

Vasilev, Aleksandar; Maksumov, Rashid

Research Report

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Critical analysis of Chapter 23 of Keynes's Notes on Mercantilism in *The General Theory of Employment, Interest and Money* (1936).

Aleksandar Vasilev
Rashid Maksumov

John Maynard Keynes starts chapter 23 in *The General Theory* discussing mercantilism, an old-fashioned theory of carrying trade. He uses their ideas as a promotional device to build on his analysis. Keynes, being a practical economist, wants to draw conclusions “as to the practical policy to which the argument leads up.”(Keynes, 1936 (1973 ed.): 338)

Mercantilism ideology claimed that positive balance of trade has to be run. But since none of the trading partners would be willing to have a deficit for a long time, mechanist system is self-constrained. Thus countries started imposing tariffs on imported products in order to continue running a positive trade balance. The neighbors followed, engaging in a senseless tariff war. As a result of those *beggar-thy-neighbor* policies, both sides suffered a lot. Welfare decreased, due to the deadweight social loss¹.

Mercantilism philosophy saw trade and war as the two sides of the same coin. The higher your exports are, the more bullion you have in your war chest. The more successful you are in war since you can allocate more money to military expenses. After leading a series of successful wars, you capture a lot of colonies, against which you usually run positive surplus.

Free trade decreases the need to lead war. In addition, it leads to international specialization. As a result of this, all countries consume and produce more than was possible previously. As Milberg claims (in Blecker, 1996: 165), Keynes himself rejected comparative advantage theories of trade because they rested on the assumptions of full employment. Similarly to Smith, he talks about *real* (absolute), not comparative advantages. Keynes, however, does not mention the dynamic gains that can occur under free trade regime, such as increasing returns to scale. He mentions, though, product

¹ Of course, Keynes analysis in the chapter should be taken with caution. During his time, economies were relatively closed. There was almost no capital movement. Countries could not restore their competitiveness by competitive devaluation of the exchange rate, because everyone would follow. That is why Keynes was one of the initiators for the establishment of Bretton-Woods institutions – IMF and World Bank. Those should provide financial assistance in the form of inter-government loans to countries with current account (CA) problems.

differentiation and difference in tastes. Otherwise, "...[i]f every person were satisfied with the simplest food, the poorest clothing, and the meanest houses, it is certain that no other sort of food, clothing, and lodging would be in existence."(Keynes, 1926: 22) This quotation, which originated from Malthus, is given by the author to oppose mercantilist view that wages should be kept as low as possible, so that domestic companies keep their costs low and thus sustain their competitiveness abroad. You cannot, however, keep workers overworked and underpaid. At one moment in time they will demand an increase in their wages and the whole trading structure will collapse.

Keynes argues that mercantilists failed to understand that foreign currency is generated from exports in order to spend it on imports afterwards. Thus, more and more precious metal accumulation makes no sense in itself. After all, there is nothing special about gold or silver. Metals are not a means for future production, e.g. investment, but merely store some value to be used for spending in the future.

Indeed, at that time most of the countries were operating under the gold standard. Thus they did not have an independent monetary policy. Rather, the change in money supply was based on the movement of gold. If the country had deficit, gold was flowing out of the country, thus decreasing the money supply, and subsequently the price level. At a certain period in the previous century wages had to be cut in Great Britain. The strong labor unions, however, fiercely opposed that and as a result, unemployment and interest rates increased.

Thus mercantilists tried to decrease these negative consequences of trade by imposing trade restrictions. An umbrella in particular sectors was opened with the argument that since it was a young one, it needed help in the short run. In the long run, however, Keynes argues that there is no political will to remove it. Current workers are given priority versus the potential new workers in new sectors that do not exist yet. Old workers have already established lobbies and have an advantage. Mercantilists just propose keeping the status quo, that is the ones already employed at their work places. Keynes states that some people blame mercantilists for promotion of closeness of economy and war².

According to free-trade view protectionist governments usually bet on the wrong horse. That is why they should leave resource allocations to the market forces and start believing in the *laissez-faire* idea. Politicians should see above national borders and play the cooperative positive-sum game, which

² Keynes is in favor of mercantilist view, though: "It is the policy of an autonomous rate of interest, unimpeded by international preoccupations, and of a national investment programme directed to an optimum level of domestic employment which is twice blessed in the sense that it helps ourselves and our neighbours at the same time." (Keynes, 1936: 349).

forms one of the reasons behind the European Union, for example. However, actual agreements are not always in the spirit of the of free trade, but feature political considerations.

In addition, Keynes differentiates between interest rate and return on investment. Interest rate should be equal to the marginal product of capital, what Keynes calls “efficiency”. The author states that “[m]ercantilists’ thought never supposed that there was self adjusting tendency by which the rate of interest would be established to appropriate level”(1976 ed.: 1). Keynes writes that mercantilists knew that “high interest on money [acted] as obstacle to growth of wealth”. He also mentions that there is “chronic tendency throughout human history for the propensity to save to be stronger than the inducement to invest”. ”(Keynes, 1936: 347) Another quotation is also self-explanatory: “The desire of individual to augment his personal wealth by abstaining from consumption is usually been stronger than the inducement to the entrepreneur to augment the national wealth by employing labor on the construction of durable assets”(Keynes, 1936: 348). Thus, low rate of interest should be pursued. Therefore, Keynes supports the view that usury laws can be used for that, he even mentions that Adam Smith was in favor of setting a maximum interest rate. In addition, Keynes notes that investment is volatile because future is uncertain - people’s expectations do matter. Since income is composed of consumption and investment, income is fluctuating as well. Still, as Keynes repeats Bentham’s argument, interest rate should be at an optimal level in order to encourage savings and risk-taking as well.

Keynes puts an emphasis on the role that money play in the real economy. He mentions the liquidity preference motive - people hold money because it is a generally acceptable means of payment. It matches buyers and sellers by eliminating the need for double coincidence of wants, as required by barter. Money acts as a lubricant of the economy because it facilitates transactions. The higher the money supply, the lower the opportunity cost of holding money. In Ch.23, Keynes emphasizes that mercantilists were aware of liquidity preference motive, thus regarding them as his predecessors. In theory, currency notes can be thought about as zero-interest bonds that never mature. But if stamping of the notes is required on a regular basis, as proposed by Silvio Gesell, that makes money less attractive for economic agent. Opportunity cost of holding them increases, and agents are better off switching to substitutes such as treasure notes, bank bills, etc.

Since the main contribution of Keynes is the theory of the stimulation of aggregate demand, the last paragraph of chapter 23 is devoted to the analysis of some authors who dealt with that issue. He mentions luxury spending, appreciated by mercantilists such as Mandeville, Laffemas, Barbon. Keynes

also tries to transfer this luxury argument on the harmfulness of excess parsimony by individuals to the argument that the excess parsimony by the state is also harmful so there is a need for the state-led stimulation of aggregate demand. Keynes quotes Malthus to support his point and to criticize Ricardo for being ignorant to Malthus's arguments: "...how can it be said that with truth that parsimony, though it may be prejudicial to producers, cannot be prejudicial to state"(Keynes, 1936: 363, A letter from Malthus to Ricardo, dated 7 July 1821). Additional support Keynes finds in Hobson and Mummery's "The Physiology of Industry", mostly their idea that "excessive saving is responsible for under-employment in the periods of bad trade" (Keynes, 1936: 365). The quote from "The Physiology of Industry" comes to show that "...[m]ost modern economists deny that consumption could by any possibility be insufficient" (Keynes, 1936: 369; "The Physiology of Industry", p. 100). This claim holds even today, if we believe the model of consumers maximizing utility in all periods, given that they are capable of doing it right.

Indeed, some contemporary societies are very much consumption-oriented, thus fulfilling the maximization assumption. There are societies, however, which are not strongly consumptive for various reasons – such as the Asian ones that are willing to sacrifice current consumption for a higher welfare in the long run. For those societies, the claims made by Malthus and Hobson may be true even today, and these societies are not necessarily some primitive ones – there is only need for sufficiently long economic crisis for people to become more cautious in their consumptive behavior. A quote from "The Physiology of Industry" states that "if a fall of Profit is to induce people to save less, it must operate in one of two ways, either by inducing them to spend more or by inducing them to produce less"(Keynes, 1936: 369; "The Physiology of Industry", p. 130). Therefore, it is relevant to Keynes's theory of cycles. Keynes says that the second alternative (to produce less) is more likely – so fall in profit lead to contraction of production.

In the chapter Keynes also expresses critical view towards classical theorists saying that some of their theories, though being nice abstractions, are inconsistent with common sense. Finally, he praises "... the brave army of heretics - with Mandeville, Malthus, Gesell and Hobson, who following their intuition, have preferred to see truth" (Keynes, 1936: 371). In this way he regards them as his predecessors and identifies himself as their true follower.

In a footnote, an intriguing citation by Hechsher from Petty is given, claiming that violent efforts to increase the quantity of money could only cease "when we have certainly more money than any of our Neighbour States"(Verbum Sapientiae, 1691) (Keynes, 1936: 346). Certainly, this idea was not

modern. Monetarists will say it will cause inflation and not prosperity. However, a slight modification of Keynes' idea in implementing the Bretton-Woods System actually shaped the world financial system as we know it today. Countries' reserves, denominated in US dollars, accumulated mostly during the Bretton-Woods period, are large and US became a great economic power partly because of it. Thus, legacy of mercantilists is important in shaping today's economic system.

As it was shown, chapter 23 from Keynes' book is relevant because he regards mercantilists as his predecessors. In his opinion, they described the situation better than the classics. That is why he uses their ideas for promotional purposes, as a framework in which he develops his analysis. Keynes is advocate of activist economic policies, despite the opposition of equilibrium theorists. His arguments can be valid even today, although only in the short-run, for countries in poverty traps and for inflexible economies, which sometimes need a push to speed up economic recovery.

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