Mercantilism and Keynesianism

By L. Albert Hahn

Nothing is so instructive for the evaluation of scientific and political ideas as the history of those ideas. It teaches us that conceptions that claim novelty and originality have been nearly always, during the course of history, not only conceived but refuted. Its knowledge can therefore prevent scientific discussion from moving always in circles. It can prevent undertaking hopeless economic experiments for the testing of which the past has already paid. And finally it can deprive some scientific or political opinions of the appeal of paradoxity that make them seemingly irresistible to many people.

In the field of Monetary Theory and Policy, history teaches us, furthermore, that ideas concerning the rôle of money in the economy swing like a pendulum from one extreme to the other. Times when the power of monetary changes is over-rated alternate with times when it is under-rated. Times when a reasonable synthesis of opinion is achieved seem seldom and short.

There seems no doubt that in our time the pedulum has again swung strongly in the direction of an over-estimation of the possibilities of influencing the economy from the money side. By the followers of the late J. M. Keynes, whose opinions prevail especially in this country, it is considered self-evident that by increasing purchasing power (or "effective demand") employment can be increased and unemployment combatted. It might therefore be appropriate to recall briefly the teachings of the school that has shown more enthusiasm for monetary manipulations than any other during history. We mean the teachings of the *Mercantilists*.

The Theories of the Mercantilists

THE RELATIONSHIP OF KEYNESIANISM to Mercantilism of the sixteenth to the eighteenth centuries is well known. Keynes, himself, in chapter 23 of his "General Theory of Employment Interest and Money"[1] has pointed to it. He has said much in praise and in defense of mercantilistic theory and policy and against arguments presented by its classical critics.

The ideas of the Mercantilists contain—in this we have definitely to agree with Keynes—theoretical insights on money which are astonishing for those times. This is why the general prejudice against them is surely unjust. But can it be concluded from this, as Keynes seems to assume, that Mercantilism can be used in support of Keynes' ideas, especially regarding the stimulation of business activity? We doubt it.

The main conclusion of the Mercantilists is—in Keynes' formulation—that "a favourable balance (of payments in international trade), provided it is not too large, will prove extremely stimulating."[2] This stimulation happens, according to the Mercantilists, by a simple mechanism: The favourable balance of payments draws precious metal into the country. This increases the circulating purchasing power. This again means increased demand for labor and thus higher production. Such a mechanism can indeed work; however, as Keynes correctly remarks, only under the condition that "the increase in the domestic level of costs (does not) begin to react unfavourably on the balance of foreign trade";[3] a condition which the Mercantilists fulfilled by "discouraging rises in the wage-unit."[4]

If the Mercantilistic employment theory thus is based on the idea that increased purchasing power results in higher

[1] J. M. Keynes, "General Theory of Employment Interest and Money," New York, 1936, p. 333 ff.: Notes on Mercantilism, the Usury Laws, Stamped Money and Theories of Under Consumption.

[2] Keynes, *loc. cit.*, p. 338.

[3] *Ibid.*, p. 336.

[4] *Ibid.*, p. 340.

employment, provided wages remain fixed, they have indeed anticipated Keynesianism. For Keynes, too, holds the theory that increased demand leads to increased production; and his theory, too, is only valid if wages and costs are prevented from rising with and through the increasing demand.[5]

This condition was fulfilled in the times of the Mercantilists. Today it is everything but fulfilled.[6] Therefore the paradoxical situation arises that Keynesianism is indeed applicable for an analysis of Mercantilistic but not of modern economy; and that on the other hand Mercantilism cannot be used to support modern Keynesianism.

However, we do not want to examine further the factual conditions under which the Mercantilistic-Keynesian Employment Theory is valid. What we want to show is that the Mercantilistic employment theory embraced in fact all essential features of modern "Effective Demand Analysis."

As far as I can see, the man who developed this analysis most conclusively is John Law who, although generally not counted among the Mercantilists proper, is undoubtedly to be considered the strongest and most interesting exponent of their ideas.

John Law is the man with the fabulous ascent and the terrible downfall. At the peak of his good fortune (1717–1720) he was master of a billion, but he died (1729 in Venice) in extreme poverty. Seldom has a man been more loved and admired and also more hated and despised. His relation to Mercantilism can be compared with the relation of Keynes to the New Deal. He was not the originator of the movement but he was the most able and mature formulator of its ideas. Law's chief works ("Money and Trade Considered as a Proposal for Supplying the Nation with Money"[7] and his

[5] *Ibid.*, p. 289.

[6] *Cf.* L. A. Hahn, "Compensating Reactions to Compensatory Spending," *American Economic Review*, 1945, p. 36.

[7] John Law, "Money and Trade Considered as a Proposal for Supplying the Nation with Money," Glasgow, 1760. (First published at Edinburgh—Andrew Anderson, 1705.)

Memoires sur les Banques and *Lettres sur les Banques*"—1717)[8] are not the works of a crank, as has been maintained by Charles Rist[9] and many other authors, but of an extremely ingenious thinker who reached conclusions amazing for his time.

Law has by no means identified abundance of money with abundance of goods, for which many Mercantilists have been correctly reproached. On the contrary, Law states expressly that money as such has no value by its use: "Money is not the value for which goods are exchanged but the value by which they are exchanged: the use of money is to buy goods, and silver while money is of no other use."[10] Money is not wealth but money creates wealth. For "National power and wealth . . . depend on trade and trade depends on money"[11] ". . . nor can more people be set to work, without more money to circulate, so as to pay the wages of a greater number."[12]

Creation of Employment through Creation of "Effective Demand"

BUT HOW IS IT that according to Law money creates wealth? Law's reply differs in form but, as far as I can see, not in essence from the reply that Keynes has given nearly two and a half centuries later. It is already a complete "analysis in terms of effective demand." We quote the famous passages from chapter seven of Law's "Money and Trade":

> Suppose an Island belonging to one man, the number of Tenants 100, each Tenant 10 in Family, in all 1000. By these the Island is labour'd, part to the Product of Corns, the Rest for Pasturage. Besides the Tenants and their Families, there are 300 Poor or Idle who live by Charity. There is no money; but Rents are paid in kind, and if one Tenant has more of one Product, and less of another than his Family has occasion for he barters with his Neighbour.[13]

[8] *Economistes financiers du dix-huiteme siecle*, Paris, Quillaumin, 1843. Edited by Daire.

[9] Charles Rist, "History of Monetary and Credit Theory," English Edition, 1940.

[10] Law, *op. cit.*, p. 188.

[11] *Ibid.*, p. 110.

[12] *Ibid.*, p. 21.

[13] John Law, *op. cit.*, pp. 182–3.

One sees that there are 300 unemployed and 1000 farmers who are employed only half the year. "For this reason," continues Law, "Tis proposed to the Proprietor that if a Money were established to pay the Wages of Labour, the 300 Poor might be employed in manufacturing such Goods as before were exported in Product; and as the 1000 that labour the Ground were idle one half their Time, they might be employed so as their additional Labour would be equal to that of 500 more."[14]

And he concludes: "But as this addition to the Money will employ the People that are now Idle, and those now employ'd to more Advantage, so the Product will be encreas'd, and manufacture advanced."[15]

This is obviously the same idea that Keynes expresses in the words: ". . . it will be possible to increase employment by increasing expenditures in terms of money"[16] and later ". . . as effective demand increases, employment increases."[17]

But what is the deeper reason for the creation of employment by the creation of new money or demand? Keynes explains the mechanism very clearly by analyzing the reason for existing unemployment. If people are unemployed, it is because their wage demands are higher than the value of their product. If new money is created the prices of the products increase in terms of money whereas wages remain stable.[18] So new money transforms former unemployed into employed by reducing the reward of labor in comparison to the value of its product. Keynes, himself, it is true, believes in the employment creating power of an increase in the quantity of money only for the "general case" because only in the "general case" can wages be considered stable. His followers, how-

[14] John Law, *op. cit.*, pp. 183–4.
[15] *Ibid.*, p. 198.
[16] Keynes, *loc. cit.*, p. 284.
[17] *Ibid.*, p. 289.
[18] *Ibid.*, p. 284.

ever, have formulated the theory in an absolute form forgetting the special Keynesian assumptions. For them, increase in purchasing power increases employment always until all unemployed are absorbed.

We have already mentioned that nowadays money wages can no longer be considered as stable when an inflationary monetary policy tends to lower real wages. In Mercantilistic times, however, the mechanism as described by Keynes could work, because the omnipotent State had absolute control over labor conditions. At that time the workers were forced to work wherever the government wanted and wages were fixed—and at very low levels—by governmental authority. It is well known that, in case of need, workers were even driven by force into the factories and a not unimportant part of labor supply was recruited among the inmates of prisons and orphanages.[19]

Creation of Purchasing Power through Creation of New Paper Money

IF THE INCREASE of purchasing power means more employment and more employment means more wealth, then the problem of increasing wealth is obviously the problem of increasing purchasing power. And here, in this question how the quantity of purchasing power (of money) can be increased, Law arrives at those statements and claims through which he gained, more than through everything else, the attention but also the curse of his contemporaries and later generations. Law claimed not only that bank notes or paper money should be created, but also, and this is the decisive part, that it should be created in any amount demanded and for which security on real estate could be given. If the authorities . . . "do not give out money when it is demanded, where good security is offer'd 'tis a hardship on the person who is

[19] *Handwoerterbuch der Staatswissenschaft*, "Merkantilimus," 1925, Band VI, pp. 548–9.

refuted, and a loss to the country: for few if any borrow money to keep by them; and if employ'd it brings a profit to the nation, tho' the employer loses."[20]

Thus according to Law's theory the size of the credit supply in a country is no longer dependent on the amounts which have been saved, nor, incidentally, on the amounts of capital goods that are available. With paper money to be created *ad libitum* every credit demand can be met at the prevailing interest rate without any disadvantageous consequences. It was this theory that served as a theoretical justification, not only for the bank which he himself was to create later on, but also for the entire sympathetic attitude towards the creation of banks of deposit and banks of issue during the eighteenth and nineteenth centuries. It led to the idea that the foundation of a bank, and especially of an Issuing Bank, is under all circumstances beneficial for every country; an idea that later on was formulated by McLeod in the words: "A bank is a gold mine."

It will be noted that Law's opinions are, to a certain extent, more conservative than those of the modern proponents of the "easy money policy." Law's idea is that every demand for credit can be satisfied through creation of new money at the same interest rate, *i.e.*, that the scarce supply need not be defended by rising interest rates. Modern easy money policy as proposed by Keynes[21] goes further in that it advocates lowerering of interest rates below the prevailing level in order to incite new demand. Generally speaking, however, it is clear that John Law can be correctly considered the founder of the modern "easy money policy."

The Experience of John Law's Bank

As is well known, Law had full opportunity to try to create employment through creation of new purchasing

[20] John Law, *op. cit.*, p. 168.
[21] Keynes, *loc. cit.*, pp. 27–8.

power, and to create new purchasing power by the issuing of paper money. He founded in 1717 his famous Issuing Bank. The bank created (at the end of 1719) probably the greatest boom of all times with more employment than was desired. But at the beginning of the year 1720, probably the biggest crash of all times followed.

The bank created paper money without hindrance and inhibitions. Every demand was satisfied—the demand of the private economy, the need of which for credits rose during the boom, as well as the demand of the government which financed its deficits through the help of the banks. The latter, incidentally, took place as the result of the pressure of the government and very much against the will of Law. The creation of paper money led at first to an increasing discount of the bills in comparison to bullion, then to their repudiation: the public no longer accepted the paper money. And all this, although all the well known techniques were applied with which governments, deteriorating their money, fight against their citizens who want to conserve their capital. The hoarding of bullion was suppressed, the use of coins only allowed for small payments. Export of bullion was punished. Wearing diamonds and pearls and their import were forbidden. Manufacture of objects in silver was prohibited and the paper money became legal tender in the entire country.[22]

It has been said that the débàcle occurred because Law was an Inflationist, *i.e.*, he consciously aimed at the depreciation of money. Nothing is more false. He believed that he could create employment by creating money and that he would be able to cease the issuance of new money the moment full employment was reached. He was, therefore, not an "Inflationist" but a "prosperity spender." Like his modern successors, he believed that prosperity created through inflation could be stabilized at a high level. He overlooked that the

[22] *Cf. Handwoerterbuch der Staatswissenschaft*, "John Law," 1925, Band VI, p. 261 (3).

inflationary boom is either followed by deflationary reaction or by a runaway inflation—this latter in case an attempt is made to prolong the boom artificially. For the stimulus of inflation only works so long as costs have not adapted themselves to rising prices. Therefore, prices have to be raised ever anew by the creation of new money in order to provide the necessary stimulus for the maintenance of the boom. The ever-renewed issuance of new money, however, leads, in the long run, to the ruin of the currency. Law's experiment, in any case, ended in severe economic depression, the bankruptcy of his bank, and the devaluation to zero of the paper money it issued.

If a great financier dies at the peak of his power it is said at his grave that he was a financial genius. If he dies, like Law, after the collapse of his creations or if it is discovered (as, for instance, in the modern case of a Kreuger) after his death that he was bankrupt, people say that he has been a ruthless speculator who has ruined his contemporaries and his country. If Law's "system" lives in the memory of posterity as the creation of a visionary, a swindler and a crook, it is because he died broke. But his theories would be objectionable even if by chance his bank had survived him for a certain time.

The Criticism of the Classicists

LAW'S THEORIES are not only interesting because of their similarity to modern ideas. Their knowledge is indispensable if one wants to do justice to the teachings of the great English Classicists in the field of monetary and general theory. It has become customary nowadays to think of the Classicists as a sort of antiquated and obsolete out-of-the-world people whose assumptions "happen not to be those of the economic society in which we actually live" as Keynes[23] charges. In reality their theories were based on the very practical experi-

[23] Keynes, *loc. cit.*, p. 3.

ences of their times and if certain, but by no means all, of their views were one-sided, this is explainable by the fact that they were the reactions to a very extreme swing of the pendulum to the unconservative side.

More Money Leads to Higher Prices Not Higher Employment

WHAT THE CLASSICISTS set against the ideas of Law, (whose name, by the way, they did not mention because they considered him too unworthy of notice) was the "Quantity Theory of Money" which they did not invent but which they reproduced and formulated anew. By so doing they expressed the basic truth of monetary theory to which science will always return after excursions into the realm of fantasy, quackery, and the illusion that basic economic maladjustments can be corrected through monetary measures. Its classical formulation of the quantity theory is found in the famous fourth paragraph of the twenty-seventh chapter of David Ricardo's "Principles of Political Economy and Taxation": "A circulation can never be so abundant as to overflow; for by diminishing its value, in the same proportion you will increase its quantity, and by increasing its value diminish its quantity."[24]

It is clear that within the framework of a quantity-theoretical attitude there is no room for the idea that employment can be increased by increasing purchasing power. If one creates additional money, prices and wages, but not employment, will increase. Employment will increase not when money but when capital consisting of tools and of means of subsistence for the worker, increases. Adam Smith expresses this idea in the second chapter of the second book of his "Inquiry into the Nature and Causes of the Wealth of Nations" in the following way:

[24] David Ricardo, "Principles of Political Economy and Taxation," 2nd edition, London, 1819, p. 448.

In order to put industry into motion, three things are requisite; materials to work upon, tools to work with, and the wages or recompense for the sake of which the work is done. Money is neither a material to work upon, nor a tool to work with; and though the wages of the workman are commonly paid to him in money, his real revenue, like that of all other men, consists, not in the money, but in the money's worth; not in the metal pieces, but in what can be got for them.

The quantity of industry which any capital can employ, must, evidently, be equal to the number of workmen whom it can supply with materials, tools and a maintenance suitable to the nature of the work. Money may be requisite for purchasing the materials and tools of the work, as well as the maintenance of the workmen. But the quantity of industry which the whole capital can employ, is certainly not equal both to the money which it purchases, and to the materials, tools and maintenance, which are purchased with it; but only to one or other of those two values, and to the latter more properly than to the former.[25]

It follows that according to the Quantity Theorists an increase of purchasing power can never lead to an increase in employment. The increase in purchasing power leads to an increase in prices, and, because the workers need the same amount of means of subsistence, to a corresponding degree of wage increases. The increase of money exhausts itself and is absorbed by these price and wage increases. There is no money left for the employment of additional labor.

It is clear that this line of thought is exactly the contrary of Law's. Whereas the latter believed that the additional money can be used profitably for the employment of workers hitherto unemployed, the Quantity Theorists contend that the additional money spent itself in increased nominal prices and wages. No wonder that in their system there was no room for what one calls today fluctuations of employment caused by fluctuations of "effective demand."

[25] Adam Smith, "An Inquiry into the Nature and Causes of the Wealth of Nations," Vol. I, 8th edition, London, 1796, p. 440.

Loanable Funds Cannot Be Increased Through Creation of Additional Money

FOR THE SAME REASONS, the Classicists deny that it is possible to increase the amount of purchasing power loanable to entrepreneurs by the issuance of new paper money. They consequently deny, too, that it is possible to lower interest rates or to prevent their rising by increasing the quantity of money.

> I do not dispute [says Ricardo in his famous essay, "The High Price of Bullion"[26]] that if the Bank were to bring a large additional sum of notes into the Market, and offer them on loan, but that they would for a time affect the rate of interest. The same effects would follow from the discovery of a hidden treasure of gold or silver coin. If the amount were large, the Bank, or the owner of the treasure, might not be able to lend the notes or the money at 4, nor perhaps above 3 per cent; but having done so, neither, the notes, nor the money, would be retained unemployed by the borrowers; they would be sent into every Market, and would everywhere raise the prices of commodities, till they were absorbed in the general circulation. It is only during the interval of the issues of the Bank, and their effect on prices, that we should be sensible of an abundance of money; interest would during that interval, be under its natural level; but as soon as the additional sum of notes or of money became absorbed in the general circulation, the rate of interest would be high and new loans would be demanded with as much eagerness as before the additional issues.

Only through increased savings can loanable funds be augmented and interest rates lowered. "To suppose that any increased issues of the Bank can have the effect of permanently lowering the rate of interest, and satisfying the demands of all borrowers, so that there will be none to apply for new loans, or that a productive gold or silver mine can have such an effect, is to attribute a power to the circulating medium which it can never possess. Banks would, if this were possible, become powerful engines indeed."[27] . . . "Profits can only be lowered by a competition of capitals not consisting of a circulating medium. As the increase of bank notes

[26] Fourth edition, London, 1811.
[27] *Ibid.*, pp. 35–6.

does not add to this species of capital, as it neither increases our exportable commodities, our machinery, or our raw materials, it cannot add to our profits nor lower interest."[28] The reason is simply that the increase of currency increases prices. The power over machines, material and labor that the entrepreneur acquires through the credits is only apparently but not actually enhanced. It is true that displacements and dislocations of the power to command production factors occur. The owner of the old money is expropriated in favor of the entrepreneur who is endowed with the new money. In a masterly way Ricardo depicts these consequences of an inflationary credit expansion: "But however abundant may be the quantity of money or of bank notes; though it may increase the nominal prices of commodities; though it may distribute the productive capital in different proportions; though the Bank, by increasing the quantity of their notes, may enable A to carry on part of the business formerly engrossed by B and C, nothing will be added to the real revenue and wealth of the country. B and C may be injured, and A and the Bank may be gainers, but they will gain exactly what B and C lose. There will be a violent and unjust transfer of property but no benefit whatever will be gained by the community."[29]

The Pendulum Has Again Swung Backwards

As we have mentioned at the beginning, times that overrated the power of monetary changes have alternated with times under-rating this power.

The aim of science should be, in this as in every other field, to achieve a synthesis of the divergent concepts. Such a synthesis, incidentally, has been reached by David Hume in his "Essay on Bank and Paper Money," 1752.[30] He describes

[28] *Ibid.*, p. 36.
[29] *Ibid.*, p. 37.
[30] "A Select Collection of Scarce and Valuable Tracts and Other Publications on Paper Currency and Banking," edited by McCulloch, 1862.

here the strong effects of inflation on production during transitory periods and the ineffectiveness of purely monetary measures for longer periods. He recognizes the reason for this: inflation no longer works as soon as the various data of the economy have become adjusted to the increased quantity of money. Thus, Hume avoids the over-estimation of the Mercantilists as well as the under-estimation of the Classicists.

A clear case of over-estimation of monetary measures can be found in German literature after the First World War when such books as my own *Volkswirtschaftliche Theorie des Bank Credits*[31] appeared. Here the possibility of "eternal prosperity by credit expansion" was seriously discussed. However, after a short period of over-enthusiasm concerning the effects of monetary changes, a sort of synthesis between classic and pre-classic concepts was found; a synthesis that placed the "monetary theory" where it belongs, namely, in the realm of business cycle theory, and limited its explanatory value to the necessarily transitory phases of the up and down swings of the business cycle. For movements outside the cycle and for all devices to influence structural or stabilized shortcomings of the economy, the classical approach remained dominant.

People seem to learn only from their last experience. Under the impression of the disastrous consequence of inflation, German monetary policy turned extremely deflationary in the early thirties. The consequence was such an increase of unemployment and such an uprooting of the entire social structure that the Nazi revolution was made possible.

The experience with deflation during the Great Depression in the Anglo-American countries was less serious but serious enough to imbue people with a terrible fear of a repetition of deflation and a great respect for reflationary measures. Out

[31] Tuebingen, 1926.

of this situation Keynes' book and its influence on his contemporaries is to be understood. In the opinion of this author, the atmosphere through which it has been created and which again it has so strongly enforced represents a swing of the pendulum away from the classic toward the pre-classic state of affairs that can only lead to deceptions. It is to be hoped that theory and policy will again revert to a reasonable synthesis of the divergent concepts.

New York