Economic history

What was mercantilism?

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This post has been updated to include a suggested reading list.

It is often said that a better understanding of economic history would have helped us to avoid the worst of the recent crisis. Over the next few weeks Free exchange will consider milestones in economic history, showing how they contributed to the development of economic thought.

MERCANTILISM is one of the great whipping boys in the history of economics. The school, which dominated European thought between the 16th and 18th centuries, is now considered no more than a historical artefact—and no self-respecting economist would describe themselves as mercantilist. The dispatching of mercantilist doctrine is one of the foundation stones of modern economics. Yet its defeat has been less total than an introductory economics course might suggest.

At the heart of mercantilism is the view that maximising net exports is the best route to national prosperity. Boiled to its essence mercantilism is “bullionism”: the idea that the only true measure of a country’s wealth and success was the amount of gold that it had. If one country had more gold than another, it was necessarily better off. This idea had important consequences for economic policy. The best way of ensuring a country’s prosperity was to make few imports and many exports, thereby generating a net inflow of foreign exchange and maximising the country’s gold stocks.

Such ideas were attractive to some governments. Accumulating gold was thought to be necessary for a strong, powerful state. Countries such as Britain implemented policies which were designed to protect its traders and maximise income. The Navigation Acts, which severely restricted the ability of other nations to trade between England and its colonies, were one such example.

And there are some amusing (and possibly apocryphal) stories of bullionism in action. During the Napoleonic Wars, the warring governments made few attempts to prevent their foes from importing food (and thereby starving them). But they did try to make it difficult for their opponent to export goods. Fewer exports would supposedly result in economic chaos as gold supplies dwindled. Ensuring an absence of gold, rather than an absence of grub, was perceived to be the most devastating way to grind down the enemy.

But there is an important distinction between mercantilist practice and mercantilist thought. The opinions of thinkers were often mangled when they were translated into policies. And a paper by William Grampp, published in 1952, offers a subtler account of mercantilism.

Mr Grampp concedes that mercantilists were keen on foreign trade. One often reads in mercantilist tomes that foreign trade would be more beneficial than would domestic trade. And some of the early mercantilists, like John Hales, were enchanted by the idea of an overflowing treasure chest.

But Mr Grampp argues that, on the whole, we should stop confusing mercantilism and bullionism. Few mercantilists were slaves to the balance of payments. In fact, they were alarmed by the idea of hoarding gold and silver. This is because many mercantilist thinkers were most concerned with maximising employment. Nicholas Barbon—who pioneered the fire insurance industry after the Great Fire of London in 1666—wanted money to be invested, not hoarded. As William Petty—arguably the first “proper” economist—argued, investment would help to improve labour productivity and increase employment. And almost all mercantilists considered ways of bringing more people into the labour force.

Mr Grampp even suggests that Keynesian economics "has an affinity to mercantilist doctrine”, given their shared concern with full employment. Keynes, in a short note to his “General Theory”, approvingly quotes mercantilists, noting that an ample supply of precious metals could be key in maintaining control over domestic interest rates, and therefore to ensuring adequate resource utilisation. In some sense the Keynesian theory of underconsumption—that is, inadequate consumer demand—as a cause of recessions was presaged by mercantilist contributions. In 1598 Barthélemy de Laffemas, a French thinker, denounced those who opposed the use of expensive silks. He argued that purchasers of luxury goods created a livelihood for the poor, whereas the miser who saved his money “caused them to die in distress”.

Mercantilism is thought to have begun its intellectual eclipse with the publication of Adam Smith’s "Wealth of Nations" in 1776. A simple interpretation of the economic history suggests that Smith’s ruthless advocacy for free markets was squarely opposed to regulation-heavy mercantilist doctrine. But according to research by Lars Magnusson of Uppsala University, Smith’s contribution did not represent such a sharp break. The father of economics was certainly concerned with the effects of some mercantilist policies. He saw the damage that overweening government intervention could do. Smith argued that the East India Company, a quasi-governmental organisation that managed parts of India at the time, was responsible for creating the huge famine in Bengal in 1770. And he hated monopolies, arguing that greedy barons could earn “wages or profit, greatly above their natural rate”. Smith also grumbled that legislators could use mercantilist logic to justify stifling regulation.

But Smith points out circumstances in which government interference is necessary. He was in favour of the Navigation Acts. And in Smith’s lesser-known "Lectures on Jurisprudence", he outlines other cases where government intervention in trade is useful. Smith was not opposed to regulation per se, but rather instances where individuals and governments could abuse their position of power for personal gain.

Nicholas Phillipson, who recently wrote a biography of Smith, argues that the notion of “free markets” was alien to the father of economics. Smith made it clear that governments would always play a part in making markets—and could not conceive of a market where the government did not play a crucial role. And in this sense, his contribution does not represent such a sharp break from mercantilist thought. The question was not whether, but how much, of a role the state would play.

Though most of the world's rich countries remain committed to free trade today, mercantilist themes are often found in economic policy debates. China and Germany are often envied for their trade surpluses or seen as economic models, and China especially has very deliberately subsidised exports. President Barack Obama has made a doubling of American exports a major policy goal, as part of his plan to help America "win the future". This zero-sum way of looking at the global economy is less rooted in the national greatness side of mercantilism than in the focus on full employment, at a time when many rich economies are suffering from insufficient demand and high rates of joblessness; it is thoroughly Keynesian, in other words. Early in the recovery some economists gave a veneer of intellectual credibility to this perspective. Paul Krugman, for instance, wrote of America's 2010 trade agreement with South Korea:

There is a case for freer trade — it may make the world economy more efficient. But it does nothing to increase demand.

And there’s even an argument to the effect that increased trade reduces US employment in the current context; if the jobs we gain are higher value-added per worker, while those we lose are lower value-added, and spending stays the same, that means the same GDP but fewer jobs.

If you want a trade policy that helps employment, it has to be a policy that induces other countries to run bigger deficits or smaller surpluses. A countervailing duty on Chinese exports would be job-creating; a deal with South Korea, not.

But importantly, the case for bullionism as a demand stimulus evaporated with a role for bullion in monetary policy. The introduction of fiat money meant that balance-of-payment goals were unnecessary to maintaining a particular monetary policy stance, since central banks no longer needed an adequate hoard of gold to pump money into the economy. The mercantilist temptation is a strong one, however, especially when growth in the economic pie slows or stops altogether. More than two centuries after Smith's landmark work, economics's foundational debate continues to resonate.

Update:

Suggested reading list:

Foucault, M., Senellart, M., & Ewald, F. (Eds.). (2009). Security, Territory, Population: Lectures at the College de France 1977--1978. Macmillan. [*The chapter on scarcity demonstrates Foucault's conventional (and, this blog would argue, incorrect) understanding of mercantilism in comparison to classical economics]*

Keynes, J.M. (1936) 'Notes on mercantilism' in The General Theory of Employment, Interest and Money. Available here. *[Readable introduction to the link between mercantilism and Keynesianism]*

Magnusson, L. (2002). Mercantilism: the shaping of an economic language. Routledge. *[The introduction is a very good primer for someone new to this subject]*

Phillipson, N. (2010). Adam Smith: An Enlightened Life. Penguin. *[Excellent examination of Smith's life and times]*

Smith, A. (1776) 'Of Restraints upon the Importation from foreign Countries of such Goods as can be produced at Home' An Inquiry Into the Nature and Causes of the Wealth of Nations, [Book IV, part ii, chapter II]. Available here. *[Smith's discussion of the Navigation Acts].*