempts to simplify the tax code and to include aristocrats in the tax base.

B. Smith

In Book IV of Wealth of Nations [1776] Adam Smith spends 200 pages critiquing what he named “the mercantilist system” and stated that it “absurdly” prioritizes domestic production over domestic consumption. Smith directly states, “consumption is the sole end and purpose of production”. In this same chapter Smith introduces “the invisible hand”.

It might be said that the purpose of Smith’s oeuvre was to refute the mercantilist system and state control over the economy as manifested in his philosophical system of “perfect liberty”. [Though it does need to be mentioned that both Heilbronner (Milberg 2004) and Robbins (LSE lectures) note that Smith recommends more than 10 interventions recommended by Smith in WN 1776, not least of which are subsidies for public works and public education].

Smith’s political economy was intended to show that the extent of the market (and the “invisible hand”) allowed the division of labor and the capital (not gold possessed by the crown) accumulation which creates wealth in society. Smith, Scottish, believed that individuals where capable of saving for the future while the state – those who controlled the mercantile system - was not. Species is necessary to facilitate trade and a country which did not have gold would have to import it, but in Smith’s metaphor only to the extent that a country without grapevines would have to import wine.

Smith discusses that how in “common language” money is seen as wealth and only countries with money are seen as conquering. For the Tartars wealth/money was seen as cattle, and Smith comments that perhaps they were more correct than the civilized world and its species-money. Smith favorably discusses Mun specifically about the need for merchants to be able to export and trade in silver and gold, and repeats Mun’s metaphor about gold exports being the seed corn which reaps greater return at harvest. Colbert is praised for his attempts at fiscal reform however was unfortunately influenced by the “sophistry” of self-serving merchants and manufacturers. Additionally Colbert’s economic nationalism led to war with the Dutch.

C. Ricardo

It is not evident that Ricardo had read the mercantilists, however Chapter VII of Ricardo 1817 is an explicit attack showing the impossibility of both hoarding gold and running a permanent current account surplus. Using Hume’s price-species-flow mechanism (again, not referenced in 1817 but abundantly elsewhere in his collected works) we find that if a country has a “natural” local comparative advantage or a productivity advantage (usually seen as an investment in “machinery”) then their price for that good will be lower than that of other countries. Exports of that good will rise, resulting in a flow of gold into that country, resulting in a general increase in prices in that country. Ricardo assumes, 1) that gold has been chosen as the “circulating” currency (in fact Ricardo helped England move to a gold standard after the Napoleonic wars) and, 2) that goods circulate according to a “natural traffic” based on comparative advantage. Relative productivity changes take place, resulting in changing trade patterns, and, gold flows which create an “equilibrium” in goods flows, goods prices, and gold flows. (This has subsequently become known as the law of one price). Because of these flows it is not possible for a nation to both continually collect gold and export more than they import.

Heilbronner [1953] states that Ricardo built his system to show the advantages of “free trade”, which is the opposite of the “mercantilist monarch”. All value is created by land and labor (note that this is a refutation of Colbert’s prioritization of manufacturing to the detriment of agriculture). Ricardo uses the declining fertility of land to show that the landed class will gain rents to more fertile land and that these rents will mean diminishing profits to capitalists. (Further, per Heilbronner it is these capitalists who drive the “economic machine”). Ricardo uses a Malthusian model of the population. An initial period of capital accumulation and profits for capitalist will mean capitalists will demand more labor. An increase in wages then leads to an increase in the population, more land (of less fertility) placed in production, which requires a higher wage relative to profits. Eventually a stationary-point is reached where capital accumulation and wealth-creation ceases.

In order for economic growth to continue there needs to be international trade. (Ricardo was especially vehement against the English Corn Laws which severely limited the importation of foodstuffs.) Under the labor theory of value, trade across nations will allow for a better "distribution of labor" due to the specific advantages of local conditions. Profits will then arise again, allowing for the accumulation of capital and investment in productive "machinery". If and only if the trade is in commodities (like food and cloths) will there be a lowering of the subsistence wage and a subsequent rise in the rate of profit. Trade in wine, velvets and silks consumed by the "rich" will leave the stationary-point unaltered (note again that this is in direct opposition to J-B Colbert's "manufactores royales" under Louis XIV). Finally, Ricardo makes the free trade argument that trade creates "universal society of nations" and creates "one common tie of interests".

D. Keynes

Keynes [1936, Ch 23] in his chapter on the mercantilists specifically states that his discussion of the mercantilists is to point-out some of the errors of what Keynes calls the "classicals", or, the *laissez-faire* economists. Keynes also specifically states the main error of the "classicals" is the assumption that the interest-rate and the volume of investment will self-adjust to full employment, something the mercantilists never assumed. Additionally Keynes criticizes the "classicals" pre-occupation with free-trade as a 'waste of time'. (Yet on the other hand, Keynes criticizes the trade-barriers recommended by the mercantilists and states that the advantages of the international division are "real and substantial". Trade barriers should not be used unless on "special grounds"). Keynes writes that the mercantilists had correctly the notion that high interest rates lead to an under—investment of productive capital, and thus, gold imports which were circulated lead to lower interest rates and investment.

Let's review a few things that Keynes found relevant in the mercantilist (keeping in mind that Schumpeter 1954 wrote that Keynes was "over-generous" in his praise of the mercantilists, contributing it to shared pre-analytical visions).

i. Keynes states that the mercantilists knew that their statecraft policies were nationalistic and could lead to war. Keynes juxtaposes this with the "classical" economists who believe that the gold standard and international trade lead to peace (writing this of course after World War I).

ii. Keynes believes that the mercantilists knew that it was people's natural tendency to save more than they invest, and that too much "kingly wealth" would choke-off local domestic investment. (It should be noted that Keynes states that the general position of the mercantilists was not "kingly wealth", yet we have seen that Heilbronner states differently. In addition Keynes seems to misspeak about Mun in that he states Mun wanted hoarding by the crown, yet we have seen that Mun had warned about inflationary and deflationary gold circulations.)

iii. Keynes believes that the mercantilists have what he calls "the fear of goods", meaning that if international competition leads to overly cheap goods (and there is a dearth of money), then domestic effective demand will not be large enough to prevent domestic unemployment. Keynes lists in a positive light some state-created industries from the 17^{th} and 18^{th} centuries as examples.

E. Comparisons

Necessarily we will start by contrasting Keynes views with those of Ricardo and Smith. First-off we can use the "laissez-faire" ideal-type and see that Keynes found something positive in the mercantilists concern over trade-balances and a state role for trade, whereas we can generalize that both Smith and Ricardo were against a role for the state in trade. Further we can see that Smith and Ricardo were supportive of Hume's price-species-flow mechanism to regulate currency circulation in the world economy, whereas Keynes believed that the state would have to supplement national investment because people tend to save more than invest. We can see that Keynes' view here is in complete opposition to that of Smith's in that Smith believed that the state was profligate and that state activity thus did not lead to capital accumulation (investment).

Next logically we will evaluate Ricardo on Smith and the mercantilists, using the mercantilist Barbon 1690 as entry-point. The difference here is a difference in value theory between Smith and Ricardo. For Barbon and Smith (and assuming here Smith's "labor-commanded" theory of value) profit is created in market exchange. For Smith profit (and rent) is money received by the seller above the money-wages paid. For Ricardo the rate of profit is regulated by the surplus product created on marginal land, it is the "produce of land and labor" which regulates the profit rate, not the act of exchange. Ricardo [1817, Ch VII] specifically states where he differs from Smith on the rate of profits due to international trade. While Ricardo agrees with Smith on the tendency for the profit rate to realize a “general” level based on capitalists seeking the highest returns for their capital, Ricardo’s value theory necessitates a difference from Smith. Whereas Smith believes that country which reforms from mercantilist protectionism to free-trade will realize higher profits in general, Ricardo’s value theory states that the even the profits in the free-trade sector(s) will fall to the general rate regulated by the surplus profit on marginal lands.