

# **History of Economic Thought I**

## **II. The Emergence of a New Science**

**(1)**

### **The Rise of Modern States and Economic Problems**

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Oct. 16, 2024

# The Billionaire Who Never Was: Chuck Feeney, 1931-2023

- Earned and gave away \$8 billion
- “I had one idea that never changed in my mind—that you should use your wealth to help people.”
- <https://www.nytimes.com/2023/10/09/business/charles-f-feeney-dead.html>



# “Evergrande bankruptcy fears spark a bank run in China,” Oct.14, 2023

Bank run at the Bank of Cangzhou's head office in Hebei province

“Cash Wall”



# Key Points for Today's Class

- How Economics as a New Science Emerged?
- Two Origins
  - A) Economics as Practicing Policy
  - B) Economics as a philosophy about the economy
- “Mercantilism” and “Physiocracy”
- How the first core knowledge of a “new science” was formed?
  - As reactions and criticisms to “mercantilism” and “physiocracy”
  - But old ideas never die out.

# Key Questions for Today's Class

- 1) What changed from the Medieval to the Modern?
- 2) What is Mercantilism? Why was (is) it (still) influential?
- 3) What lessons can we learn from John Law and his System?

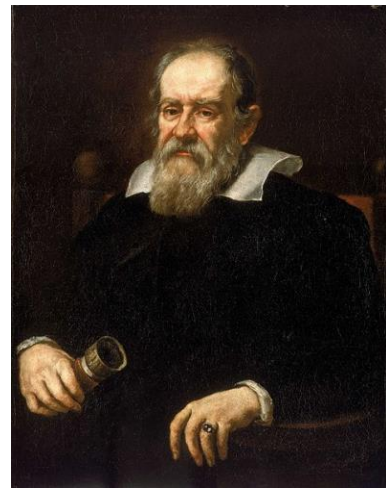
# Economic problems sprung up and Economic Thought changed

- Two reactions to problems
- A) What is happening? What to do about it, as policy? Practical reactions
- B) What to make normative sense of it? Normative or Philosophical reactions

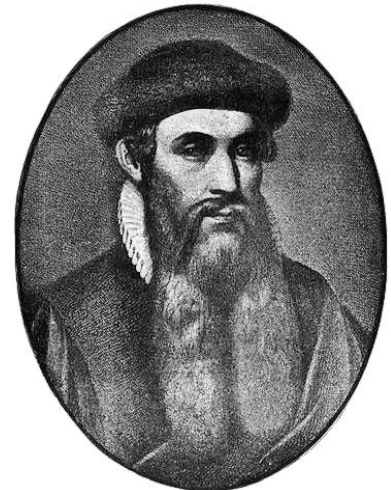
# The Modern Age and the Rise of the West

- The Black Death (1346 to 1353): 14<sup>th</sup> century
  - From labor to capital, change in energy sources
- The First Information Revolution
- The First Globalization
  - the “discovery” of Americas (1492)
  - The Price Revolution
- Development of Commerce and the credit economy
- The Renaissance and modern science
- The Reformation
  - Freedom of belief, conscience, and thought
- War and the Rise of Nation States
  - The Military Revolution (Parker 1996)
  - “War makes states and states make war” (Tilly 1975)
  - The Fiscal-Military State (Brewer 1990)
    - Army and Navy
    - Centralized government
    - Who could raise tax?

# The Medieval Science

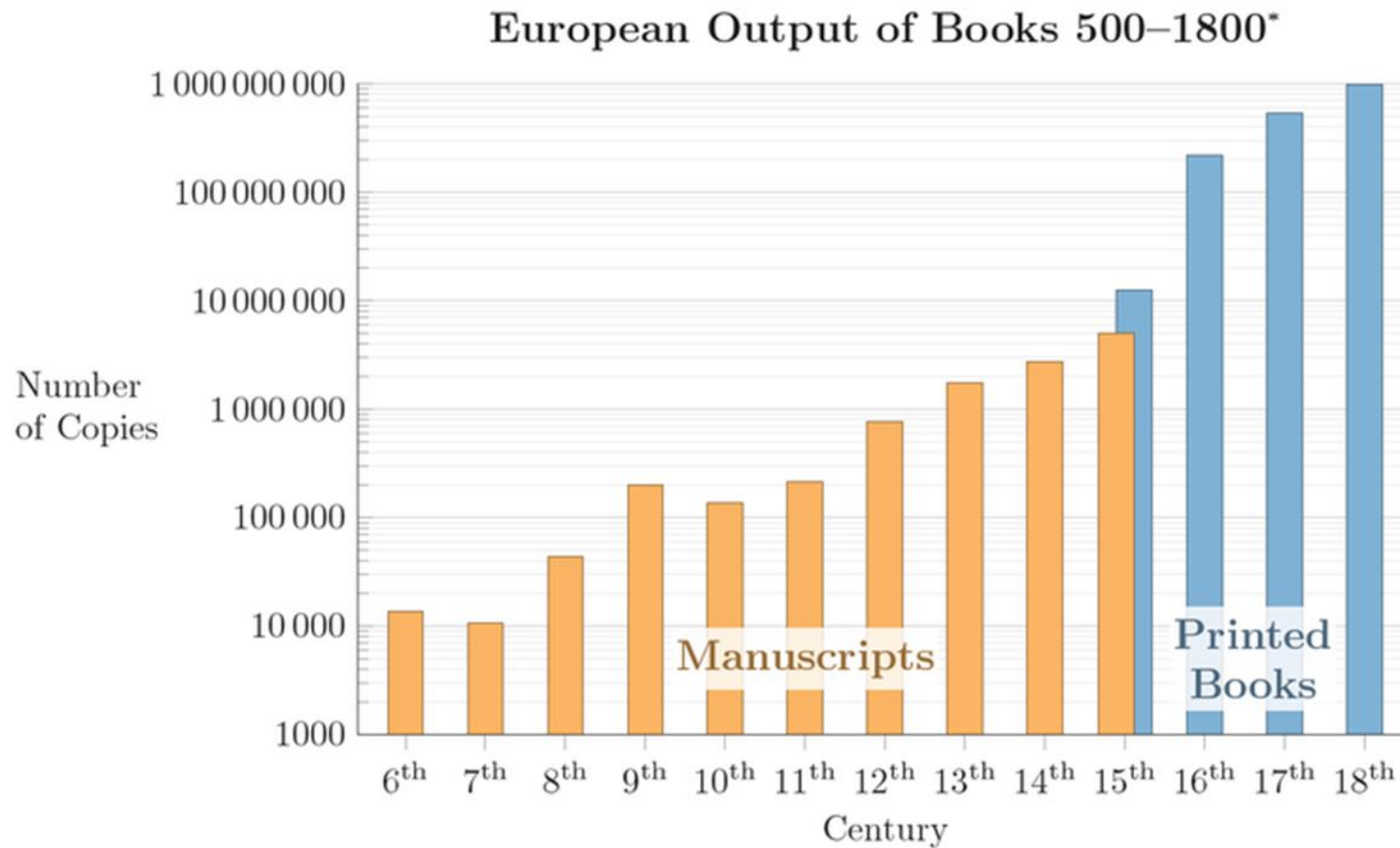


- Empiricism spread
- The Church suppressed some scientists, but scientists prevailed
  - John Hus, Copernicus, Bruno Hildebrand, Galileo
- Johannes Gutenberg (1398 –1468)
  - “invention” of Printing Press





# The First Information Revolution



\*without Southeast Europe (Byzantine, later Ottoman realm) and Russia



# The Reformation



- Printing Press → Lowered the cost of making books → Improved literacy
- 1515: The Pope Leo X began selling indulgences → reactions
- Martin Luther
  - 1517: Ninety-Five Thesis
  - 1530: The Augusburg confession
  - Salvation through secular work
- Max Weber hypothesis
  - *The Protestant Ethic and the Spirit of Capitalism* (1904-5)
  - Protestantism did not give birth to capitalism
  - But only in Western Europe and the USA capitalism developed highly
  - Protestantism cherished Industry and Hard Work
  - Transformation from Consumption to saving, rituals to industry
  - Still hotly debated
    - Empirical work
    - Culture and Economic Growth, the rise of the Rest

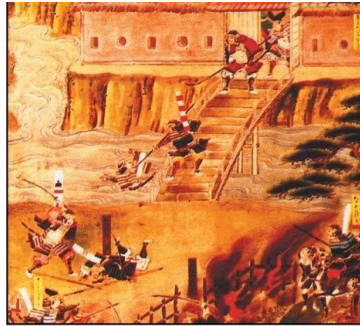
“As soon as a coin in the coffin rings,  
The soul from purgatory springs.” (Johann Tetzel)





# The Military Revolution

SECOND EDITION



## *The* MILITARY REVOLUTION

*Military innovation  
and the rise of  
the West  
1500–1800*

GEOFFREY PARKER

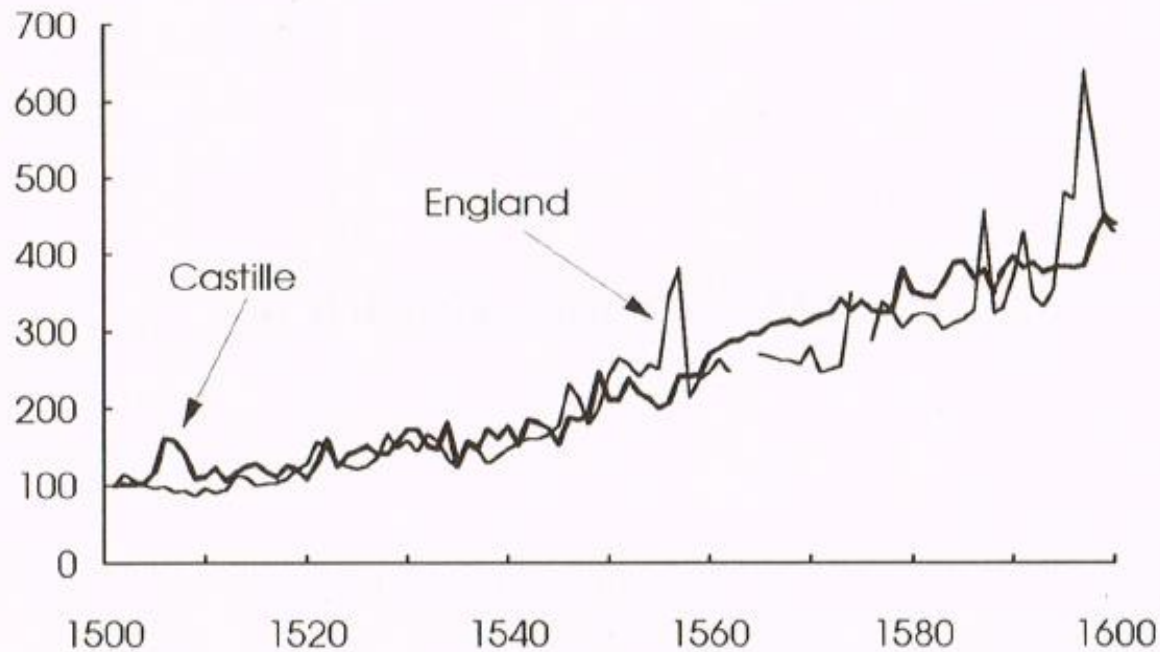


## Strand A : Economic Problems Sprung up and Economic Thought changes

- Inflow of precious metals from South American colonies, Inflation in European continent
  - The Birth of the Quantity Theory of Money
- School of Salamanca, Spain, 16<sup>th</sup> century
  - University of Salamanca
  - Francisco de Vitto, 1483-1546、Navarro, 1492-1586、Domingo de Soto, 1494-1560、Luis Molina aka Molineus, 1535-1600

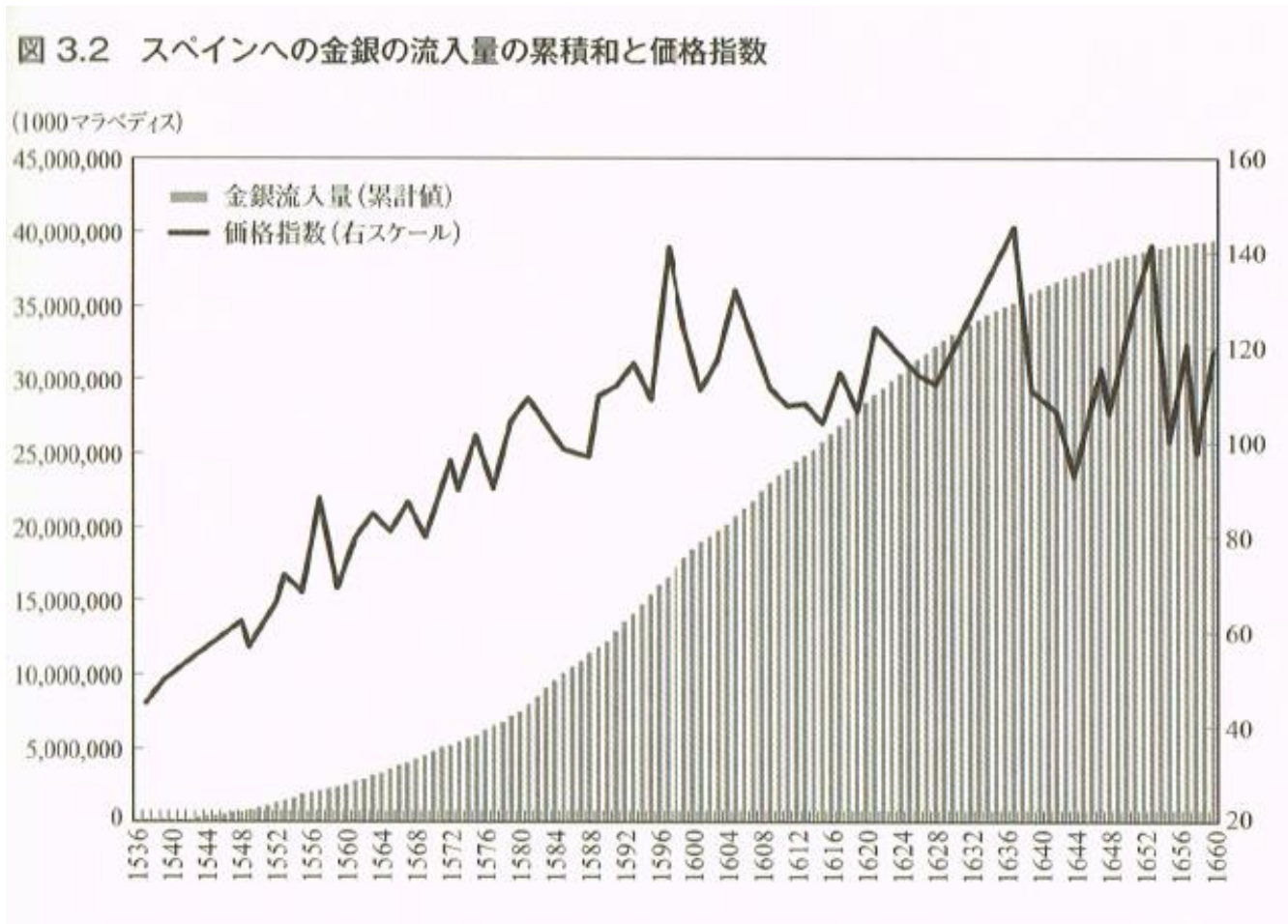
# 16<sup>th</sup> Century Inflation

## Backhouse 1987, p.110



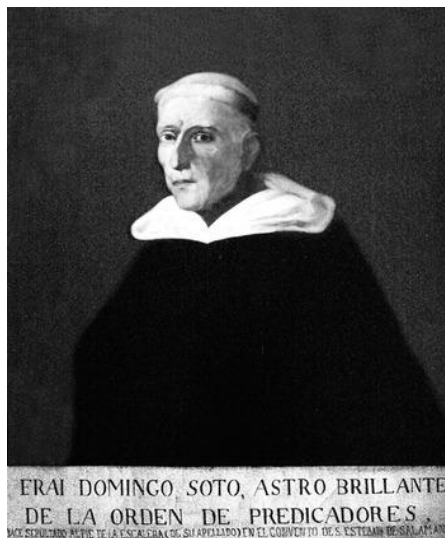
**FIGURE 4.1** Sixteenth-century inflation

# Cumulative Inflow of Gold and Silver and the Price Index





# School of Salamanca





## Martín de Azpilcueta aka Navarro, 1492-1586

- *Comentario resolutorio de usuras* (1556) :
- “All goods are dearer when there is a great demand for them, and there is a small supply of them, and money is a good as long as it is sold or exchanged with other money, or exchanged on other contracts, therefore money becomes dear when the demand for it is large and the supply of it is small”
- “Other things being equal, in countries where there is a great scarcity of money, all other saleable goods, and even the hands and labor of men, are given for less money than where it is abundant. Thus we see by experience that in France, where money is scarcer than in Spain, bread, wine, cloth and labor are worth much less. And even in Spain, in times when money was scarcer, saleable goods and labor were given for very much less than after the discovery of the Indies, which flooded the country with gold and silver. The reason for this is that money is worth more where and when it is scarce than where and when it is abundant.”
- International currency values: PPP, exchange rates are explained by relative amount of currencies

# The Birth of the Quantity Theory of Money (QTM)

- What is The Quantity Theory of Money ?
- Irving Fisher's summary
  - Exchange equation :  $MV=PT$ 
    - $M$  (money) 、  $V$  (velocity) 、  $P$  (Price Level) 、  $T$  (the amount of transactions)
  - Given  $V$  and  $T$  constant,  $M \uparrow \downarrow \Rightarrow P \uparrow \downarrow$
  - But  $V$  and  $T$  may vary.
- ① Long-run neutrality of money :  $M \uparrow \downarrow \Rightarrow P \uparrow \downarrow$
- ② Short-run non-neutrality :  $M \uparrow \downarrow \Rightarrow T \uparrow \downarrow$

# Evaluation

- No sophistication of the latter day QTM
  - No distinction between  $M$  and  $V$
  - No distinction between precious coins and money supply (understandable)
  - No discussion of  $T$
- But, great insights
  - Money has its own value which is determined by the relationship with other goods, and that is determined by the supply and demand like goods

# The Price Revolution Reassessed

- Part of the controversy surrounding the QTM
- Classical studies (Earl J. Hamilton 1928, 1934)
- Criticism
  - Real factors: population growth  $\rightarrow$  rise in food prices
- Fisher 1989 time series analysis
  - Granger causality from Spanish prices to prices in France, England, Germany and Austria
  - Granger causality from Money to Prices in France
- Inflation in early 16<sup>th</sup> century due to Increase in silver production in Mid Europe (Munro 2003)
- New Dataset: Spain, 1492—1810:  $M \uparrow \rightarrow P \uparrow$  (Chen, Palma and Ward 2021)
  - $M \uparrow \rightarrow$  real GDP  $\uparrow$ , persistent (Palma 2022)

# Strand A: Policy-oriented Science

- How to measure and improve “National Strength”
- Public Finance, Public Debt
- Population
- Quantitative approach to national strength and the birth of Statistics
- Sir William Petty, 1623-1687
- Oxford University Professor of Anatomy
- Surgeon General of Oliver Cromwell’s Irish Expeditionary Force



# Petty, Political Arithmetician

- Background①Medicine
  - Wide-ranging Science: Anatomy, Data collection, Experiment
  - State-of the Art Practical Science to cure diseases
- Background②Francis Bacon (1561-1626), “Knowledge Is Power”
  - Social Reform Program based on understanding truth
  - Truth is productive in bringing products and fruits

# *Political Arithmetic* (1690) as a Science of Government

- “Or a Discourse Concerning, The Extent and Value of Lands, People, Buildings: Husbandry, Manufacture, Commerce, Fishery, Artizans, Seamen, Soldiers; Publick Revenues, Interest, Taxes, Superlucration, Registries, Banks, Valuation of Men, Increasing of Seamen, of Militia's, Harbours, Situation, Shipping, Power at Sea, &c. As the same relates to every Country in general, but more particularly to the Territories of His Majesty of Great Britain, and his Neighbours of Holland, Zealand, and France.”
- Statistics: Statistik from German word Stat. status, or state
- Science of Government: finding out an order within the body politic

# “Number, Weight, or Measure”

- “The Method I take to do this, is not yet very usual; for instead of using only comparative and superlative Words, and intellectual Arguments, I have taken the course (as a Specimen of the Political Arithmetic I have long aimed at) to express my self in Terms of Number, Weight, or Measure; to use only Arguments of Sense, and to consider only such Causes, as have visible Foundations in Nature; leaving those that depend upon the mutable Minds, Opinions, Appetites, and Passions of particular Men, to the Consideration of others: Really professing my self as unable to speak satisfactorily upon those Grounds (if they may be call'd Grounds).”



# THE Principal Conclusions OF THIS TREATISE

- Chap. 1. That a small Country, and few People, may by their Situation, Trade, and Policy, be equivalent in Wealth and Strength, to a far greater People, and Territory. And particularly, How conveniences for Shipping, and Water Carriage, do most Eminently, and Fundamentally, conduce thereunto.
- Chap. II. That some kind of Taxes, and Publick Levies, may rather increase than diminish the Commonwealth.
- Chap. III. That France cannot, by reason of Natural and Perpetual Impediments, be more powerful at Sea, than the English, or Hollanders.
- Chap. IV. That the People, and Territories of the King of England, are Naturally near[53] as considerable, for Wealth, and Strength, as those of France.
- Chap. V. That the Impediments of Englands Greatness, are but contingent and removeable.
- Chap. VI. That the Power and Wealth of England, hath increased above this forty years.
- Chap. VII. That one tenth part, of the whole Expence, of the King of England's Subjects; is sufficient to maintain one hundred thousand Foot, thirty thousand Horse, and forty thousand Men at Sea, and to defray all other Charges, of the Government: both Ordinary and Extraordinary, if the same were regularly Taxed, and Raised.
- Chap. VIII. That there are spare Hands enough among the King of England's Subjects, to earn two Millions per annum, more than they now do, and there are Employments, ready, proper, and sufficient, for that purpose.
- Chap. IX. That there is Mony sufficient to drive the Trade of the Nation.
- Chap. X. That the King of England's Subjects, have Stock, competent, and convenient to drive the Trade of the whole Commercial World.

# Strand B: Changing Norms about Commerce and Merchant

- Medieval times : Merchant and Commerce downgraded
  - NO Usury: Prohibition or restriction of taking interest
  - “Just Price” :  $\text{Price} = \text{Value}$ : No “Buy low, sell high”
- Cassiodorus (6<sup>th</sup> century) condemned merchant and commerce: “commerce is nothing but buying low and selling high. Thus, merchants are despicable species, those who have no regard to God’s justice, are contaminated by extraordinary greed for money, and make their goods heavier with their lies”
- St. Goderic (11<sup>th</sup> to 12<sup>th</sup> century, England) 、 Pierre Valdo (Lyon, France), St. Francis of Assisi (Francesco d'Assisi, 1182 - 1226)
- Change in the 13<sup>th</sup> century: Pierre de Jean Olivi (1248-1298)
  - Role of the Common Good
- But still no approval of unlimited pursuit of self-interest

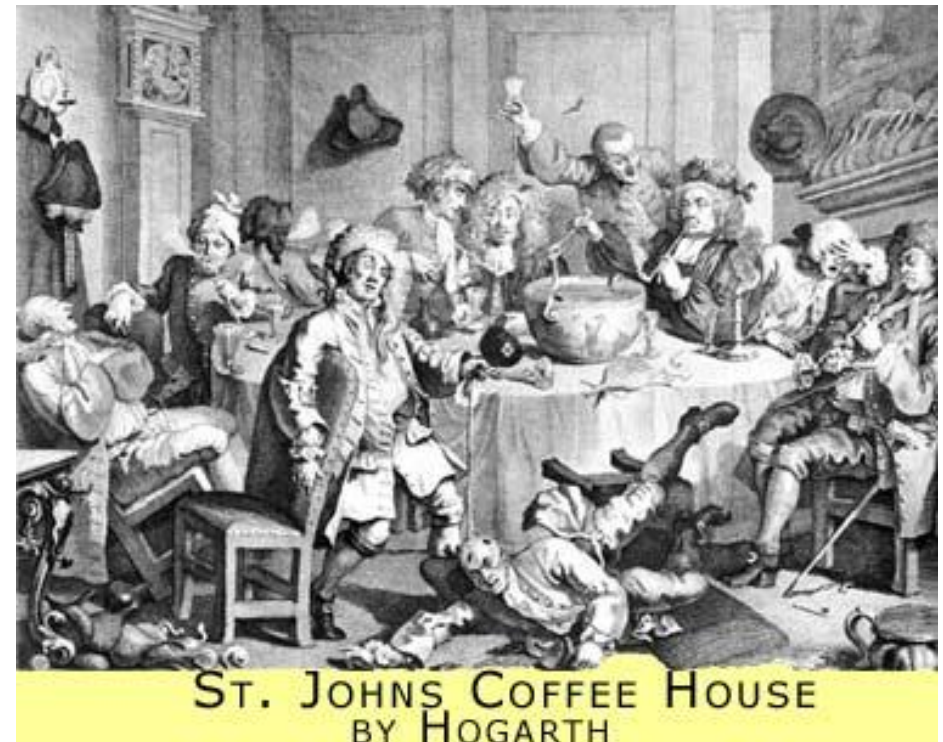
# School of Salamanca

## Domingo de Soto, 1495-1560

- Scarcity determines price. “Everything sold has value.”
- “Except frauds or malice, merchants should be left to set prices”.
- Origin of Supply and Demand theory: “Price goes up when there are more buyers than sellers and goes down when there are less buyers. Likewise, it goes down when there are more seller and less buyers”
- Changed definition of “just price” : From the “ongoing price” to price under competitive conditions. Fairness leads to criticism against monopoly.
- Monopoly price and the resultant monopoly profit are not approved of from the point of fairness. Defending just price became criticizing monopoly.

# B: How to understand the modern society

- Consumption Revolution
  - The New World -> New consumption goods (coffee, tea, sugar)
  - Urbanization, urban culture
- Debates on luxury: should luxury be approved of?
- Should self-interest, self-love, other self-regarding desires be approved of?



# Mandeville, *The Fable of the Bees* (1705)

- Bernard de Mandeville, 1660-1733
- “Private Vices, Public Benefits”
- “The Grumbling Hive”: Rhetoric of the Bee-Hive
- Approval of private desires: Vices = Non-conscious pursuit of the common good ⇒ The order comes out spontaneously
- Recognition of “unintended consequences”
  - Smith the “invisible hand”, Hayek “Spontaneous Order”
- “Mercantilist”
  - ① No regard for the lower classes
  - ② Only positive feedback

# “Mercantilism” as the Conclusion of Strand A

- Product by opponents: “System of Commerce” Adam Smith
- Its characteristics
  - (1) From the perspective of ruler, emphasis on “national interests” than on people
  - (2) Emphasis on external trade, trade surplus, zero-sum game perspective on trade, “international competitiveness”
  - (3) Emphasis on governmental control and regulation of the national economy
  - (4) Emphasis on Money and Underemployment
- Thomas Mun (1571-1641)、Sir Josiah Child (1630-1699)、Sir James D. Steuart (1713-1780)

# Evaluation

- (1) Are they systematic? Changing arguments, from pure Bullionist to Emphasis on the National Economy
- (2) Popular discourse rather than theory?
  - Smith's attack
  - But Schmoller and Keynes
- (3) Powerful as a popular discourse. The economics of nationalism, international competitiveness, zero-sum game view on trade, primacy of government intervention

# UK: Transformation of Mercantilism and Decline

- Economic Theory of Regulation (Ekelund and Hebert 2014, 60-65)
  - Rent-seeking
  - Fragility of cartel
- Increased power of the judiciary ⇒ Competition among the powers
- Development of the Parliament and decline of mercantilism
  - More dispersion of powers, the more cost of policy making increased
- No centralized “mercantilist” policy (Hoppit 2017)



# France: Mercantilism in Crisis

- Problematic because of the strong sovereign power
- The collapse of Colbertism in France
  - Jean Baptiste Colbert, 1619-1683, Comptroller General of Finance of Louis 14
  - Tradition of dirigism
- Artificial economic control = stagnation and decline of the French Economy
- Escape Plans
  - 1) Injecting Money and Credit. John Law's "Systeme"
  - 2) "Back to basics": Agriculture revival plan. The Physiocracy.

# Louis 14, the Sun King (1638 — 1715、King from 1643)



# Exploding Spending

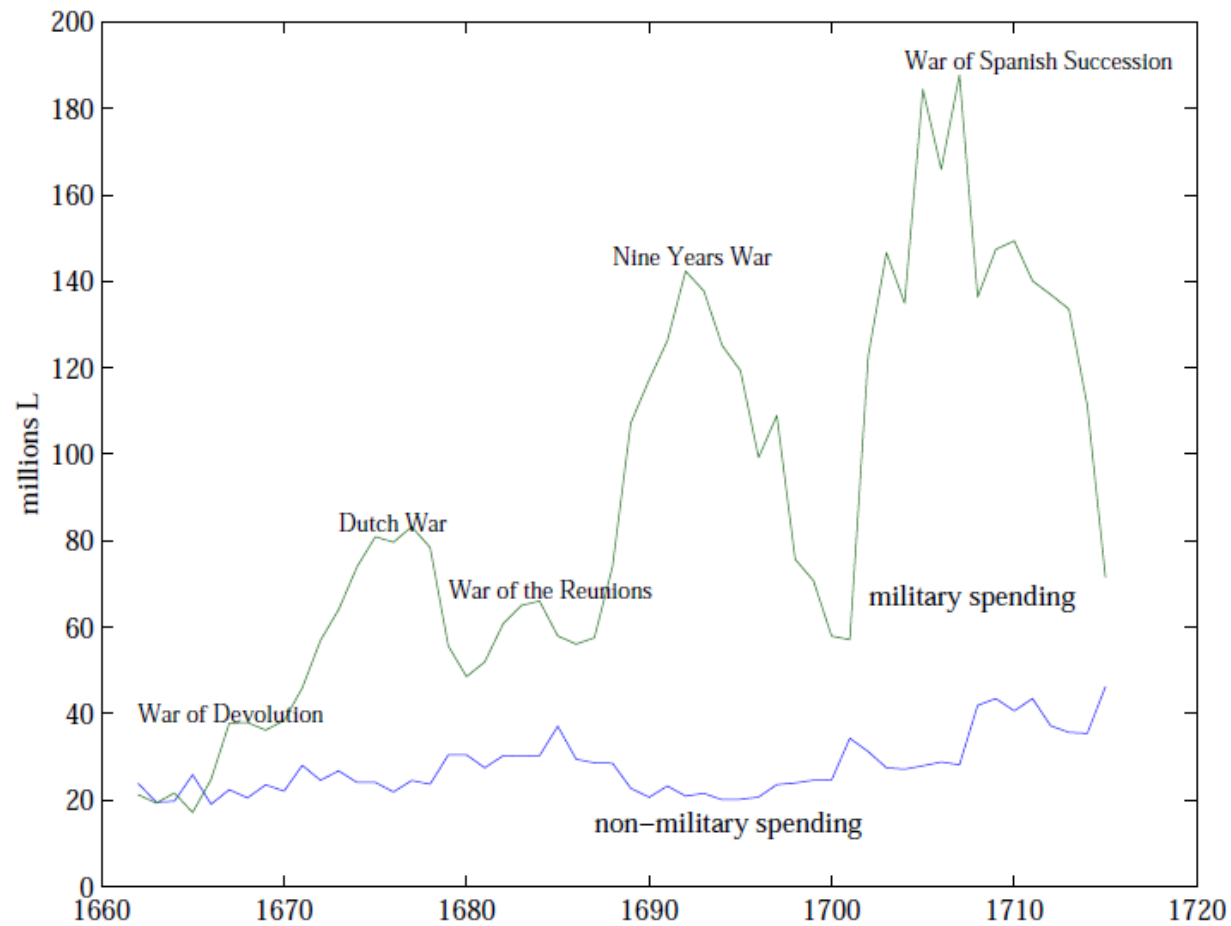


Figure 1: Military and non-military spending in France, 1662–1715 (debt service excluded).

# Spending > Revenues = Deficit

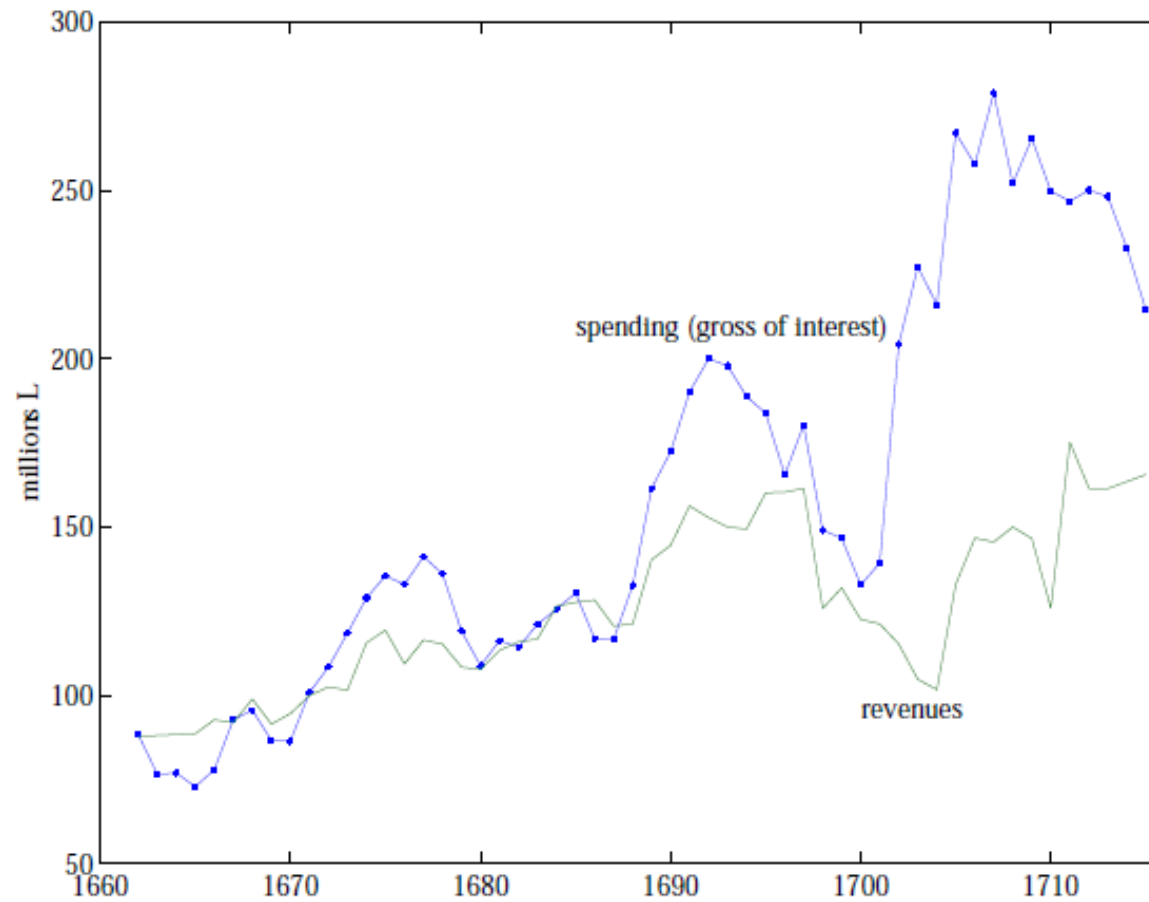
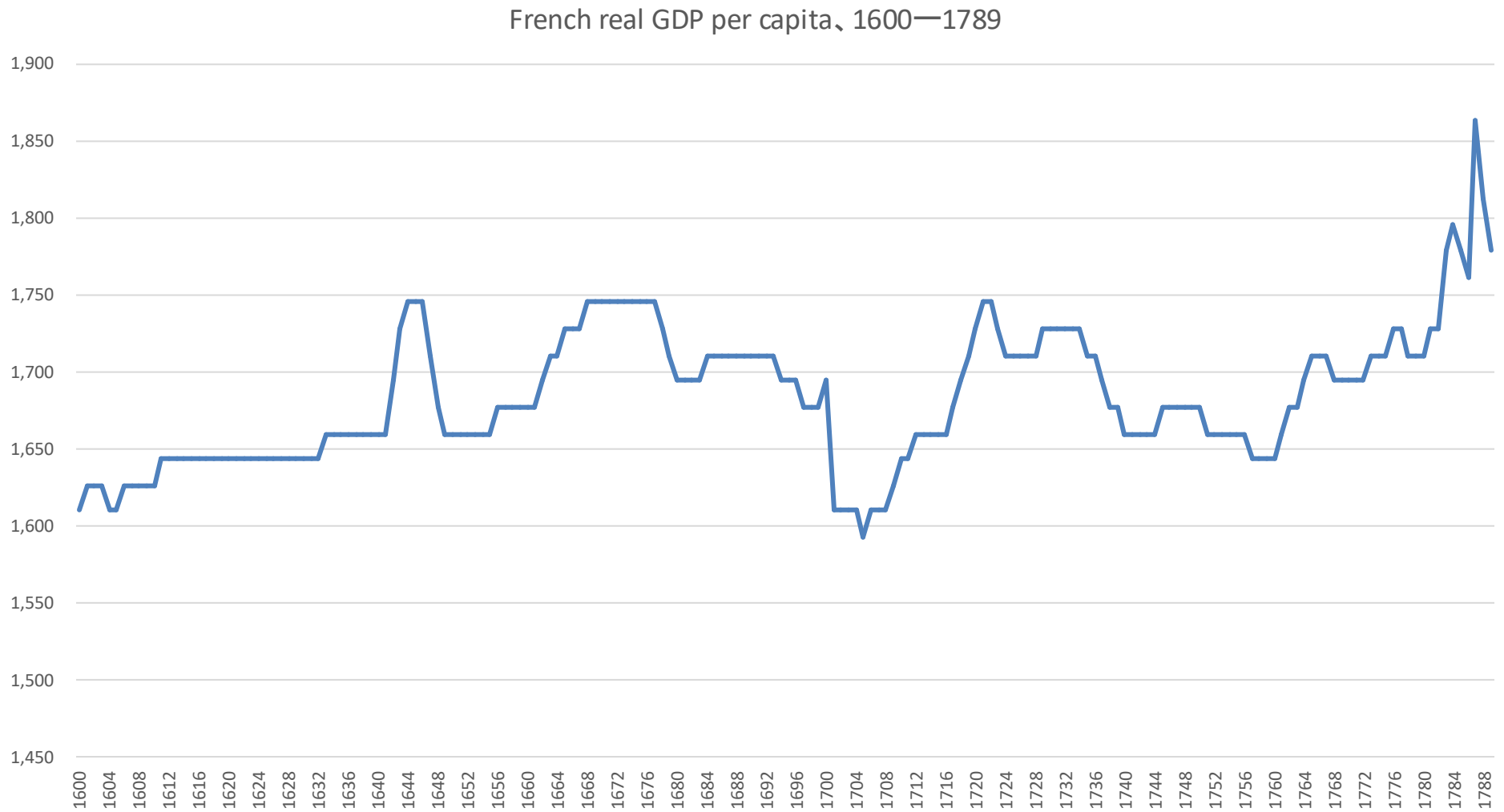


Figure 3: Revenues and spending, 1662–1715.

# Stagnant French Economy



# John Law, 1671-1729

- Born in Scotland
- Gambler, Policy promoter, Genius and Visionary in Financial innovation
- Development of international financial market: Exchange banks at Amsterdam as a model



## *Money and Trade Considered with a proposal for supplying the nation with money (1705)*

- A Proposal for the Scottish Parliament
- The cause of stagnation: the lack of money
- Precious metal are in constant shortage
- The nature of money is credit
- The best way to increase money is bank
- Issuing paper money with land as the collateral
  - Bank on Real Estate

# Law's Systeme

- 3 Components
- ① Trading of private joint-stock companies
- ② Skillful use of inconvertible paper money
- ③ debt-equity conversion of the government debt



# Chronology

- 1716: Banque Generale (General Bank) Founded
- Sept., '17: Compagne des Occident (Company of the Occident) (Mississippi Company) Founded
- Dec., '18: General Bank to Royal Bank
- April 22, '19: Edict to announce that Paper money does no longer depreciate in relation to silver. Beginning of conversion from coins to paper money
- May, '19: Company of the West to Company of the Indies
- July, '19: Royal Bank acquired rights to collect 9 years worth of returns from the Royal Mint
- August: Royal Bank acquired the rights to collect indirect taxes.
- October: Royal Bank acquired the rights to collect direct taxes.
- Jan., '20: Law became Controller General of Finances
- March, '20: Prohibition of the circulation of species
- May 21, '20: Edict to announce the contraction of currency. Law lost credibility. Stock price plummeted.
- May 29, '20: Law was fired. But returned soon. Stock price recovered temporarily.
- Oct. 10, '20: The Government reintroduced gold and silver to domestic transactions. Stock price plummeted. Law went into exile.

# The Main Features of Law's Systeme

- Bank, not only a mere paper money-issuing bank, a central bank?
- Emphasis on Trust and Credit as foundations of Money
- The Empire as Collateral
  - “expected return” from French Louisiana, Trade Monopoly, Tax collection

# Share prices of the Company of the Indies

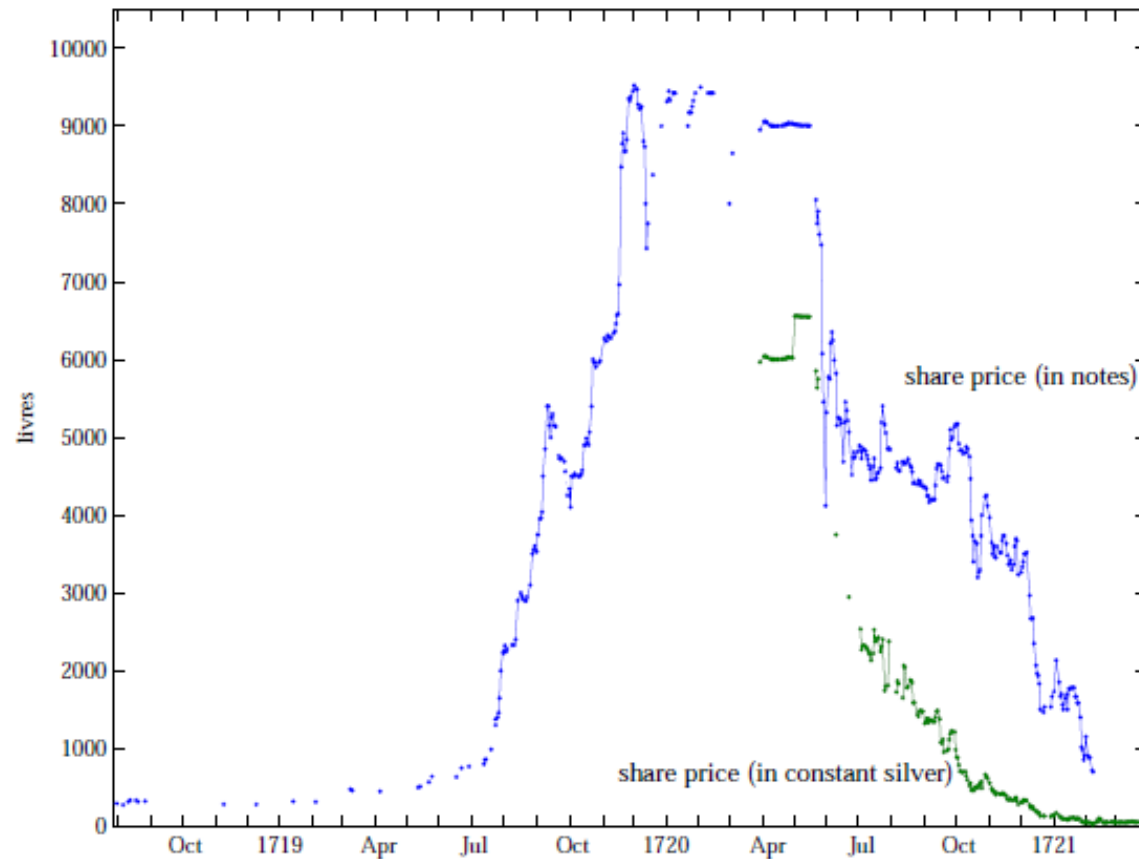


Figure 4: Prices of shares in the *Compagnie des Indes*. From June 1720 to Feb. 1721, the series is also shown converted into silver coin at 60L/marc. Source: see Appendix.

# High Inflation

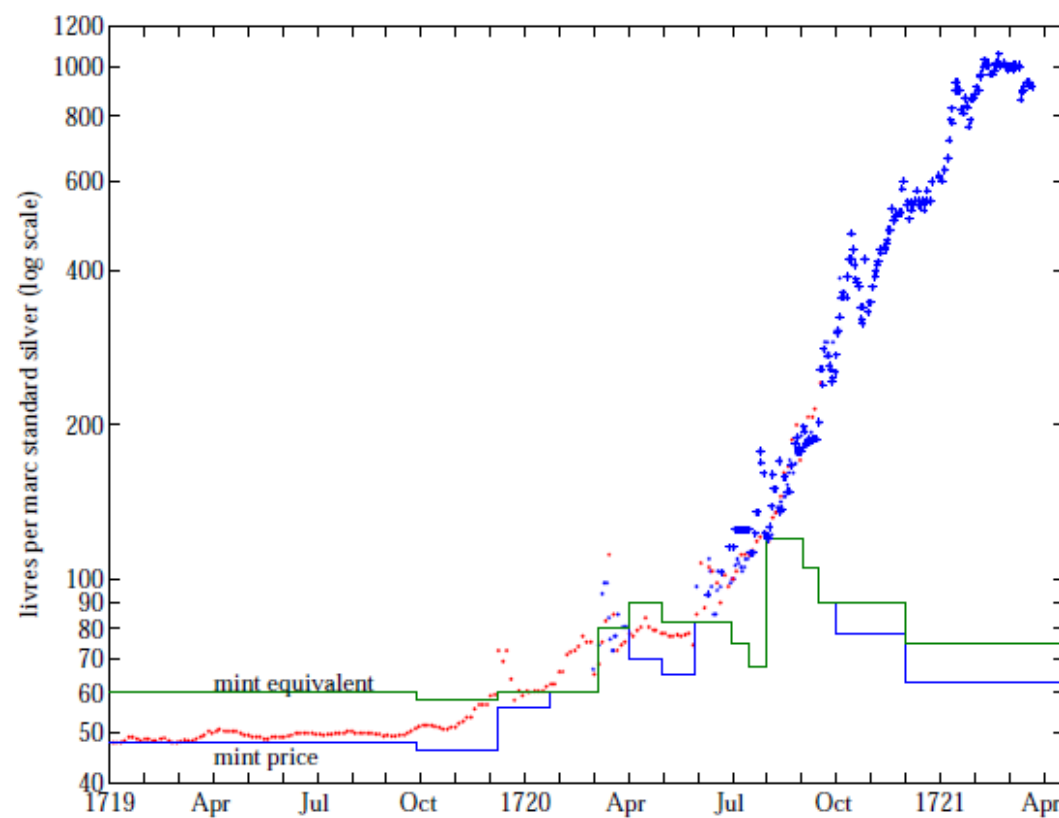


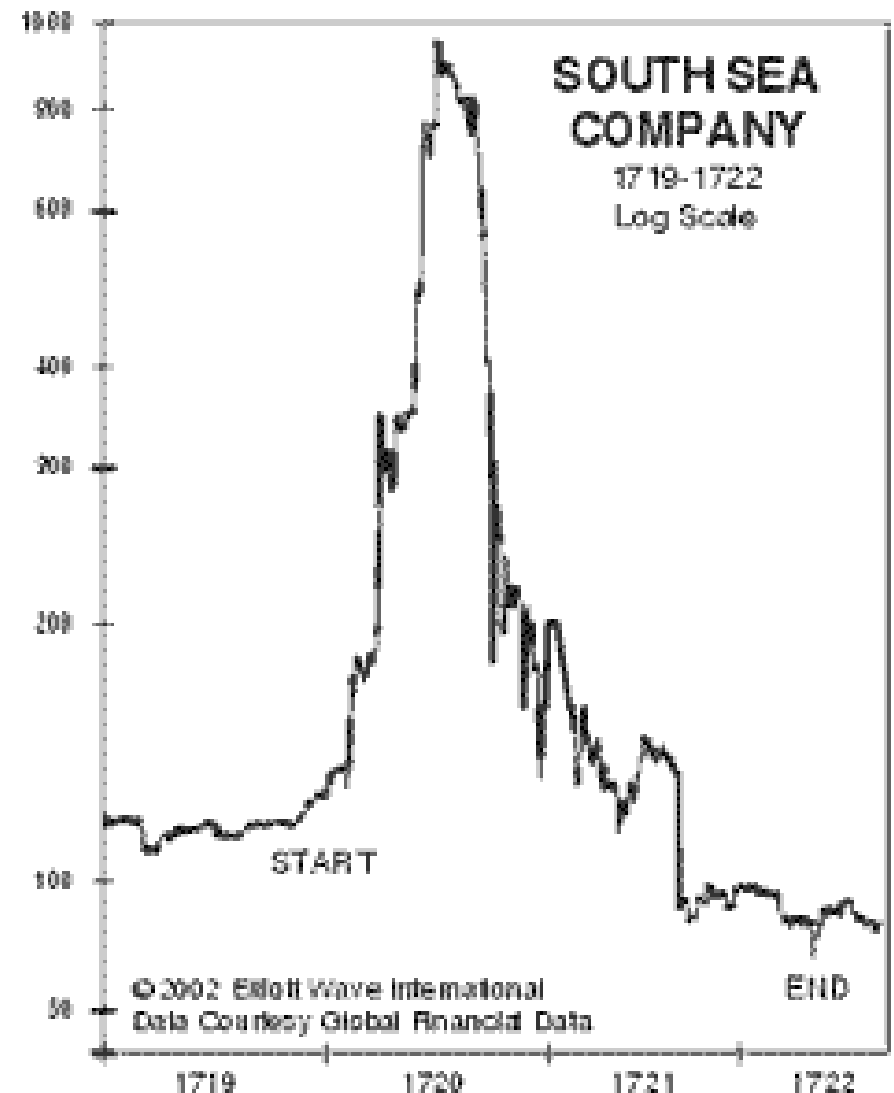
Figure 8: Indices of the bank-note price of a marc of standard silver. The dots are (transformations of) the price of French livres in foreign exchange markets, January 1719 to September 1720; the stars are based on the specie price of bank-notes, June 1720 to March 1721. The mint equivalents and mint prices for the French silver coinage are also shown. Source: *Course of the exchange* (ESFDB database), Appendix.

# Evaluation

- In the end, his policy “failed”.
  - The Bubble and High inflation
- But he succeeded in liquidating the government debt.
- Was John Law a fraud?
  - He was sincere, reforming many things.
- Why he failed?
  - Did not understand the QTM
  - The real bills doctrine
- Could he have succeeded?
  - Needed a better social scientific technology

# The South Sea Bubble

- The same time at UK
- 1711: South Sea Company
- “Expectations”: monopoly of trade rights with Spanish colonies in South America
- Inspired by John Law
- Countless many bubble companies
- "I can calculate the movement of the stars, but NOT the madness of men."





# Contemporary Image of South Sea Bubble





# History of Famous Bubbles

- 1636-37 : Tulip Bubble, Netherlands
- 1719-20 : Mississippi Bubble, France
  - John Law's "Bubble"
- 1720 : The South Sea Bubble, England
- 1844-46 : Railway Mania, UK
- 1869-73 : Railway Bubble, USA
- 1886-93 : Land Boom, Australia
- 1895-98 : Bicycle Mania, UK
- 1924-29 : The "Roaring Twenties", USA
- 1987-1990 : Real Estate Bubble, Japan, Scandinavian countries
- 1996-2000 : Dotcom Bubble, USA
- 2003-2008 : Subprime Bubble, USA, UK, Ireland, Spain
- 2015-2022? : Property Bubble, China



# The Economics of Bubble

- Economic Definition of Bubble :
  - Divergence of Asset Price from Fundamentals
  - Extremely difficult to know the divergence beforehand
    - Alan Greenspan
- Prerequisites
  - Assets
  - Capital market
    - E.g. Stocks, and Joint-stock companies
  - “Expectations” for the Future
    - Innovations (new products, new organizations) and growth
    - Story or narrative: “New Era,” “New Economy”

# Think Further

- Marx, Keynes and Hayek appreciated Mandeville very highly. Summarize what those differing three economists have said about Mandeville.
- Why Didn't Petty's Political Arithmetic Become the mainstream of Economics soon after?
- "The ideas of Mercantilism never die. On the contrary, they are still one of the most powerful ideas today". Discuss.
- Was John Law a visionary or a con-man?
- Is a bubble necessarily bad? By consulting history, in what circumstances could it be "good"?

# Next Week

- Read the following texts:
  - Cantillon, *Essay*, Part I, Chapter 13, Part II, Chapter 6.  
<https://oll.libertyfund.org/title/essay-on-the-nature-of-trade-in-general-lf-ed>
  - Hume, *Essays*, “Of Commerce,” “Of Refinement in the Arts,” “Of Money,” “Of Balance of Trade,” “Of the Jealousy of Trade”  
<https://oll.libertyfund.org/title/hume-essays-moral-political-literary-lf-ed>
  - Smith, *Wealth of Nations*, Book I, Chapters 1-3,7, 10, Book II, Introduction, Book IV Introduction, Chapters 1, 8, 9. <https://oll.libertyfund.org/title/smith-an-inquiry-into-the-nature-and-causes-of-the-wealth-of-nations-cannan-ed-vol-1>
- Watch the following videos on YouTube:
  - <https://www.youtube.com/watch?v=IYO3tOqDISE>
  - [https://www.ted.com/talks/thomas\\_thwaites\\_how\\_i\\_built\\_a\\_toaster\\_from\\_scratch](https://www.ted.com/talks/thomas_thwaites_how_i_built_a_toaster_from_scratch)
  - [https://www.ted.com/talks/a\\_j\\_jacobs\\_my\\_journey\\_to\\_thank\\_all\\_the\\_people\\_responsible\\_for\\_my\\_morning\\_coffee](https://www.ted.com/talks/a_j_jacobs_my_journey_to_thank_all_the_people_responsible_for_my_morning_coffee)

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- ——— (2009), “Was John Law's System a bubble? The Mississippi Bubble revisited,” Jeremy Atack, and Larry Neal (eds.), *The origins and development of financial markets and institutions: from the seventeenth century to the present*, Cambridge, UK ; New York : Cambridge University Press.