

Late pre-classical economics and classical economics (Smith)

LECTURE 3.

Late pre-classical economics and classical economics (Smith)

General characteristics of the period

- increase in economic activity
- markets become more important
- still pre-industrial economies, agriculture is the most important sector of the economies
- economic thought is developing from simple applications toward more complicated views of the economy

Main mercantilist ideas

- very diverse views on economic problems
- no systematic accounts of the entire economy
- the main economic problem: best economic policies for promoting the power and wealth of the nation, policies for increasing the power and prosperity of the nation
- assumed that the total wealth of the world is fixed and constant (zero-sum game assumption)
- What do you think about that?
- Average real global per-capita Gross Domestic Product increased by 38% from 1600 to 1800. Over the 200 years, as free-market ideas and practice took root, global GDP per capita increased by at least 1200%
 - GDP is the monetary measure of the market value of all final goods and services produced in a period (quarterly or yearly)
- the goal of the economic activity is production
- And about that?

Mercantilism (16th – 18th centuries)

- ideas produced in all European countries
- mercantilist writers were mostly merchant businessmen, bankers, practitioners of the economy etc.
- often focused on economic questions related to the writers' particular private interests
- huge growth in the quantity and quality of economic literature

Mercantilist ideas, cont.

- mercantilists advocated encouraging production, increasing exports and holding down domestic consumption
- they insisted on low wages of laborers to give the economy competitive advantage in international trade; wages should be set on the subsistence level (minimum income covering biological needs only); higher wages would lead to a decrease in labor supply and fall in the national output
 - Is this true? Why they argued for this in your opinion?
- so in result, they advocated the poverty of the masses
- they insisted on the notion of the positive balance of trade

Positive balance of trade

- mercantilists argued that in order to increase its wealth a nation should in the first place achieve a positive balance of foreign trade
- Is balance of trade a good (best?) indicator of wealth?
- Is positive balance of trade a good policy? Do we need imports?
- What about „economic patriotism” (e.g. „buy Polish products”)?
- What are the dangers of trade deficit?
- therefore, according to mercantilists a country should increase exports and discourage imports by means of tariffs, quotas, subsidies, and taxes
- Is imposing (higher) tariffs on imports (trade protectionism) a good policy?
- secondly, the government should stimulate national production by intervening in the economy, especially to help economic sectors producing export goods.
 - What about this policy?

Mercantilism today: Donald Trump

- Foreigners are “killing us on trade” because Americans spend much more on imports than the rest of the world spends on American exports. China’s unbalanced trade with the United States, he said Tuesday night, is “the greatest theft in the history of the world.”
- “Our trade deficit with China is like having a business that continues to lose money every single year,” Mr. Trump told The Daily News in August. “Who would do business like that?”
- In January 2018, Trump imposed tariffs on solar panels and washing machines of 30 to 50 percent. Later the same year he imposed tariffs on steel (25%) and aluminum (10%) from most countries. On July 6, the Trump administration set a tariff of 25% on 800 categories of goods imported from China worth \$50 billion

Why did mercantilists argue for the positive balance of trade?

- Early mercantilists (bullionists) defined nation's wealth in terms of its holdings of precious metals like gold or silver (bullion).
- Is this a good concept of wealth?
- These were the times when money was mainly gold or silver coins
- A positive balance of foreign trade ($E > I$), would lead to a flow of gold/silver into the economy

Why later mercantilists argued for the positive balance of trade?

- According to later mercantilists, wealth should be measured in real (non-monetary) terms (the level of production or real output).
- But, monetary factors (money supply = amount of circulating coins) are the chief determinants of the economic activity
- More money = more credit and more investment in the economy
- Therefore, they thought that increases in the quantity of money generate increases in the level of production or real output.
- Hence, a positive balance of trade (that is a flow of gold money into the economy) would increase overall production or real output, and therefore contribute to the increasing wealth of nation.
 - What do you think about this argument?

David Hume, *Political Discourses*, 1752

- Assumes that we live under the gold standard
 - International payments are in the form of gold
- Price specie-flow mechanism – positive balance of trade ($E > I$) leads to an increase in the specie within (English) economy, which in turn leads to ...
- a rise in the level of prices in this economy (with a positive balance of trade), and...
- in effect, exports in England will decrease and imports will increase because England prices will become relatively higher than those of other economies.

Classical economics (1776 – 1890)

- Interested mainly in long-run economic processes (economic growth; distribution of income over time etc.)
- Optimistic about the workings of free markets (markets are in some sense optimal mechanisms)

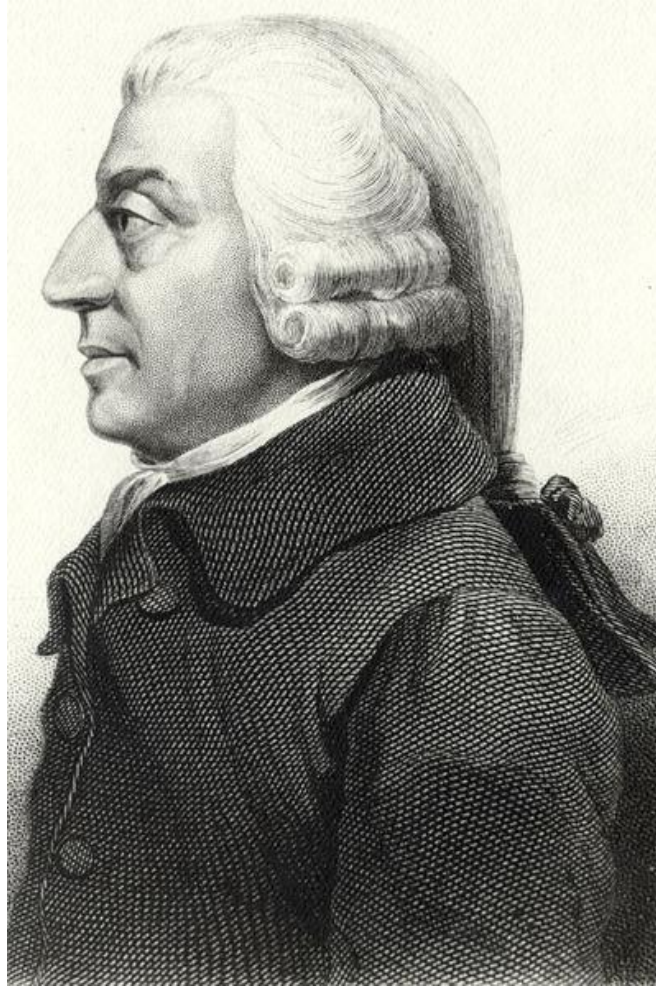
Main classical economists

- Adam Smith (1776-1790), *Wealth of Nations* 1776
- David Ricardo (1772-1823), *Principles of Political Economy and Taxation*, 1817
- John Stuart Mill (1806-1873), *Principles of Political Economy*, 1848

Economists related to classical economics

- Thomas Robert Malthus (1766-1834): demographic theory used by classicals
- Heterodoxy versus orthodoxy (or mainstream vs non-mainstream economics)
- Karl Marx (1818-1883): borrowed some classical ideas, but rejected most of others

Adam Smith (1723-1790)



Adam Smith

- Scottish economist, philosopher, wrote also on law, rhetoric and even astronomy
- Professor of Moral Philosophy at Glasgow University from 1752 to 1764
- Interested in broad social questions, not only economic ones
- Influenced by his teacher Francis Hutcheson (1694-1746) and by his personal friend philosopher-economist David Hume (1711-1776)

Adam Smith

- Often called “the father of economics”, because he was able to synthesize his and previous achievements into one coherent, integrated system explaining:
 - how markets function (price determination),
 - how economic growth operates,
 - what policies accelerate economic growth,
 - how domestic economy interacts with others (international trade),
 - what is the appropriate role for the state in the economy, etc.
- Not a great theoretical economist (but advanced e.g. price theory, growth theory, trade theory, etc)
- Biggest impact in terms of promoting and popularizing the economic policy and economic worldview of **free market capitalism with very limited government interventionism (state as a night watchman, minimal state role in the economy)**
 - **Direct and largest impact in Anglo-Saxon countries, but through Americanization of culture in the XX century also in other regions (e.g. in Poland)**

Adam Smith

- Main economic work:

Inquiry into the Nature and Causes of the Wealth of Nations, 1776

- Wrote also on: rhetoric, the law, and even astronomy

Subject and methodology of the *Inquiry into the nature and causes Wealth of Nations*

- Main problem – causes of the national income, forces of the economic growth and policies for encouraging growth
- Methodology – deductive reasoning combined with historical description

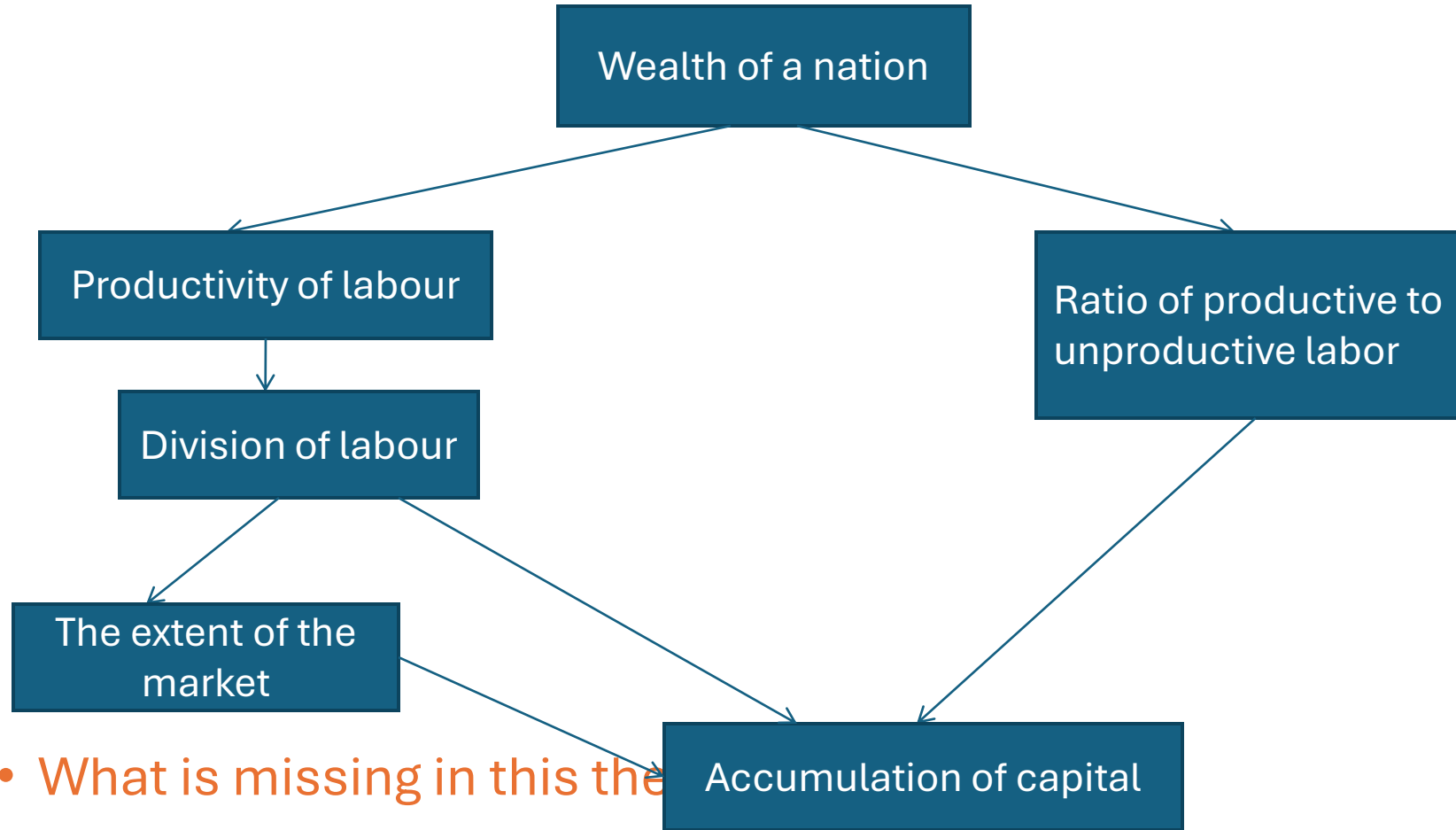
Theoretical achievements of A. Smith

- Theory of economic growth
- Theory of international trade
- Value theory (theory of relative prices)
- Distribution theory

Adam Smith's theory of economic growth

- Wealth of a nation = an annual flow of material goods (services not included, unproductive labor)
- Consumption, not production is the ultimate end of economic activity
- Wealth of nations should be measured in *per capita* terms

What are the causes of the wealth of nations?



Benefits from the division of labour - pin factory example

- Without specialization productivity was:
maximum 20 pins a day per worker
- With extensive specialization productivity rose to
4800 pins a day per worker
- Why?
- Learning by doing
- Saving time
- Small improvements to tools
- Are there any downsides of extensive job or task specialization?

Smith's assumptions in matters of economic policy

- humans maximize their own gains (self-interest, homo oeconomicus)
- free markets exist (free movement of the factors of production, no government obstacles to that)

Smith's economic policy

- There is a natural process at work in the economy, which leads from private self-interest to the public good for society.
 - So harmony emerges out of potentially conflicting self-interests
- The process is described as working through the invisible hand (of markets)

Smith's invisible hand – a quotation from the Wealth of Nations

„As every individual, therefore, **endeavours as much as he can** both to employ his capital in the support of domestic industry, and so **to direct that industry that its produce may be of the greatest value**; every individual necessarily labours to render the annual revenue of the society as great as he can.

He generally, indeed, neither intends to promote the public interest, nor knows how much he is promoting it.

By preferring the support of domestic to that of foreign industry, he intends only his own security; and by directing that industry in such a manner as its produce may be of the greatest value, he intends only his own gain, **and he is in this, as in many other cases, led by an invisible hand to promote an end which was no part of his intention.**

Nor is it always the worse for the society that it was no part of it. By pursuing his own interest he frequently promotes interest of the society more effectually than when he really intends to promote it. I have never known much good done by those who affected to trade for the public good”. (*emphasis added*)

Smith's arguments for laissez-faire

- The phrase *laissez-faire* is French and literally means "let [them] do", but it broadly implies "let it be," "let them do as they will," or "leave it alone".
- So it implies a free market based economy with no or minimal state interventionism (regulations, coercion, restrictions, taxes, etc.)
- Did not prove rigorously that markets without (or with little) interventionism (a system of **laissez-faire**) lead to the best possible economic order
- For example, did not prove that producers employ the optimal (the most efficient) combination of factors of production or that consumers buy the optimal (maximizing satisfaction) bundle of commodities
- But pointed to (and analyzed informally) some steps in such a reasoning (low prices, high growth)
- Opposed monopoly – realized that monopoly prices are higher than competitive prices
- Reviewed past mercantilist regulations and analyzed their inefficiency

Smith's view on the role of the government („night-watchman state”, minimal state)

- Adam Smith advocated only qualified (not complete) laissez-faire policy; he saw some exceptions from laissez-faire:
 - system of justice;
 - national defense;
 - provision of quasi-public goods (roads, bridges, navigable canals, post-office, basic education etc.):

„... last duty of the sovereign or commonwealth is that of erecting and maintaining those public institutions and those public works which though they may be in the highest degree advantageous to a great society are, however, of such a nature that the profits could never repay the expenses to any individual or small number of individuals, and which it therefore cannot be expected that any individual or small number of individuals should erect."

Summary of Adam Smith's economics

- Extremely influential, especially in economic policy (laissez-faire)
- Interested mainly in understanding the process of competition, workings of the free market, economic policy and causes of economic growth
- Supporter of (qualified) laissez-faire: policy of government non-intervention (3 exceptions)
- Contextual economic policy
- His theories of economic growth, value and distribution inspired later classical economists
- Provided a grand vision of the free market economy, guided by the invisible hand, that leads from private interests to social optimum.

Practice 3.

- <https://www.youtube.com/watch?v=jNmQM2rECjc>
- [Afrika legnagyobb gettója: veszélyes és zsúfolt, akkor miért jó ott lakni? - Első rész](#)
- [Ilyen lopást még nem látott: egy egész gettót ejtettek túszul a kartellek](#)
- [Honnan származik, hogy a jóból is megárt a sok? | 24.hu](#)
- [Miért fontos a boldogságszint mérése? - Világgazdaság](#)

- [Can Money Really Buy Happiness? | Psychology Today](#)
- [Understanding Life in The Ghetto | Namibia, Africa | Documentaries | Part 2 |](#)
- [\(470\) Windhoek Ghetto life || Havana Namibia || Namibia Documentaries #CommunitySpirit || ExploreLife - YouTube](#)

Lecture 4.

Classical Economics after Adam Smith

- David Ricardo (1772-1823)
- Thomas Malthus (1766-1834)
- Malthus vs. Ricardo on the problem of stability of capitalism
- Ricardo – contributions to methodology of economics, theory of value, international trade theory, public finance, distribution theory etc.

Thomas Malthus (1766-1834)



Thomas Malthus' principle of population

- Malthus, *Essay on the Principle of Population*, 1798, 1803
- Malthus's population principle (population thesis) - population tends to increase faster than the food supply
- Assumptions:
 - Food is necessary for the existence of humankind;
 - Passion between sexes is necessary and will remain unchanged.

Thomas Malthus' principle of population, cont.

- In absence of checks on population growth it will grow in geometric progression (i.e. 1, 2, 4, 8, 16...), while food supply increases arithmetically (i.e. 1, 2, 3, 4, 5,...).
- But, in reality checks on population will develop in society to keep the rate of population growth in line with the growth rate of food supply.

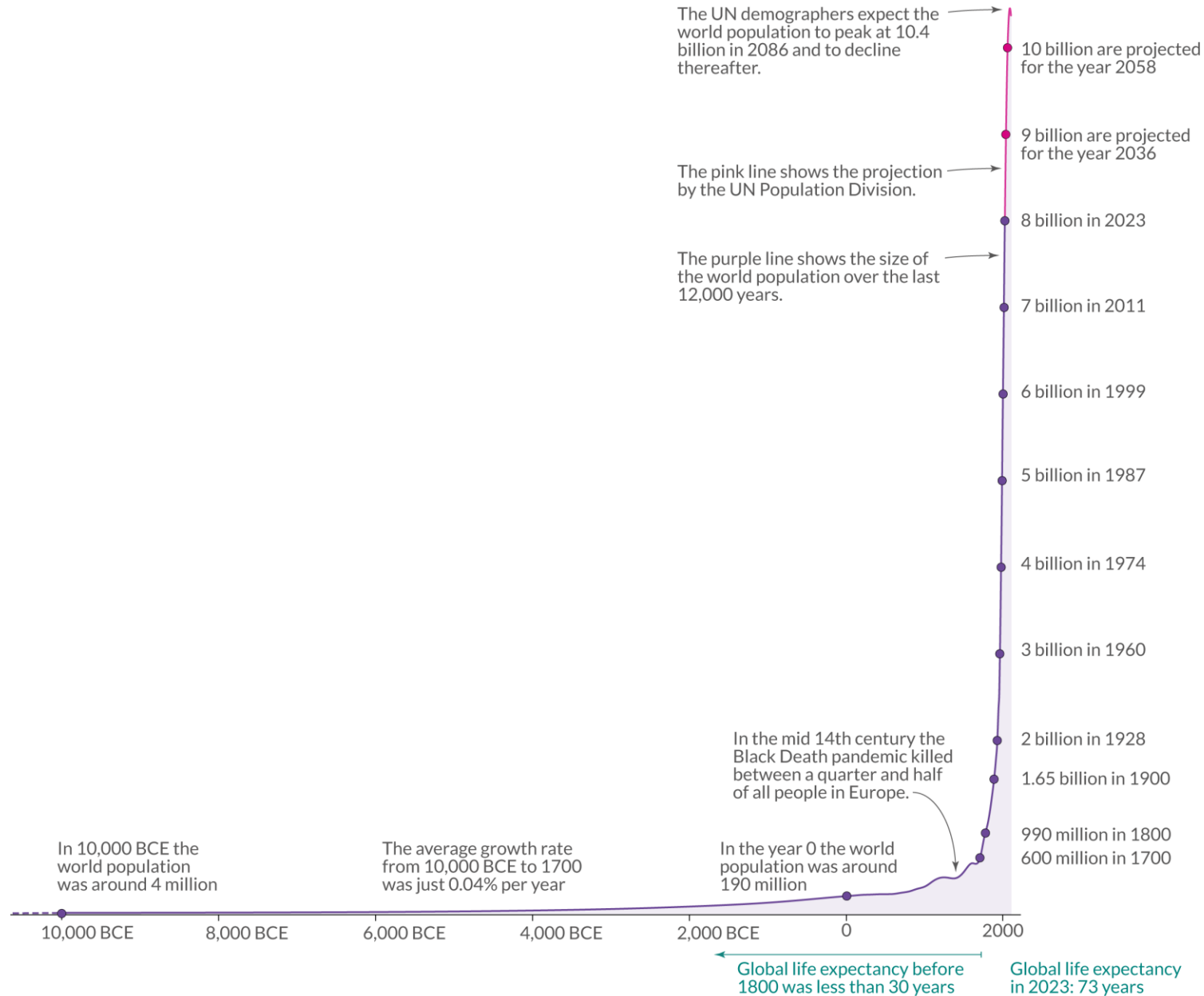
Thomas Malthus' principle of population, cont.

- Population checks:
- 'Positive' – increases in the death rate in result of wars, famines, diseases etc.
- Preventive – postponement of marriage, prostitution, contraception, moral restraint etc.

Thomas Malthus' principle of population, cont.

- Economic implication of Malthus's population principle:
 - There is mass poverty in the society and you can not help it; if the welfare of the poor is increased above the subsistence level, they start to reproduce at a higher rate than the rate of growth of their welfare and in the end the welfare of the poor returns to the subsistence level.
- Malthus's principle was used to defend the so-called 'iron law of wages' – wages of labourers can never rise above the subsistence level (it allows the labourers barely to survive).
- What is wrong with Malthusian theory?

The size of the world population over the long-run

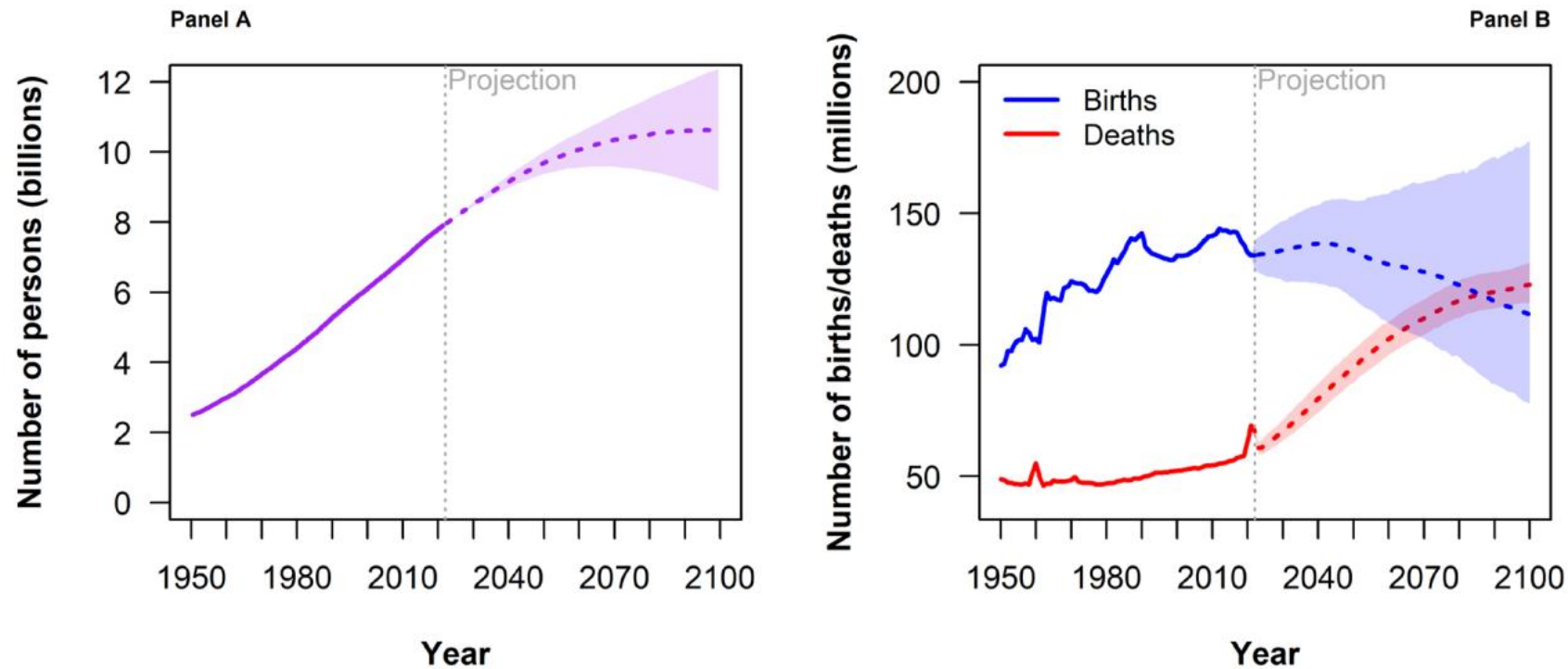


<https://ourworldindata.org/population-growth-over-time>

United Nations' World Population Prospects 2022

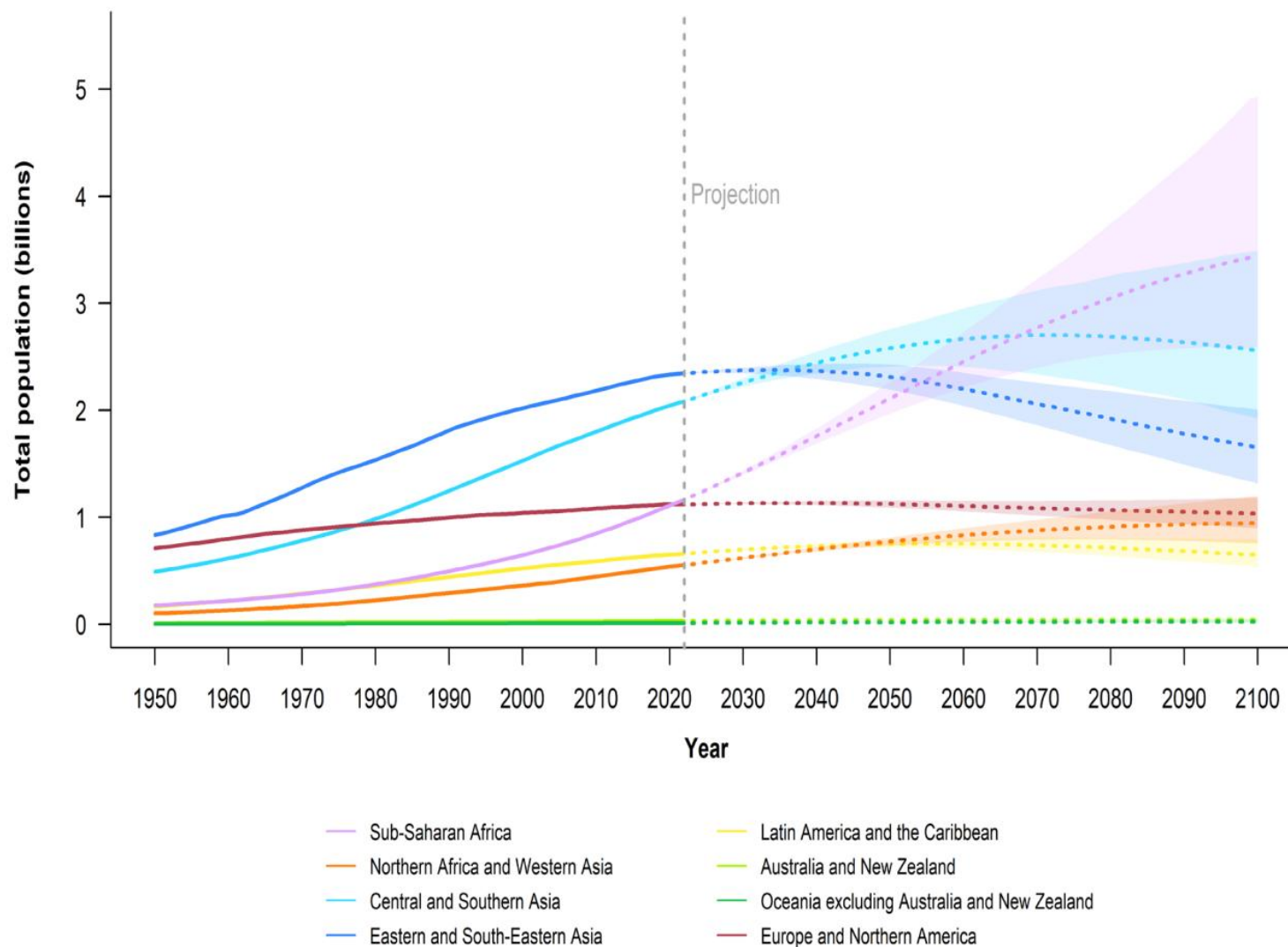
Figure III.1

Global population size and total number of births and deaths, estimates (1950-2022) and medium scenario with 95 per cent prediction intervals, 2022-2100



United Nations' World Population Prospects 2022

Population by SDG region: estimates, 1950-2022, and medium scenario with 95 per cent prediction intervals, 2022-2100



South Korea's Falling Fertility Rate

Long workdays, low wages, and dwindling marriage rates are some of the constraints on childbearing

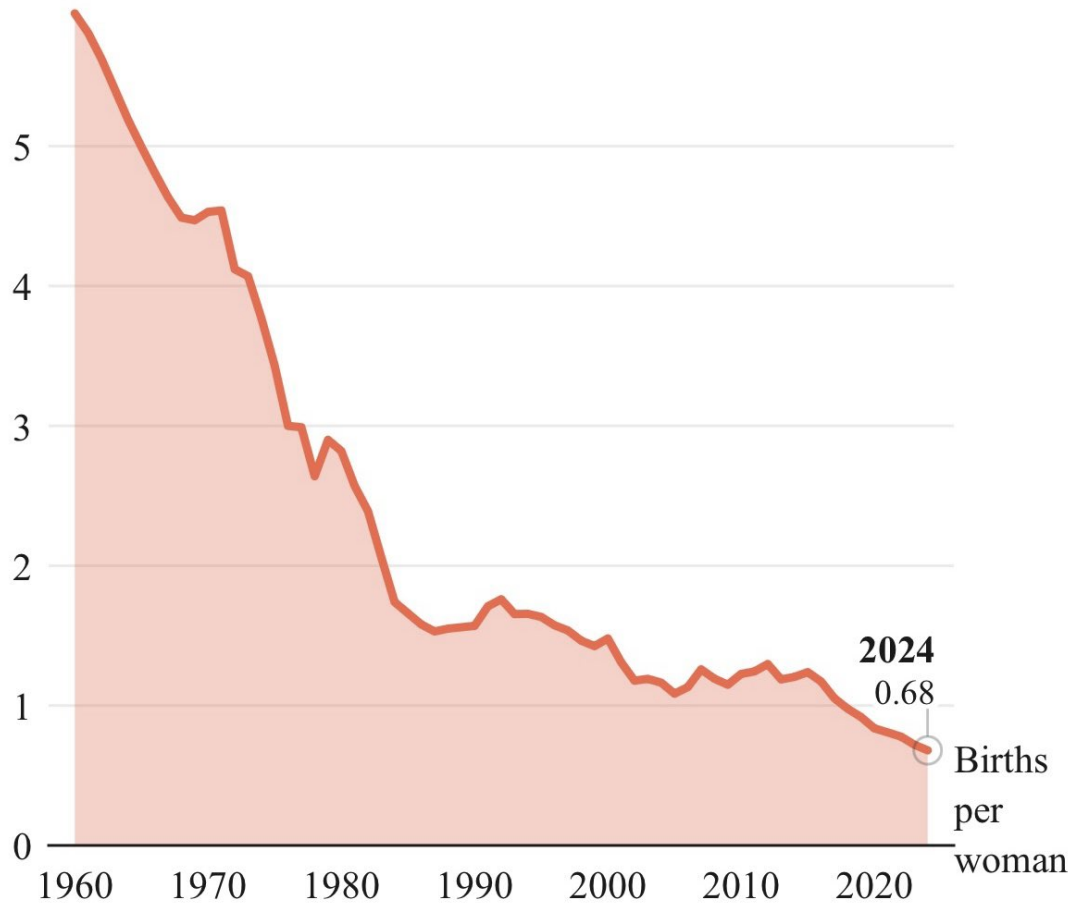


Chart: CFR/Caroline Kantis • Source: [World Bank](#)

Think Global Health

From a tweet on X:

“If a generation of 30 million people has a fertility rate of 0.68, the next generation contains only 10.2 million people.

The first generation's grandkids number only about 3.5 million, and their great-grandkids number only about 1.2 million.

Korea will disappear overnight.”

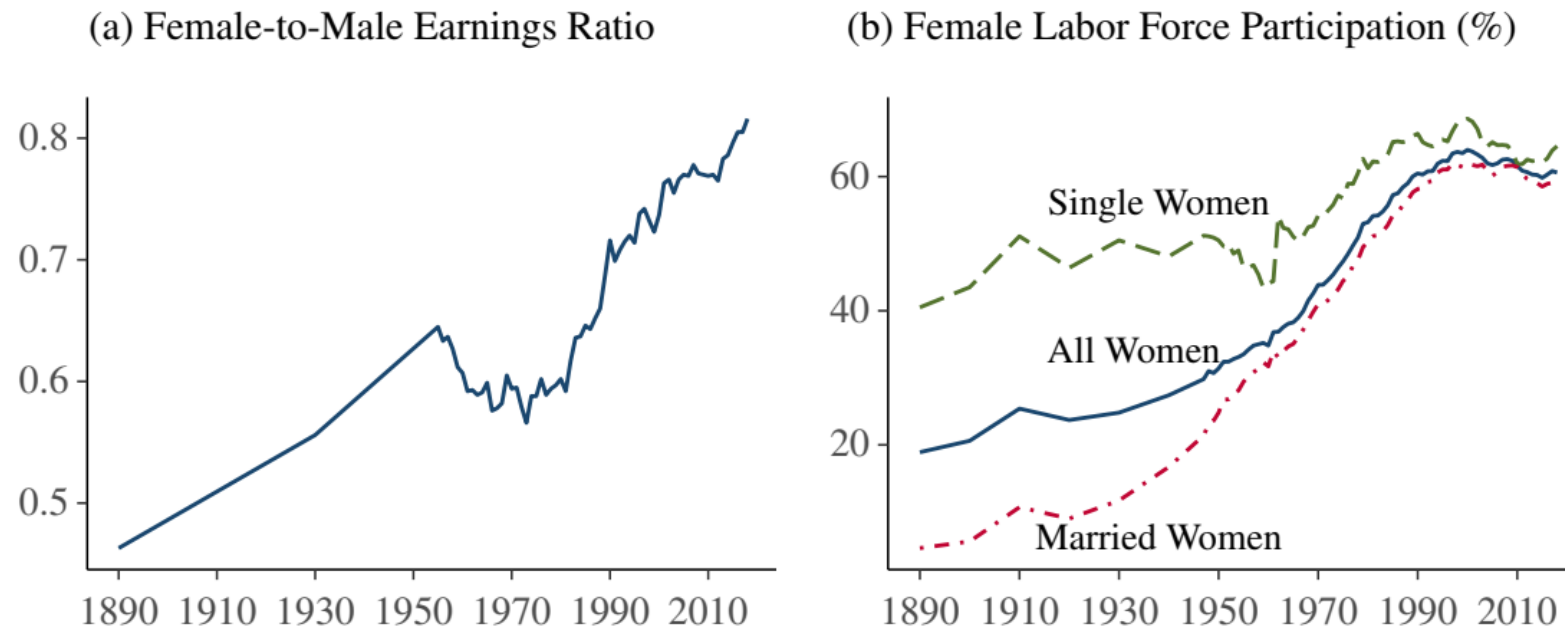
Demographics of South Korea

Why fertility is declining around the world?

- Income growth and substitution effect (earning higher wages instead of having more children) dominating the income effect (children are more affordable)
- Changing social norms about life goals, marriage, having children
- Increased cost of raising children?
- Public pension systems and safety nets (no need for having children as insurance against old-age poverty)

Doepke, M., Hannusch, A., Kindermann, F., & Tertilt, M. (2022). The Economics of Fertility: A New Era (No. 17212). CEPR Discussion Papers.

Figure 5: Female Labor Market Opportunities, United States



Sources: Panel (a): Female-to-male ratio of median earnings between 1890 and 2018. Data for 1890 and 1930 and 1955 to 1959 comes from [Goldin \(1990\)](#). Data from 1960 to 2018 comes from [Shrider et al. \(2021\)](#), Table A-7. Panel (b): Female labor force participation for the 16 and older age group. Data between 1890 and 1961 comes from [US Department of Commerce \(1975\)](#), Tables D49–62. Data from 1962 to 2018 comes from the CPS-ASEC, author's calculations. Singles do not include widowed, divorced, or separated women.

Is declining fertility an economic problem?

- Main measure of economic standard of living:
 - $\text{GDP per capita} = \text{GDP} / \text{population}$
- Labor supply may shrink
 - Not enough people to work in firms → shortages of produced goods
 - How to counteract this?
 - Upward pressure on wages → inflation
- Coupled with rising life expectancy declining fertility leads to a reduction in the number of workers per retired persons
 - In pay-as-you-go pension systems there is a fall in contributions to the system → need to compensate from other tax revenues → budget deficit or cut other expenditures or raise taxes
 - How can we cope with this in other ways?
- Innovation and technological progress
 - AGI? What could be the impact of AGI on economic growth?
- Lowering down consumption and domestic demand → reduction in investment by firms → long run stagnation

Malthus's arguments against the stability of capitalism

- Labour does not receive the whole product produced in the economy – demand created by the labour class is not sufficient to purchase all final goods at market prices.
- Too much savings in capitalism can produce troubles in the long-run
- Today's savings reduce the demand for consumer's goods, but the process of investment leads to production of more consumer's goods in the future – but the demand for those goods is already reduced. So in the long run consumers' demand will not be sufficient to purchase all final goods produced.

Practice 4.

- [What is Capitalism? Capitalism Explained | Pros and Cons of Capitalism? Who is Adam Smith?](#)
- **What is capitalism?**
- **What types are there?**
- **How does Adam Smith come into this again? What are the arguments in favor of it?**
- **What are the arguments against it?**

POGÁTSA ZOLTÁN: Mi a kapitalizmus?

190. Mi a kapitalizmus?

- Why do we talk so little about capitalism?
- Is there a definition of capitalism? Is it uniform?
- Is growth a natural phenomenon?
- Private property and market/competition. Do these two words describe capitalism?
- What is the main characteristic of capitalism?
- How is specialization related to growth and how is it related to interdependence between nations?
- How does methodological individualism relate to the topic?
- Max Weber: The Protestant Ethic and the Spirit of Capitalism
- How did the first large companies come about?