

## **Session 3    12<sup>th</sup> October 2004**

### **Introduction**

Discussions about the history of economic theory revolve around the production of wealth. In the Mercantilist period wealth was accumulated in the form of bullion or specie through state led policies of trade [and sometimes through piracy!]. At this time, before the late 18<sup>th</sup> century, people did not theorise about economics and trade in the way that happens today. A system of national economics had not yet been laid out but the European literature of the 16<sup>th</sup> to the 18<sup>th</sup> century illustrates that a great deal of effort was spent by merchants convincing governments of the emerging and developing nations that the power of a nation lay in its store of bullion. The way to increase the national treasury through trade was to encourage exports and place great restraint on imports. In this way more wealth entered the nation than left it. The association of national power with bullion wealth was one of the characteristics of the emerging state in Europe.

Different ideas about trade and how it should be organised emerge out of different historical contexts. As do the different justifications for particular trade practices. The fifteenth to the mid-eighteenth century is generally referred to as the mercantilist period of trade. This definition was applied towards the end of this period when mercantilism came under strong criticism from economic liberalism and was finally discredited. This does not mean that mercantilist ideas about trade are archaic. This strand of thought still exists in practices and policies today.

This week we look at mercantilism, followed next week by the economic liberalism of Smith who argued that manufacturing labour at the heart of the economic system was the source of wealth, and that value lay in production for exchange.

### **Pre-Classical Economics: Mercantilism and Physiocracy**

Trade has taken place across the millennia. But there is a significant difference between current trade practice and trade before the sixteenth century. Today's trading arrangements are organised globally by an institutionalised set of rules. In the fifteenth century there were individual merchants buying and selling for profit. The merchants were distributed mainly across Northern Europe and travelled from there across the globe to Asia and Africa in search of goods and markets. Many factors have contributed to the development of a global trading system from these ad hoc trading patterns.

First was the shift from the ad hoc pattern under feudalism to a 'system' of trade encouraged and protected by the emerging state as it began to shape into a national bloc. The belief that bullion or specie was the source of national power encouraged the state to protect its merchants' trade and helped them to flourish by assigning a market to a single merchant, or to a crown trading company, or to one of the regulated companies.

Ideas about what constituted national power affected patterns of trade. Put differently, the development of the state included the idea that state power rested on the accumulation of wealth in the form of gold and silver. It was also the belief that the amount of gold and silver in the world was limited and therefore the state must secure as much of it as possible since if one state has it, then the others do not. Under these beliefs about state power trade became the tool for acquiring wealth. "...to sell more to strangers yearly than we consume of theirs in value" (T Mun 1571-1641).

To achieve a favourable national balance of wealth it was agreed under mercantilism that government intervention was necessary to impose tariffs and duties to discourage imports and give subsidies and grants to encourage exports. Imports were to consist of cheap raw materials, which could be finished and exported at a profit. And in order that trade was as effective as possible in gathering wealth, whole areas of the world were assigned to individual merchants and sometimes to trading companies.

Not only was the development of the state (and its requirement of specie for reasons of power) an important factor influencing ideas about trade. Equally important was the discovery of the New World in 1492, where bullion and specie was rumoured to be plentiful and for the taking. Taken together, the need for gold and silver and its location around the globe were equally important in encouraging the protectionist trade policies of the mercantilists. This also implies conflict between countries in the pursuit of the accumulation of wealth. The more wealth a nation had the more powerful it was. With wealth a nation could raise armies to secure more wealth. Quite often trade was overtaken by piracy and ships were looted for the bullion they were carrying back home.

The shift from ad hoc patterns of trade to a system increasingly organised by the crown marks the beginning of the organisation of trade. Regulations were increasingly introduced in order to support merchants and gain revenue for the state. At this time the economics of a country were not unified into a national economic system. The first economic school did not emerge in England but in France with the Physiocrats in the mid-eighteenth century.

Despite the absence of a unifying theory of political economy there was a variety of speculation on the nature of the economic process which had engaged the mediaeval mind. Numerous judgements were made, mainly by merchants, on the importance of government intervention such as tariffs on imports to reduce their volume and desirability, subsidies, and protection for monopoly traders. This degree of state intervention was judged the only way to produce the surplus necessary to maintain a strong position in the highly competitive world of rising nations.

The protection of markets and the monopoly traders encouraged the expansion of trade, as did the expansion of colonial settlements. Transporting the goods needed by the colonists and returning to England and other European countries with the colonists' production of tobacco and cotton was the basis of trade expansion in Europe at this time.

As markets expanded and production from manufacturing increased those merchants (and others) who had invested in manufactures sought markets for their goods. A debate arose between those who believed that wealth lay in the continued accumulation of specie through government intervention in trading matters (a trade surplus), and those who believed that the wealth of nations was achieved through removing restrictions to the free trading of the new industrial growth in manufactures a production surplus). Adam Smith took the latter position and in his book, *An Inquiry into the Nature and Causes of the Wealth of Nations*<sup>1</sup>, developed a theory of economic growth<sup>2</sup> based on labour as 'the measure of value'.<sup>3</sup>

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<sup>1</sup> first published 1776

<sup>2</sup> W.J.Barber (1967) *A History of Economic Thought*, Harmondsworth, Penguin books Ltd, p27

<sup>3</sup> *ibid.*,p31

Although Smith has come to be known as the founding father of political economy (or Economics) his was not the first theory of political economy. As mentioned earlier the first economic school, physiocracy, emerged in France in the mid-eighteenth century. When visiting Paris in 1765 Smith visited 'the leading progenitors of the school'<sup>4</sup> who called themselves Les Economistes. Smith began writing *The Wealth of Nations* during his stay in France and the influence of the Physiocrats is evident in his work.

Physiocracy means 'rule of nature'<sup>5</sup> and, like the mercantilists, the physiocrats also emphasised the importance of an economic surplus<sup>6</sup> but for them agriculture was the only genuinely productive sector of the economy, and the generator of a surplus. The Physiocrats rose to prominence in their attack upon the mercantilist view that value was synonymous with money and that trading produced a surplus. Under the 'rule of nature' the physiocrats claimed that everything depended upon agriculture which was unique in that you plant one seed and in time reap twenty. This was genuine production. A manufacturer could not multiply production in this way. He could only reshape the input materials. Manufacturing was sterile<sup>7</sup> whereas agriculture was productive. In this way mercantilist policies were undermined as being supportive of sterile manufacturing at the expense of productive agriculture.

A leading physiocrat, Francois Quesnay (1694-1774), produced the 'Tableau Economique'<sup>8</sup> (first published in 1758) which illustrated the economy as a continuous interdependent flow. Quesnay used the idea of the flow of blood circulating around the human body as an analogy for the circular flow of money and goods through the economic system. A major importance of the physiocratic school of thought is the contribution of the circular flow to economics.<sup>9</sup>

The Tableau Economique assumed a 'natural' social order which gave harmony to the physical world. This was a reflection of Newtonian mechanics that informed the intellectual climate of the times.<sup>10</sup> This view of the world was in opposition to the state intervention and protection of mercantilists. Under the rule of nature

value was defined in terms of the production of *physical* goods and productivity in terms of the production of a physical surplus, that is the gift from a bountiful physical environment.<sup>11</sup>

Agriculture was considered the only producer of value which filtered through the system from the land to the populace, the manufacturing sector, the propriety class and back into the land. Value accumulated on plants growing on the land. The main points of the economic theories of physiocracy are as follows:- *le droit naturel* which refers to the concept of natural law; the guiding rule of *laissez faire, laissez passer*, to let things be

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<sup>4</sup> JKGalbraith (1987) *Economics in Perspective: A Critical History*, Boston, Houghlin Mifflin Co. p48

<sup>5</sup> D.Miller Ed. (1991) *The Blackwell Encyclopaedia of Political Thought*, Oxford, Blackwell Publishers, p372

<sup>6</sup> Barber (1967) *A History of Economic Thought*, p18

<sup>7</sup> *ibid.*, p20

<sup>8</sup> *ibid.*, p20

<sup>9</sup> E.R.Canterbery (1976) *The making of Economics*, Ca., Wadsworth Publishing Inc., p35

<sup>10</sup> Barber (1967) *A History of Economic Thought*, p21

<sup>11</sup> K.Cole et al (1983) *Why Economists Disagree: The Political Economy of Economics*, Harlow, Longman Group Ltd, p28

the way they will; and the concept of the *produit net* – that all wealth originates in agriculture.

At its conception by the Physiocrats economics was deeply rooted in nature, but the classical economics of Smith that followed dismissed the idea of agriculture as the source of value as an idea of little importance.

It would not, surely, be worthwhile to examine at great length the errors of a system which never has done, and probably will never do any harm in any part of the world.

...its followers are very numerous; and as men are fond of paradoxes, and of appearing to understand what surpasses the comprehension of ordinary people, the paradox which it maintains, concerning the unproductive nature of manufacturing labour, has not perhaps contributes a little to increase the number of its admirers. (Book 4, Chapter 9<sup>12</sup>)

For present day neo-classical economists this is even more nonsensical since they follow a model based on purely economic relations and do not place economics within the natural sphere, as it is in reality.

The mercantilists saw value in trade and the subsequent accumulation of wealth where wealth was finite. The Physiocrats saw nature as the source of all value and although theirs was a mechanistic view, which moved between production and consumption it was not independent of the natural world but dependent on it. The classical view of Smith and others which followed the Physiocrats took the circular flow and represented it as a closed system quite independent of the natural world and taking no account of the natural resources used up in production and waste.

P.Shaw 5.10.04

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<sup>12</sup> quoted in Galbraith (1987) *Economics in Perspective* p48, p56.