Mercantilism, Classical School & Keynes

Contents

- Mercantilism: views on trade and wealth of a nation
- Classicists: Free markets (**laissez-faire**, a French term that translates as "leave alone") minimal role of government in economic activity (production, consumption and distribution decisions of individuals). Increased money supply can only result in increasing prices and not increase in output.
- Says's Law, Long run Equilibrium, Flexibility of wages and prices, no unemployment, excess demand or excess supply.
- Keynes: Markets do not necessarily clear, money wages inflexible downwards resulting in unemployment and less than full employment output, need for govt intervention, relationship between output and money supply is positive for situations of less than full employment.

Selected School of Thought in Economics

- **Mercantilism**
- **Classicists**: Adam Smith (*Wealth of Nations* , 1776), David Ricardo (*Principles of Political Economy*, 1817), and John Stuart Mill (*Principles of Political Economy,*1848). Classicists: the equilibrium level of output would always converge to *full employment.* Actual output would converge to potential output. No output gap. The classical model provides the starting point for challenges that have been mounted against the Keynesian theory by *monetarists, new classical economists* , and *real business cycle theorists* .
- **Neo-classicists** : Alfred Marshall (*Principles of Economics* , 1920) and A. C. Pigou (*The Theory of Unemployment,* 1933).
- **Keynes:** Macroeconomic theory of the classicists and neoclassicists was similar enough to be dealt with as a whole.

The Mercantilism

- *Mercantilism* . Mercantilist thought was associated with the rise of the nation state in Europe during the sixteenth and seventeenth centuries. Two tenets of mercantilism were:

1. Bullionism: belief that the wealth and power of a nation were determined by its stock of precious metals.
2. Belief in the need for state action to direct the development of the capitalist system.

Current trade war between China and US: **Mercantilist**

WTO: ensuring free trade, ruling out undue intervention in trade affairs by countries: **Classicists**

- Adherence to bullionism led countries to attempt to secure an excess of exports over imports to earn gold and silver through foreign trade. Methods used to secure this favorable balance of trade (Exports-Imports) included export subsidies, import duties, and development of colonies to provide export markets. State action was believed to be necessary to cause the developing capitalist system to further the interests of the state.
- Foreign trade was regulated, and the export of bullion was prohibited to accumulate precious metals. Government intervention was also advocated so as to develop and protect domestic industries, to reduce consumption of imported goods, and to develop both human and natural resources (infant industry, import substitution, Government ownership of natural resources in India).
- Money spurred economic activity. In the short run, mercantilists argued, an increase in the quantity of money would lead to an increase in demand for commodities and would stimulate production and employment. A positive relationship between money supply, production and employment

The Classical Revolution .. contd

- Classical economics emerged as a revolution against a body of economic doctrine of *mercantilism*.
- Importance of *real* factors in determining the "wealth of nations" and stressed the optimizing tendencies of the free market in the absence of state control.
- Primarily *real* analysis; the growth of an economy was the result of increased stocks of the factors of production and advances in techniques of production.
- Money played a role only in facilitating transactions as a *means of exchange* . Most questions in economics could be answered without analyzing the role of money (veil).

The Classical Revolution

- Mistrusted government and stressed the harmony of individual and national interests when the market was left unfettered by government regulations, except those necessary to ensure that the market remained competitive.
- Stress on real factors and the belief in the efficacy of the free-market mechanism—developed in the course of controversies over long-run questions concerning the determinants of economic development.
- These classical positions on long-run issues were, however, important in shaping classical economists' views on short-run questions.

CLASSICAL MACROECONOMICS AND SAY'S LAW

- Market economy tends to converge to a long-run full-employment equilibrium and hence the government intervention in economic activity (production, consumption and distribution activities) is not desirable, except in a few cases (such as, public goods, externalities, imperfect markets, etc.)
- Classical approaches (Classical, Neo-classical and New-Classical) are based on the self-correcting forces in an economy, i.e., excess demand (supply) will increase (decrease) the price in any market. In other words, the classical approach is based on the premise that prices and wages are flexible, both upwards as well as downwards.

Say’s Law of Markets

- Classical analysis is rooted in the **Say’s Law of Markets.** French economist J. B. Say (advocated in 1803) stated that “supply creates its own demand.” If there is increase (decrease) in supply for given demand then prices will fall (rise) until increased (decreased) demand matches the increased (decreased) supply. In other words, there is neither under production nor overproduction.

- In the classical economics (based on Say’s law) implies that output is determined by aggregate supply, and aggregate demand affects only the price level.

Keynes: The General Theory of Employment Interest and Money (1936)

- Depression of 1929 proved classicists wrong. Keynes who also believed in classical school, started rethinking about it and provided a diametrically opposite argument, pleading for government intervention and discretionary policies to stabilize production and achieve full employment.

Aggregate Demand (AD)

AD refers to the total amount that different sectors in the economy willingly spend in a given period.

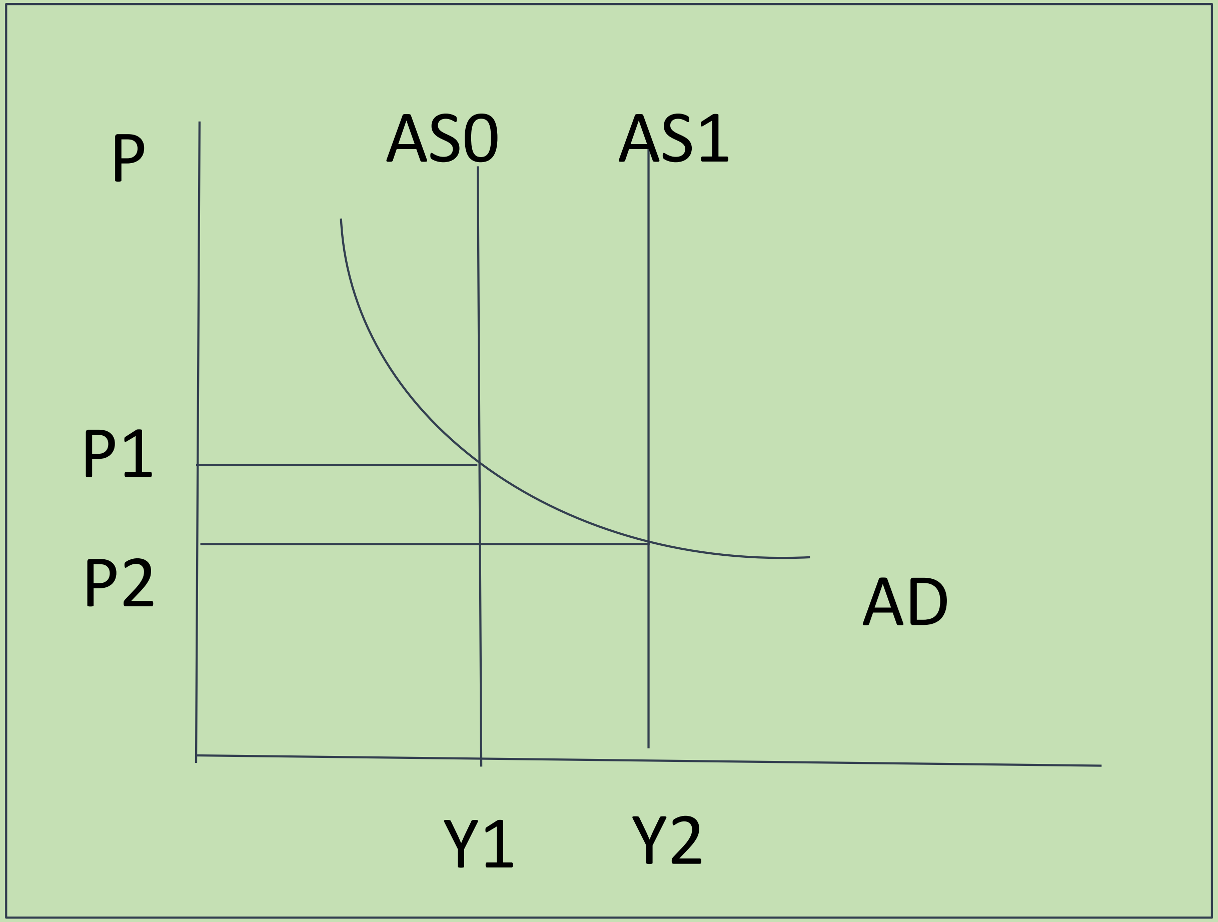
AD = Total spending on goods and services $Y = C + I + G + X - M$

AD depends on the 'general' level of prices, as well as on monetary policy, fiscal policy and other factors.

Aggregate Supply (AS)

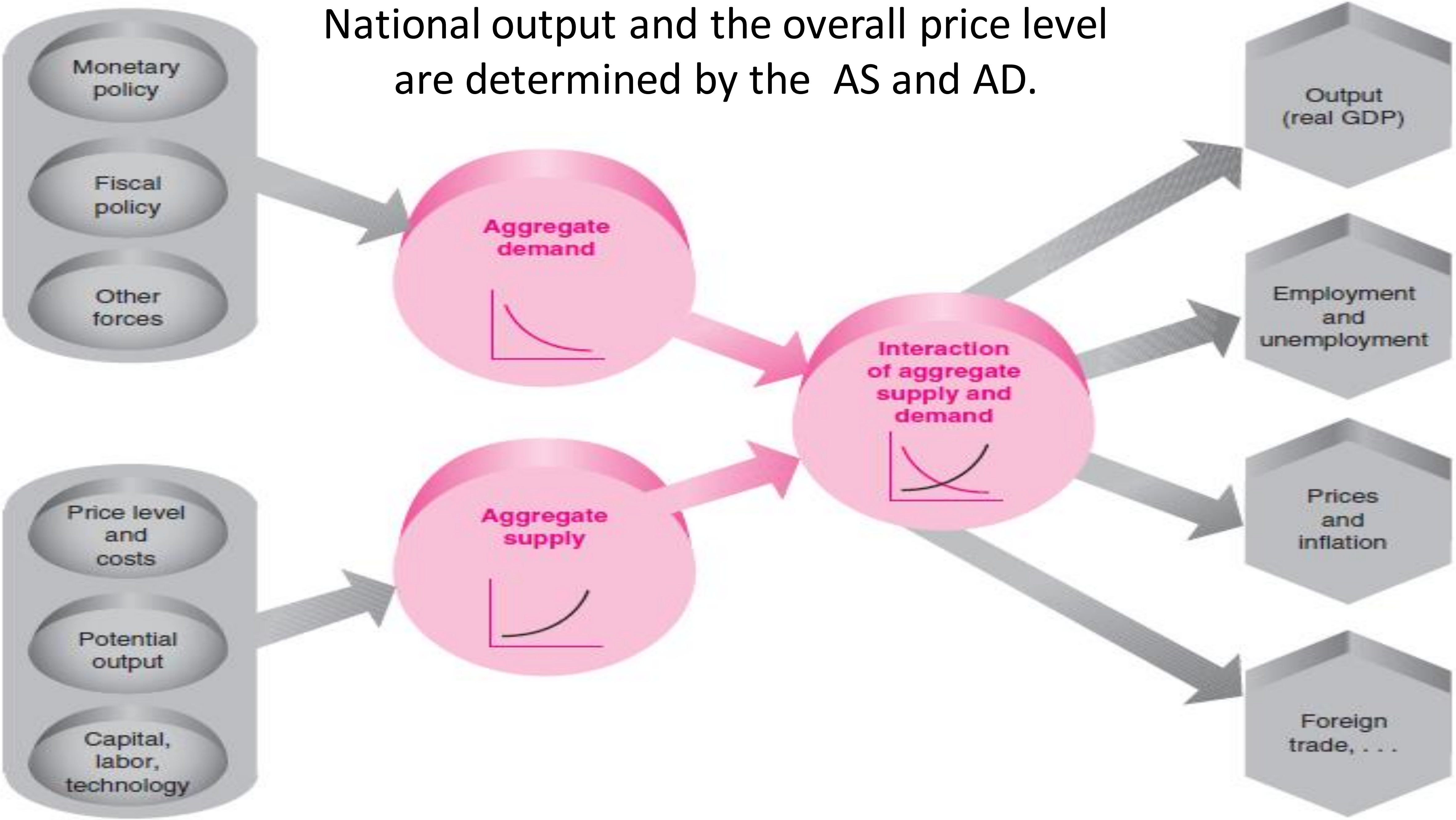
- AS refers to the total quantity of goods and services that a country’s businesses are willingly produce and sell during a given period of time.
- AS depends upon the ‘general’ level of price level (movement variable), the productive capacity of the economy/potential output and the level of costs (shift factors).
- Potential output is determined by the availability of inputs/resources/ factors of production and the state of technology. Generally regarded as the maximum level of output that an economy can sustain without generating inflationary pressure (Okun, 1962). This definition is particularly prevalent among monetary policy makers

Equilibrium Output and Price Level



Equilibrium Output and Price Level

National output and the overall price level are determined by the AS and AD.



Source: Samuelson and Nordhaus, Economics, 19th Edition

Thanks for your attention!