History of Economic Thought

Schools of Economic Thought:

School of Thought	Period Promoted	Associated Economists
Mercantilists	16th-17th century	Sir Thomas Mun
Physiocrats	18th century	Francois Quesnay
Classical Economists	18th-19th century	Adam Smith, Thomas Malthus, Jean Baptiste Say, David Ricardo, John Stuart Mill
Socialism	19th-20th century	Karl Marx
Neo-classical economics	Late 19th century	Alfred Marshall
Keynesian Economics	20th century	John Maynard Keynes
Monetarism	20th century	Milton Friedman
Supply-Siders	20th century	Robert Mundell

Mercantilists

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 artifact—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.

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.

- **In summary**
  - They believed wealth consisted of gold and silver
  - The said countries should try to achieve a favourable balance of trade by increasing exports and lowering imports
  - They thought countries should acquire colonies to export to and thus acquire gold and silver
  - They believed a country should aim to be self-sufficient and pursue protectionist policies to pursue that

Physiocrats

Physiocracy was a theory of wealth. The physiocrats, led by Quesnay, believed that the wealth of nations was derived solely from the value of agriculture. Quesnay's understanding of value-added was rather primitive—he could not see, for example, how manufacturing could create wealth. Farmers, on the other hand, could. As Karl Marx explains in "Das Kapital", "the Physiocrats insist that only agricultural labour is productive, since that alone, they say, yields a surplus-value".

The physiocrats are most commonly known for these simplistic economic ideas. But this was not their most important contribution to economic thought. Rather, it was the physiocrats' methodological approach to economics that was revolutionary.

Before physiocracy, economics was not a very scientific discipline. Mercantilist thinkers sometimes assumed that amassing gold was the best economic strategy. Economic efficiency was a pretty alien idea.

But Quesnay was a scientist (for most of his life, he was a medical doctor). And he wanted to apply the scientific principles of medicine to the study of wealth. The "Tableau Economique", which shows in a single page how an entire economy functions, is Quesnay's most famous contribution. Quesnay showed that the economy was something to be respected, analysed and understood—much like a human body. It could not simply be moulded to suit the will of a self-important monarch.

This was a hugely important step forward. The Comte de Mirabeau, an important figure during the Revolution, considered Quesnay's Tableau to be one of the world's three great discoveries—equalled only by the invention of printing and the discovery of money.

Familiar notions of contemporary liberal economics derive from Quesnay's scientific approach. The physiocrats, like many other thinkers of the eighteenth century, subscribed to the idea of a "natural order". They showed that unchanging laws governed all economic processes. Consequently, it is generally thought that the physiocrats were opposed to government intervention. The dead hand of the state would only corrupt the natural evolution of the economy. Jacob Viner, the Canadian economist, referred to the physiocrats as one of the “pioneer systematic exponents” of laissez-faire (alongside Adam Smith).

A good example of the physiocrats’ new, scientific approach to economics is found in the writings of a little-known disciple, Louis Paul Abeille. Abeille, writing in the 1760s, discussed the grain trade. He opposed mercantilist ideas of what to do during a period of food scarcity—for example, after a bad harvest. Received wisdom suggested that during a period of scarcity, a government should step in and forcibly lower the price of grain, so that people could afford to buy it. Governments might also choose to ban grain exports.

But Abeille argued that government intervention in the grain trade was self-defeating. With lower prices, he argued, grain producers would produce less. They would also make less profit—and therefore have less money to invest in the next year’s harvest. Government intervention, in other words, would disrupt the efficient working of the free market in grain, which would ultimately turn scarcity into a famine.

So he argued that the government should step back and let local prices rise. Producers in other parts of the country would respond to the high prices, and the area would be flooded with grain. Problem solved. But Abeille recognised that there would be a time lag between the price rise and the demand response. And so according to some writers, the implication of Abeille’s argument is that people who cannot afford grain should be allowed to die. Efficient economic management trumped humanitarianism.

Unsurprisingly, many writers criticised the physiocrats for their dogmatism. Adam Smith, in an amusing passage towards the end of the "Wealth of Nations", reckoned that they were carried away by the desire for perfection. Smith, aware that Quesnay was a medical doctor, argued that:
Some speculative physicians […] have imagined that the health of the human body could be preserved only by a certain precise regimen of diet and exercise, of which […] the smallest, violation necessarily occasioned some degree of disease or disorder […] however [...] the

human body frequently preserves, to all appearances at least, the most perfect state of health under a vast variety of different regimens […] Mr. Quesnai […] seems to have entertained a notion of the same kind concerning the political body.

Smith reckoned that the physiocrats wanted a perfect system of laissez-faire economic management—or no system at all. But on this occasion, Smith got it wrong. The physiocrats were less dogmatic than most people think. Turgot, for example, subscribed in theory to the idea that free trade in grains was the best way of resolving scarcity. But he was responsible for dealing with an actual famine in south-west France in 1770. And in practice, Turgot supported a variety of programmes that cannot be described as laissez-faire: a programme of public employment and support for imports, among other policies. The Marquis de Condorcet, another writer associated with the physiocratic school, was also in favour of expanding public employment during periods of dearth.

The physiocrats are a misinterpreted bunch. Much of their economic theory is rather useless. But their approach to the study of economics was an invaluable contribution. And, unlike much academic economics today, their fascination with abstract models did not make them as inflexible and authortarian as many believe.

- **In summary**
    - They believed agriculture was the main source of a country's wealth
    - They promoted a laissez-faire economic system
    - They believed the right to own private property was very important
    - They supported the idea of free competition

Classical Economists

The dominant theory of economics from the 18th century to the 20th century, when it evolved into neo-classical economics. Classical economists, who included Adam Smith, David Ricardo, John Stuart Mill and Thomas Malthus, believed that the pursuit of individual self-interest produced the greatest possible economic benefits for society as a whole through the power of the Invisible Hand. They also believed that an economy is always in equilibrium or moving towards it.

Equilibrium was ensured in the Labour market by movements in wages and in the Capital market by changes in the rate of interest. The interest rate ensured that total savings in an economy were equal to total investment. In disequilibrium, higher interest rates encouraged more saving and less investment, and lower rates meant less saving and more investment. When the demand for labour rose or fell, wages would also rise or fall to keep the workforce at full employment.

In the 1920s and 1930s, John Maynard Keynes attacked some of the main beliefs of classical and neo-classical economics, which became unfashionable. In particular, he argued that the rate of interest was determined or influenced by the speculative actions of investors in bonds and that wages were inflexible downwards, so that if demand for labour fell, the result would be higher unemployment rather than cheaper workers.

Ideas of classical economists:

- The Iron Law of Wages
    - This theory explained why wages could never rise above subsistence level. If wages rose, so too would the population as workers could then afford larger

families. As the population rose, so too would the supply of labour, and wages would fall back to subsistence level again.

- Laissez Faire
  - Let-it-be economics: the belief that an economy functions best when there is no interference by government. It can be traced to the 18th-century French physiocrats, who believed in government according to the natural order and opposed mercantilsim. Adam Smith and others turned it into a central tenet of classical economics, as it allowed the invisible hand to operate efficiently. (But even they saw a need for some limited government role in the economy.) In the 19th century, it inspired the British political movement that secured the repeal of the Corn Laws and promoted free trade, and gave birth to *The Economist* in 1843. In the 20th century, laissez-faire was often seen as synonymous with supporting monopoly and allowing the business cycle to boom and bust, and it came off second best against keynesian policies of interventionist government. However, mounting evidence of the inefficiency of state intervention inspired the free market policies of Ronald Reagan and Margaret Thatcher in the 1980s, both of whom stressed the importance of laissez-faire.
- Wages Fund Theory
  - There is at any one time a rigid capital fund available for wage payments, and increases in wage rates to any groups will only redistribute wage payments, not increase the aggregate of wages paid
- Classical Theory of Loanable Funds
  - Savers supply the loanable funds; for instance, buying bonds will transfer their money to the institution issuing the bond, which can be a firm or government. In return, borrowers demand loanable funds; when an institution sells a bond, it is demanding loanable funds. The Interest Rate is the equilibrium of the supply and demand of loanable funds.

- **<u>Adam Smith (1723 - 1790)</u>**
  - A classical economist who wrote the *"An Inquiry into the Nature and Causes of the Wealth of Nations" in* 1776.
  - **Main Ideas**
    - The pursuit of self interest
      - This best benefited the individual and hence best benefited society. People were motivated by self interest and led by an <u>invisible hand</u>. He argued that if <u>free to pursue his own self-interest</u>, each individual was "led by an invisible hand to <u>promote an end that was no part of his intention</u>". For example, if an individual sets up a business to make profit, he/she will also create employment for other people.
    - Division of Labour
      - Increased productivity and a country's wealth. His example - the manufacture of pins illustrated the benefits of the division of labour.
    - Labour Theory of Value
      - The value of an item was equal to the amount of labour that went into producing the product.
    - State protection of property rights

        - Encourages the accumulation of personal wealth. 'Invisible hand of competition' – Allows a self regulating market to operate thus ensuring economic progress is achieved.
    - Perfect Competition
        - Free entry into markets; profits sufficient to reward entrepreneurs; inefficiency penalised and price would be based on the cost of production. Monopolies would not persist.
    - Laissez-faire
        - No justification for government intervention in the economy except for defence/justice.
    - Canons of Taxation
        - To fund the state's defence/justice systems taxation was necessary and he devised the four principles of a fair tax system: equity, economy, certainty and convenience.
    - Paradox of Value
        - He distinguished between 'value in use' and 'value in exchange'. Some items had a vast utility (air, water) but are not exchanged, while others (diamonds) possessed little utility but could command a great value in exchange.
    - Free Trade
        - He advocated international free trade unhindered by the imposition of tariffs so that markets could operate effectively

- **<u>Thomas Robert Malthus(1766-1834)</u>**
    - He wrote *"Essay on the Principle of Population as it Affects the Future Improvement of Society"*
    - **Main Ideas**
        - The Theory of Population and Food Supply
            - At the end of 1700s in England, the population was rising geometrically (doubling and doubling). However the food supply was increasing arithmetically (1, 2, 3, 4…). Rev Tomas Malthus observed this and wrote about it in An Essay on the Principle of Population. He pessimistically predicted that the situation could not continue. He wrote that eventually there would be too many people and not enough food, resulting in famine disease/war (positive checks) and a fall in population.
            - This prediction did not occur because:
                - There was an increase in the food supply from America.
                - Improvements in technology resulted in a greater increase in the food supply.
                - The population increases were not as big as he predicted.

- **<u>David Ricardo (1771 - 1823)</u>**
    - He wrote the *"Principles of Political Economy and Taxation*."
    - **Main Ideas**
        - Law of Comparative Costs/Advantage
            - Ricardo supported the idea of free trade and developed the law of comparative costs which states that a country should

specialise in the production of those commodities in which it is relatively most efficient and trade for the remainder of its requirements.

- Theory of Economic Rent
  - If population increased it was necessary to use inferior / more remote land. For use of this land rent was paid. As a result the price of food rose. Cost of producing on the best land was lower therefore food produced on this land earned a surplus over that produced on inferior land. This surplus led to an increase in rent payable for the use of good land.
- Accepted the Subsistence Wages Theory
  - He believed that any increase in wages above the subsistence level would cause an increase in population which would in turn cause wage levels to fall.

- **Jean Baptiste Say (1767 - 1832)**
  - He Wrote *"Treatise on Political Economy"*
  - **Main Ideas**
    - He developed Say's law (law of markets) which states that supply creates its own demand. According to Say production is the source of demand. When an individual produces a product or service, he or she gets paid for that work, and is then able to use that pay to demand other goods and services.
    - He is also credited with dividing the factors of production in four categories: Land, Labour, Capital, Enterprise.

- **John Stuart Mill (1806 - 1873)**
  - He Wrote *"Principles of Political Economy with some of their Applications to Social Philisopy"*
  - **Main Ideas**
    - He developed the wages fund theory which says that at any one time a rigid capital fund available for wage payments, and increases in wage rates to any groups will only redistribute wage payments, not increase the aggregate of wages paid
    - He rejected the labour theory of value, stating that both demand and supply were equally important is assessing the value of a product
    - He was one of the first economists to write about the law of diminishing marginal returns
    - Mill predicted that many industries would be dominated by a small number of large firms who benefit from increasing returns to scale. Doubling inputs can more than double outputs.

Neo-Classical Economics

The school of economics that developed the free-market ideas of classical economics into a full-scale model of how an economy works. The best-known neo-classical economist was Alfred Marshall, the father of marginal analysis. Neo-classical thinking, which mostly assumes that markets tend towards equilibrium, was attacked by Keynes and became unfashionable during the Keynesian-dominated decades after the second world war. But, thanks to economists such as Milton Friedman, many neo-classical ideas have since become widely accepted and uncontroversial.

- **Alfred Marshall**
  - Marshall wrote the *"Principles of Economics" (1890).*
  - **Main Ideas**
    - Theory of Value
      - The value of a commodity was determined in the short-run by its utility and demand and in the long-run was determined by its cost of production.
    - Distribution of income / wealth
      - The return to each of the factors of production was determined by their marginal productivity.
    - Competition regulated economic activity
      - Government intervention and inter-business co-operation could regulate economic activity and enhance economic freedom.
    - Growth of monopolies could be prevented by:
      - Regulation by government; consumer information; increased number of small investors/more accountability.
    - Quasi rent
      - The economic rent earned by factors of production in the short run when demand exceeded supply.
    - Developed concepts of price-elasticity of demand / consumer surplus / how markets adjusted to changes in D & S over time:
      - quantifying buyers' sensitivity to price; the surplus value or utility a consumer enjoys; Market period, short period and long period.

Socialism

The exact meaning of socialism is much debated, but in theory it includes some collective ownership of the means of production and a strong emphasis on equality, of some sort.

Socialism is a social and economic system characterised by social ownership of the means of production and co-operative management of the economy, as well as a political theory and movement that aims at the establishment of such a system. "Social ownership" may refer to cooperative enterprises, common ownership, state ownership, citizen ownership of equity, or any combination of these.[] There are many varieties of socialism and there is no single definition encapsulating all of them. They differ in the type of social ownership they advocate, the degree to which they rely on markets or planning, how management is to be organised within productive institutions, and the role of the state in constructing socialism.

A socialist economy is based on the principle of production for use, to directly satisfy economic demand and human needs, and objects are valued by their use-value, as opposed to the principle of production for profit and accumulation of capital. In the traditional conception of a socialist economy, coordination, accounting and valuation are performed in kind (using physical quantities), by a common physical magnitude, or by a direct measure of labour-time in place of financial calculation. For distributing output, two alternative principles have been proposed: *to each according to his contribution* and *from each according to his ability, to each according to his need*. The advisability, feasibility and exact way of allocating and valuing resources are the subjects of the socialist calculation debate.

- **Karl Marx (1818-1883)**
  - He wrote *"Das Kapital"* in which he predicted the collapse of capitalism to be replaced by socialism first and eventually communism
    - **Main ideas**
      - He lived at a time when workers had enough of a struggle and exploitation and very poor living and working conditions as a result of capitalism. In the communist manifesto (along with Friedrich Engels), he outlined what he believed would happen. Marx argued that workers were paid subsistence / minimum wages by their employers. The value of the goods produced by a worker was more than the wages paid to the worker. (The difference between the two he called the 'surplus value' or profit to the employer). The workers would be exploited and in time would be replaced by capital, developed using the profit, resulting in the unemployment of the worker. This would result in a two tier society made up of the Prolietariat and the bourgeoisie.
      - Marx argued that eventually the exploited working classes (proletariat) would grow in numbers, organise themselves, revolt and overthrow capitalists (bourgeoisie). The workers would redistribute wealth. A communist society could be arranged to replace capitalism – it would be a classless so city with no need to struggle.
      - Marx also forecasted the emergence of trade cycles as producers made more goods than there was demand for.

Keynesian Economics

A branch of economics, based, often loosely, on the ideas of Keynes, characterised by a belief in active government and suspicion of market outcomes. It was dominant in the 30 years following the second world war, and especially during the 1960s, when fiscal policy became bigger-spending and looser in most developed countries as policymakers tried to kill off the business cycle. During the 1970s, widely blamed for the rise in inflation, Keynesian policies gradually gave way to monetarism and microeconomic policies that owed much to the neo-classical economics that Keynes had at times opposed. Even so, the idea that public spending and taxation have a crucial role to play in managing demand, in order to move towards full employment, remained at the heart of macroeconomic policy in most countries, even after the monetarist and supply-side revolution of the 1980s and 1990s. Recently, a school of new, more pro-market Keynesian economists has emerged, believing that most markets work, but sometimes only slowly.

- **John Maynard Keynes (1883- 1946)**
  - He wrote *"Treatise On Money"* (1930) and *"The General Theory Of Employment, Interest And Money"* (1936)
  - **Main Ideas**
    - Fiscal Intervention
      - He suggested government cut direct taxation to boost income, therefore boosting expenditure to help create jobs. The government could increase its expenditure, thereby increasing demand (through direct public works) so as to help create jobs.
    - National Income at less than full employment:

- Keynes observed that national income could reach equilibrium without reaching full employment and hence he suggested government intervention to help create jobs when required.

- Output is demand determined.
  - The size of national income depends on expenditure i.e. Y = C + I + G + X − M
- Investment decisions by entrepreneurs.
  - He stated that investment by entrepreneurs depended more on businessmen's expectations than on the rate of interest.
- Investment could be less than savings.
  - This could result in a leakage in spending which decreases national income and employment.
- The Multiplier
  - He developed new tools to explain his theories including the multiplier: Any initial increase in spending will cause a much greater increase in GNP due to the fact that one person's expenditure is another person's income. He developed concepts such as: MPC, MPM, etc.
- He also supported the idea of the Paradox of Thrift.
  - The paradox states that if everyone tries to save more money during times of economic recession, then aggregate demand will fall and will in turn lower *total* savings in the population because of the decrease in consumption and economic growth.
- Liquidity Preference Theory
  - People may prefer to hold their wealth in money form for three reasons: transactionary; precautionary and speculative reasons. Managed system of exchange rates: He favoured a system of foreign exchange rates which could be 'managed' by the state rather than the gold standard.
- Managed system of exchange rates
  - He favoured a system of foreign exchange rates which could be 'managed' by the state rather than the gold standard.

Monetarism

Control the money supply, and the rest of the economy will take care of itself. A school of economic thought that developed in opposition to post-1945 keynesian policies of demand management, echoing earlier debates between mercantilism and classical economics. Monetarism is based on the belief that inflation has its roots in the goernment printing too much money. It is closely associated with Milton Friedman, who argued, based on the quantity theory of money, that government should keep the money supply fairly steady, expanding it slightly each year mainly to allow for the natural growth of the economy. If it did this, market forces would efficiently solve the problems of inflation, unemployment and recession. Monetarism had its heyday in the early 1980s, when economists, governments and investors pounced eagerly on every new money-supply statistic, particularly in the United States and the UK.

Many central banks had set formal targets for money-supply growth, so every wiggle in the data was scrutinised for clues to the next move in the rate of interest. Since then, the notion

that faster money-supply growth automatically causes higher inflation has fallen out of favour. The money supply is useful as a policy target only if the relationship between money and nominal GDP, and hence inflation, is stable and predictable. The way the money supply affects prices and output depends on how fast it circulates through the economy. The trouble is that its velocity of circulation can suddenly change. During the 1980s, the link between different measures of the money supply and inflation proved to be less clear than monetarist theories had suggested, and most central banks stopped setting binding monetary targets. Instead, many have adopted explicit inflation targets.

- **Milton Friedman (1912 - 2006)**
  - He Wrote *"Inflation, Causes and Consequences"*
  - **Main Ideas**
    - Monetary policy should be the main instrument used by the government to manage the economy and not fiscal policy.
      - Increased government expenditure would only lead to higher prices and not increased output and employment as advocated by Keynes.
    - Control of money supply
      - Monetarists suggest strict control of the money supply so as to control inflation. Limiting credit availability, keeping interest rates high would control consumer borrowing.
    - Reduction in inflation
      - This increases competitiveness which may lead to relatively cheaper exports, increased exports and job creation in the long run. Companies should keep wage increases to a minimum in order to avoid cost-push inflation.
    - Laissez faire principles
      - Monetarists favour a return to laissez faire principles: minimum state intervention; de-regulation of markets; privatisation of state bodies.
    - Supply side policies
      - Monetarists favoured any policies which improve market efficiency / boost supply/ reduce the ability of trade unions to interfere with the labour market.

Supply-Siders

Increasing economic growth by making markets work more efficiently. In the 1980s, Ronald Reagan and Margaret Thatcher championed supply-side policies as they attacked keynesian demand management. Pumping up demand without making markets work better would simply lead to higher inflation; economic growth would increase only when markets were able to operate more freely. Thus they pursued policies of deregulation, liberalisation and privatisation and encouraged free trade.

To reduce unemployment, they tried to increase the efficiency of the jobs market by cutting the rate of income tax and attacking legal and other impediments to labour market flexibility. The results of these programmes are much debated. In particular, the belief, apparently supported by the laffer curve, that cutting tax rates would increase tax revenue did not always stand up well to real-world testing. Even so, it is now recognised that supply-side reforms are a crucial element in an effective economic policy.