

# CHALLENGING MERCANTILISM: THE IMPACT OF DAVID HUME ON THE EVOLUTION OF MONETARY THOUGHT

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*Despite its somewhat irrational and outdated nature, mercantilist sentiment is very much alive today. In times of economic slowdown, it often bubbles to the surface of popular economic discourse, threatening to make an unwelcome return to politics and policy. The spirits of mercantilism and protectionism have always gone very much hand in hand. In this paper, Alexander Toft provides an excellent appraisal of David Hume's monetary thought, in particular examining his attack on the 17th century mercantilist monopoly over economic discourse.*

## Introduction

The history of economic thought can be viewed as a series of ideological battles, and key amongst them must rank the debate surrounding the notion that the government has a role to play in ensuring a more favorable balance of trade – what is commonly called mercantilism. Adam Smith is often credited with initiating this debate when he attacked the concept in *The Wealth of Nations* (Smith, 1776). However, this paper will examine the work of another original detractor from mercantilist thinking, David Hume. A philosopher and historian first and foremost, Hume was also an eminent economist. This paper will argue that through his analysis of the influence of money on inflation and the balance of payments, Hume played a pioneering role in challenging the mercantilist monopoly on economic thought. He contributed towards the development of an alternative theory which centered on free trade, as opposed to a ‘fear of goods’ and ‘love of money’. To this end, the following paper will outline and analyze Hume’s work on monetary policy, breaking it into three main components: his view of money, the interest rate and the balance of payments. Finally, the impact of these ideas on the evolution of economic thought will be considered.

## Mercantilism

Before we begin, it is important to define what exactly mercantilism is. According to Speigel, the concept has its roots in the ‘bullionist’ regulations of medieval times, but took hold as a more formal doctrine when developed and articulated by writers such as Sir Thomas Mun in the early seventeenth century (Speigel 1991). It is undoubtedly a rather general concept with many possible interpretations. However, perhaps its defining feature is the belief that monetary balances, as the key source of a nation’s wealth, are crucial to the state and should thus be supported by protectionist policies. More specifically, it was (and still is) a view which held:

‘that a favorable balance of trade was of transcendent importance for a nation’s political economy; that a low rate of interest was caused by the bullion surplus earned by a favorable trade balance; and that both at home and abroad the control over the use of resources should be regarded as a zero-sum game in which what one country gained another lost’ (Rostow, 1990: 21).

This attitude is what Hume was contending against. Keeping this in mind, we are now ready to discuss his work.

## Hume’s Monetary Thought

Hume’s economic writings constitute only a small fraction of his work, but nonetheless cover a wide range of topics, from commerce to public credit. These writings can be largely derived from the essays that make up his *Political Discourses* (1752). In this section we will limit our analysis to his work on money, interest rates, and the balance of payments, examining each in turn.

### Of Money

In the essay *Of Money*, Hume challenges traditional mercantilist thinking by claiming that ‘money is not, properly speaking, one of the subjects of commerce; but only the instrument which men have agreed upon to facilitate the exchange of one commodity for another’ (Hume, 1752 cited in Rotwein, 1998: 33). Its value is therefore ‘fictitious’ and nothing more than ‘the representation of labor and commodities’, which are the true sources of economic power (ibid: 37). A key implication of this definition is that money is neutral; changing its quantity affects nothing but the price level (Niehans, 1990: 52). Consequently, in a closed

economy, ‘it is evident, that the greater or less plenty of money, is of no consequence’ (Hume, 1752 cited in Rotwein, 1998: 33). Money does not constitute the wealth of a nation or the ‘wheels of trade’ as mercantilism often holds, but is simply ‘the oil which renders the motion of the wheels more smooth and easy’ (ibid: 33).

Hume does not suggest, however, that money is irrelevant. In an open economy, the inflationary effects of money give it significance. The logic is as follows: when a country grows rich through trade and specie accumulation it experiences higher prices, including higher wages. The resulting cost pressures lead manufacturers to leave the country and relocate elsewhere, ‘whither they are allured by the cheapness of provisions and labour’ (ibid: 34, 35). Thus:

‘the dearness of every thing, from plenty of money, is a disadvantage, which attends an established commerce, and sets bounds to it in every country, by enabling the poorer states to undersell the richer in all foreign markets’ (ibid: 34,35).

Therefore, money can have the effect of undermining a country’s ability to engage in profitable foreign trade.

Hume provided an important break from mercantilist thought by suggesting that the value of money is ultimately fictitious and that an increase in the money supply has inflationary effects, which may be damaging to a country’s economy. However he did acknowledge that:

‘in every kingdom, into which money begins to flow in greater abundance than formerly, everything takes a new face; labor and industry gain life; the merchant becomes more enterprising, the manufacturer more diligent and skilful, and even the farmer follows his plough with greater alacrity and attention’ (ibid: 37).

What Hume identifies here is the seemingly paradoxical short-term non-neutrality of money, despite its long-term neutrality. The explanation for this phenomenon can be considered one of his greatest contributions to economics – that an increase in the money supply is not immediately followed by an increase in the price level. Rather there exists an interval between an increase in the money supply and a rise in prices during which money gradually disperses from the hands of a few merchants, stimulating industry and increasing both output and employment. Nevertheless, in the long-run, ‘the whole effect [exhausts] itself out in neutral price increases’ (Niehans, 1990: 54). Such a theory leads Hume to

advocate a monetary or trade policy which maintains a gradually increasing money supply, arguing that:

‘the good policy of the magistrate consists only in keeping [money], if possible, still encreasing; because, by that means, he keeps alive a spirit of industry in the nation, and encreases the stock of labour, in which consists all real power and riches’ (Hume, 1752 cited in Rotwein, 1998: 39, 40).

### **Of Interest**

Hume’s thoughts on the interest rate derive from his views on money. In particular, his belief that money possesses a fictitious value allows him to dismiss the notion, later defended by J.M. Keynes in *The General Theory* (1937), that a low interest rate is a result of a high money supply. Indeed, in *Of Interest*, Hume suggests that the rate of interest is ‘not derived from the quantity of precious metals’ at all (ibid: 48).

However, he does not dismiss the actuality that ‘nothing is esteemed a more certain sign of the flourishing condition of any nation than the lowness of interest’ (ibid: 47). Rather it is argued that low interest rates have sources other than money. These sources include a low demand for borrowing, an abundance of riches to supply that demand, and small profits arising from commerce – all of which derive from ‘the encrease of industry and commerce, not of gold and silver’ (ibid: 49). In this way, interest rates reflect the supply and demand of real capital, which in large part are dependent upon ‘the habits and way of living of the people’ (Spiegel, 1991: 211).

In proposing such a theory, Hume provided a unique counterpoint to mercantilist thinking. Economists such as Sir William Petty had, in some ways, already managed to play down the role of money as a driving force in the economy. However, Hume more specifically demonstrated that money is unable to produce low interest rates, undermining the logic that Keynes would eventually use to defend mercantilist policies (Higgs, 1926: 342).

### **Of the Balance of Trade**

For the purposes of this paper, *Of the Balance of Trade* represents the culmination of Hume’s economic writings as it contains his most direct attack on mercantilism. In it, he dismisses as ‘groundless apprehension’ what he perceives to be mercantilist ‘jealousy with regard to the balance of trade, and a fear, that all their gold and silver may be leaving them’ (Hume, 1752 cited in Rotwein, 1998:

61). This reasoning can be traced back his theories on money and is explained in the following key passage outlining the logic behind the price-specie flow mechanism:

‘Suppose four-fifths of all the money in Great Britain to be annihilated in one night, and the nation reduced to the same condition, with regard to specie, as in the reigns of the Harrys and the Edwards, what would be the consequence? Must not the price of all labour and commodities sink in proportion, and everything be sold as cheap as they were in those ages? What nation could then dispute with us in any foreign market, or pretend to navigate or to sell manufactures at the same price, which to us would afford sufficient profit? In how little time, therefore, must this bring back the money which we had lost, and raise us to the level of all neighbouring nations? Where, after we have arrived, we immediately lose the advantage of the cheapness of labour and commodities; and the farther flowing in of money is stopped by our fullness and repletion’ (ibid: 63).

The price-specie flow mechanism constitutes perhaps Hume’s most important contribution to economic thought and can be summarized as follows: in an open economy, a fall in the money supply leads to a fall in prices which boosts exports, resulting in an inflow of money that eventually raises the price level back to its original position. So what Hume describes is ‘an automatic feedback control mechanism’ through which the amount of specie in each nation automatically reverts towards an equilibrium where exports and imports are in balance (Niehans 1990: 55). This monetary influence on the balance of payments contradicts the mercantilist notion that a country can maintain a continuously favorable balance of trade. This implies that the amount of specie a nation can accumulate does not derive from protectionist policies, but is dependent upon a nation’s level of economic development, which is determined in turn by its population and the ‘spirit of industry of its people’ (Eatwell et al, 1987: 693).

It is important to recognize, however, that in *Of the Balance of Trade* Hume does not simply set out to discredit the protectionist policies that may arise from a mercantilist obsession with money. Rather he is attempting to provide a robust defense of free trade (Rostow 1990: 21). In his own words:

‘From these principles we may learn what judgment we ought to form of those numberless bars, obstructions, and imposts, which all nations of Europe, and none more than England, have put upon

trade; from an exorbitant desire of amassing money, which never will heap up beyond its level, while it circulates; or from an ill-grounded apprehension of losing their specie, which never will sink below it. Could any thing scatter our riches, it would be such impolitic contrivances. But this general ill effect, however, results from them, that they deprive neighbouring nations of that free communication and exchange which the Author of the world has intended, by giving them soils, climates, and geniuses, so different from each other' (Hume, 1752 cited in Rotwein, 1998: 75).

According to Hume, trade is by no means a zero-sum game, but rather is critical to the promotion of a country's economic development. Spiegel suggests that: '[for Hume], individuals as well as nations need not fear the prosperity of their neighbours; they can only benefit from being members of a prosperous community' (Spiegel, 1991: 209).

## Hume's Impact

At this point we have analyzed some key aspects of Hume's monetary thought. But what impact did such thoughts have? The influence of Hume's writings on his friend and countryman Adam Smith has been well documented. In particular, his belief in economic individualism and critical attitude towards the mercantilists was shared by Smith, even if he surprisingly failed to mention Hume's price-specie flow mechanism (Spiegel 1991).

However, Hume's legacy extends even further than his own time. There are a number of striking similarities with twentieth century economists such as Milton Friedman. In the *Quantity Theory of Money* (1987), which tellingly opens with a passage from Hume, Friedman concludes that the short-run effect of a change in the money supply is primarily on output, but that the long-run effect is on the price level. It can be argued that Friedman's conclusions quite clearly resemble Hume's own pivotal notion that the inflationary effect of an increase in money supply is a gradual process, causing money to exhibit short-term non-neutrality (Wennerlind, 2005: 224). In addition, his argument in *The Role of Monetary Policy* (Friedman, 1968) that steady, moderate growth in the money supply would be good for the economy and avoid both inflation and deflation is the same conclusion Hume reaches in *Of Money*. Friedman was perhaps best known as a proponent of free-markets. Once again, Hume's explicit and implicit attacks on protectionist policies and his promotion of free-trade at a time when mercantilist thinking still ruled, makes him an important forerunner in this

respect.

But does this really afford Hume a key place in the canon of monetary thought? After all, his views on wealth, interest and his general opposition to mercantilist thinking can be said to have been preceded by economists such as Barbon, Berkeley and Massie in the same way we have argued that his writings preceded Smith's and Friedman's (Higgs, 1926: 341). This paper argues that Hume does deserve such a place because he was able to combine the ideas of his predecessors and contemporaries into a systematic whole which presented an alternative to mercantilist thought. His writings prepared the way for a new set of doctrines specifically designed to replace the traditional teachings of Adam Smith's predecessors. Indeed that 'new set of doctrines' has proved remarkably enduring. The second half of the twentieth century can be viewed as the triumph of free-trade and globalization following the struggle between a Keynesian belief in the merits of government regulation and the free market system (Yergin and Stanislaw, 1998). Hume's role as one of the original detractors from mercantilists thinking and key architect of 'classical' economics suggests he was critical to this eventual triumph.

## **Conclusion**

The ideological debate over the merits of mercantilism is far from over. However the purpose of this paper is not to suggest that mercantilism is either right or wrong, but to highlight the critical role of David Hume in providing an alternative to the mercantilist monopoly on seventeenth century economic thought. Hume argued that the value of money is 'fictitious'. He outlined the long-term neutrality of money, in particular its inability to affect the interest rate, by demonstrating the inflationary effects of increases in the money supply. Finally, he challenged the view that foreign trade is simply 'a strategic device to produce specie' (Spiegel, 1991: 208). He proposed a relationship between money, the price level, and the balance of payments, culminating in his price-specie flow mechanism, which provided an important counterpoint to traditional mercantilist thinking. Hume will perhaps always be best remembered for his work as a philosopher and historian, but his contribution to economic thought appears no less significant.

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