# Banking History – Part 8

**Mike Morley**

## *Adam Smith (1723 - 1790)*

Smith believed that economic development was best fostered in an environment of free competition that operated in accordance with universal "natural laws." Because Smith's was the most systematic and comprehensive study of economics up until that time, his **economic** thinking became the basis for classical **economics**.

He studied at Glasgow and Oxford Universities. He returned to Kircaldy in 1746 and two years later he was asked to give a series of public lectures in Edinburgh, which established his reputation.

In 1751, Smith was appointed professor of logic at Glasgow University and a year later professor of moral philosophy. He became part of a brilliant intellectual circle that included David Hume, John Home, Lord Hailes and William Robertson.

In 1764, Smith left Glasgow to travel on the Continent as a tutor to Henry, the future Duke of Buccleuch. While travelling, Smith met a number of leading European intellectuals including Voltaire, Rousseau.

In 1776, Smith moved to London. He published what he intended to be the first part of a complete theory of society, covering theology, ethics, politics and law. This volume, 'Inquiry into the Nature and Causes of the Wealth of Nations', was the first major work of political economy. Smith argued forcefully against the regulation of commerce and trade and wrote that if people were set free to better themselves, it would produce economic prosperity for all.

In 1778, Smith was appointed commissioner of customs in Edinburgh. In 1783, he became a founding member of the Royal Society of Edinburgh. He died in the city on 17 July 1790.

### The Wealth of Nations:

### The book's broad themes

The first theme in The Wealth of Nations is that regulations on commerce are ill-founded and counterproductive. The prevailing view was that gold and silver was wealth, and that countries should boost exports and resist imports in order to maximize this metal wealth. Smith's radical insight was that a nation's wealth is really the stream of goods and services that it creates. Today, we

would call it gross national product. And the way to maximise it, he argued, was not to restrict the nation's productive capacity, but to set it free.

Another central theme is that this productive capacity rests on the division of labour and the accumulation of capital that it makes possible. Huge efficiencies can be gained by breaking production down into many small tasks, each undertaken by specialist hands. This leaves producers with a surplus that they can exchange with others or use to invest in new and even more efficient labour-saving machinery.

Smith's third theme is that a country's future income depends upon this capital accumulation. The more that is invested in better productive processes, the more wealth will be created in the future. But if people are going to build up their capital, they must be confident that it will be secure from theft. The countries that prosper are those that grow their capital, manage it well, and protect it.

A fourth theme is that this system is automatic. Where things are scarce, people are prepared to pay more for them: there is more profit in supplying them, so producers invest more capital to produce them. Where there is a glut, prices and profits are low, producers switch their capital and enterprise elsewhere. Industry thus remains focused on the nation's most important needs, without the need for central direction.

But the system is automatic only when there is free trade and competition. When governments grant subsidies or monopolies to favoured producers, or shelter them behind tariff walls, they can charge higher prices. The poor suffer most from this, facing higher costs for the necessities that they rely on.

A further theme of The Wealth Of Nations is that competition and free exchange are under threat from the monopolies, tax preferences, controls, and other privileges that producers extract from the government authorities.

For all these reasons, Smith believes that government itself must be limited. Its core functions are maintaining defence, keeping order, building infrastructure and promoting education. It should keep the market economy open and free, and not act in ways that distort it.

**Production and exchange**

The Wealth of Nations begins with Smith explaining production and exchange, and their contribution to national income. Using the example of a pin factory, Smith shows how specialisation can boost human productivity enormously. By specialising, people can use their talents, or acquire skill. And they can employ labour-saving machinery to boost production. Then they exchange those

specialist products, spreading the benefits of specialisation across the whole population.

How far and how fast the benefit spreads depends on how wide and efficient is the market. Often, employers try to rig markets in their own interests, and call on governments to help them. But the best interests of ordinary people are served if policymakers avoid such interventions and promote open competition.

**The accumulation of capital**

Smith goes on to say that building up capital is an essential condition for economic progress. By saving some of what we produce instead of immediately consuming it, we can invest in new, dedicated, labour-saving equipment. The more we invest, the more efficient our production becomes. It is a virtuous circle.

Thanks to this growth of capital, prosperity becomes an expanding pie: everyone becomes richer. But capital can be lost, through mistakes, or theft, or profligate government spending. Governments should aim to allow people to build up capital in the confidence that they will enjoy its fruits and should be aware that their own taxation and spending will eat into the nation's productive capital.

**Economic policy**

Just as individuals gain from specialisation, says Smith, so do nations. There is no point trying to grow grapes in Scotland when they grow so plentifully in France. Countries should do what they are best at and trade their products. Restrictions on international trade inevitably make both sides poorer. Legislators think too much of themselves when they believe that by intervening, they can direct production better than the market can.

**The role of government**

Smith is critical of government and officialdom, but is no champion of laissez-faire. He believes that the market economy he has described can function and deliver its benefits only when its rules are observed – when property is secure and contracts are honoured. The maintenance of justice and the rule of law is therefore vital.

So is defence. If our property can be stolen by a foreign power, we are no better off than if our own neighbours steal it. And Smith sees a role for education and public works too, insofar as these collective projects make it easier for trade and markets to operate.

Where tax has to be raised for these purposes, it should be raised in proportion to people's ability to pay, it should be at set rates rather than arbitrary, it should be easy to pay, and it should aim to have minimal side effects. Governments should avoid taxing capital, which is essential to the nation's productivity. Since most of their spending is for current consumption, they should also avoid building up large debts, with draw capital away from future production.

**The Wealth of Nations today from the Adam Smith Organisation.**

Smith's world was very different, the Industrial Revolution changed everything. Smith, by showing how the freedom and security to work, trade, save and invest promotes our prosperity, without the need for a directing authority, The Wealth Of Nations still leaves us with a powerful set of solutions to the worst economic problems that the world can throw at us. The free economy is an adaptable and flexible system, which can withstand the shock of the new, and cope with whatever the future brings.

https://www.adamsmith.org/the-wealth-of-nations

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***Karl Marx (1818-1883)***

Born in Trier, Prussia, on May 5, 1818, Marx was the son of a successful Jewish lawyer who converted to Lutheranism before Marx's birth. Marx studied law in Bonn and Berlin.

In Berlin, Marx was introduced to the philosophy of G.W.F. Hegel. He became radicalised by the young followers of Hegel who criticized the establishment of the day. Marx received his doctorate from the University of Jena in 1841.

After living in Prussia, Marx lived in France where he met his lifelong friend Friedrich Engels. He was expelled from France, eventually moving to London where he spent the rest of his life with his wife. Marx died of bronchitis and pleurisy in London on March 14, 1883. He was buried at Highgate Cemetery in London. His original grave was modest but replaced, in 1956 by The British communist party with a grandiose tomb and bust complete with the dedication "Proletarians of all countries, unite!"

Marx was a philosopher, author, social theorist, and an economist. He is famous for his theories about capitalism and communism. Marx, in conjunction with Friedrich Engels, published *The Communist Manifesto* in 1848; later in life, he wrote *Das Kapital* 1867 the second and third volumes were published posthumously in 1885 and 1894, which discussed the labour theory of value. Max despite his revolutionary thinking was a social conservative. His great friend and benefactor, Engels, who supported the Marx family financially through the profits from the factories in the UK, run by Engels and owned by Engels, had what we now call a Partner who was then referred to as a 'Common Law Wife'. Marx would not allow a woman who was living in sin into his house.

Marx was inspired by classical political economists such as Adam Smith and David Ricardo, while his own branch, Marxian economics, is not a part of mainstream thought. Nevertheless, Marx's ideas have had a huge impact on societies, most prominently in communist countries such as the USSR, China, and Cuba.

While many equate Karl Marx with socialism, his work on understanding capitalism as a social and economic system remains a valid critique now. In *Das Kapital* (or *Capital* in English), Marx argues, like Adam Smith, that society is composed of two main classes: Capitalists are the business owners who organize the process of production and who own the means of production

such as factories, tools, and raw material, and who are also entitled to any and all profits. The other, much larger class is composed of labour (Marx's "the proletariat"). Labourers do not own or have any claim to the means of production, the finished products, or any of the profits generated from sales of those products. Labour works only in return for a money wage. Marx argued that because of this uneven arrangement, capitalists exploit workers.

Nearly everything Marx wrote was viewed through the lens of the common labourer. From Marx comes the idea that capitalist profits are possible because the value is "stolen" from the workers and transferred to employers. He was, without question, one of the most important and revolutionary thinkers of his time.

In 1898, economist Eugen von Böhm-Bawerk's *Karl Marx and the Close of His System* was first translated into English. In his damning rebuke, Böhm-Bawerk showed that Marx failed to incorporate capital markets or subjective values in his analysis, nullifying most of Marx's more pronounced conclusions.

Though he was the capitalist system's harshest critic, Marx understood that it was far more productive than previous or alternative economic systems. In *Das Kapital*, he wrote of "capitalist production" that combined "together of various processes into a social whole," which included developing new technologies. He believed all countries should become capitalist and develop that productive capacity, and then workers would naturally revolt into communism. But, like Adam Smith and David Ricardo before him, Marx predicted that because of capitalism's relentless pursuit of profit by way of competition and technological progress to lower the costs of production, that the rate of profit in an economy would always be falling over time.

Marx understood the labour theory better than his predecessors (even Adam Smith) and contemporaries, and presented a devastating intellectual challenge to laissez-faire economists in *Das Kapital*: If goods and services tend to be sold at their true objective labour values as measured in labour hours, how do any capitalists enjoy profits? It must mean, Marx concluded, that capitalists were underpaying or overworking, and thereby exploiting, labourers to drive down the cost of production. Marx and Engels believed that once the proletariat understood how and why they were being thy would rise up against their bosses. Engels who had military training was always assessing the area around

him, studying the terrain for when the revolted proletariat would surge over the hill.

While Marx's answer was eventually proved incorrect, his simple assertion was enough to show the weakness of the labour theory's logic and assumptions; Marx unintentionally helped fuel a revolution in economic thinking.

Dr. James Bradford "Brad" DeLong, professor of economics at UC-Berkeley, wrote in 2011 that Marx's "primary contribution" to economic science actually came in a 10-paragraph stretch of *The Communist Manifesto*, in which he describes how economic growth causes shifts among social classes, often leading to a struggle for political power.

This underlies an unappreciated aspect of economics: the emotions and political activity of those involved. A corollary of this argument was later made by French economist Thomas Piketty, who proposed that while nothing was wrong with income inequality in an economic sense, it could create blowback against capitalism among the people. The good old proletariat, Thus, there is a moral and anthropological consideration of any economic system. The idea that societal structure and transformations from one order to the next can be the result of technological change in how things are produced in an economy is known as historical materialism.

We think of Marx the communist party Stalin and the purges, Putin and the new world order but perhaps we should consider that Marx wanted capitalism to succeed but that the profits should be more evenly divided?

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## *John Maynard Keynes. 1883-1946.*

Keynes was born in Cambridge. His father, a professor at Cambridge and the Author of a book on the Political Economy. After Eton and Kings College, where he studied economics, Keynes worked for the Civil Service in the India Office, lectured at Cambridge, edited journals, was secretary of the Royal Economic Society and in 1911 joined the Treasury. In 1919 he was the Treasury's principal representative at the Paris Peace Conference. Disagreeing at the punitive measures against Germany and arguing that the consequences would lead to financial disaster for Germany and Europe he resigned. Keynes then taught at Cambridge until heart trouble in 1937 forced him to stop. He had completed his major work." *The General Theory of Employment, Interest and Money"* in !936. This argues against the idea that a market economy leads to full employment as suggested by Alfred Marshall and most economists who went before.

At the end of the 2nd World War he was sent to America, when very ill, by the Labour government to negotiate the lease lend agreement. The huge sum demanded by the Americans was threatening to derail Attlee's spending plans. Keynes was the foremost exponent of ways to control international Money at the Bretton Woods discussions on setting up an International Bank and the IMF.

Keynes, unlike his upright peers was a sexual libertarian. Cataloguing from1901 every gay conquest in detail until he married, in 1925, the Russian ballerina Lydia Lopokova. Sean O'Grady. Independent 11/03/2015. Accessed 18.00 17/08/2020. Book by Richard Davenport-Hines.

**Understanding the Economics of John Maynard Keynes., maybe.**

An understanding of Keynesian themes, psychology, uncertainty and expectations can be helpful in evaluating macro policies and the search for macroeconomic stability in terms of prices, jobs, incomes and profits for both developed and developing countries

Keynesian economics focuses on these themes. In Keynesian economics, the state of animal spirits is vital. Animal spirits, a phrase coined by Keynes, are the important changes in consumer and business sentiment which effect the state of the markets and the economy.

- Keynesian economists believe that free markets are volatile and not always self-correcting**.**
- The free-market system is naturally prone to periods of recession & depression
- The volatility can be explained by important changes– also known as animal spirits.
- In a world of economic stagnation and/or depression, the standard rules of economics may no longer apply, and direct intervention may be essential.
- Free markets are not always self-correcting:
- When a recession or a depression occurs, the free market economic system is not necessarily self-correcting – indeed en-masse, individuals can become trapped in a deflationary depression which is in no one's interest but which, on our own, no one can counter-act.

*Professor Robert Skidelsky*, Keynes Biographer makes the point that One of Keynes's revolutionary propositions was that following a big economic shock - usually a collapse in investment - there were no automatic recovery forces in a market economy. The economy would go on shrinking until it reached some sort of stability at a low level. Keynes called this position "under-employment equilibrium"

Persistent deflation can be as costly as high inflation – it can be damaging especially in economies where there are huge levels of private & public sector debt. One cannot always rely on new inventions, innovations and other natural economic stabilisers to drag an economy out of a recession. (they do happen apparently)

The paradox of thrift helps to explain why a rise in precautionary saving, in other words people looking for security and hanging onto their money, can lead to a fall in demand and incomes and a reduction in output, income and wealth.

- These conditions can drag production and employment in the economy to a low level where it can remain for some time unless there is some external stimulus, generally government intervention to lift demand and output again
- On an international level, when the global desire to save exceeds the global willingness to invest the result is a contraction in world demand and production, a fall in incomes and employment, which eventually

brings savings back into balance with investment. Keynes "under-employment equilibrium"

Recession (and worse – a deep depression) represents a pure waste of scarce economic resources. Unemployed workers want to work, and businesses want to supply goods and services. If they did, then the things they produced would be available for all to buy, and the incomes they received would enable them to purchase the products of others. Incomes from higher wages and stronger profits would be made, feeding through the circular flow in the standard macro model.

But in a recession a country can experience a persistent state where output is well below potential.

- In normal circumstances it is possible to boost demand by cutting interest rates. But there is a level below which interest rates cannot go (they have been at 0.5% in the UK since the spring of 2009 and at low levels in other countries) and at that point monetary policy may become powerless.
- Even if interest rates can be lowered this may have no effect if people cannot or will not borrow. This is known as the liquidity trap.
- At this point, aggregate demand can only be boosted by the Government borrowing more, either to spend directly, infrastructure, as America did in the Great Depression, or to give to others via tax cuts or the like.
- In other words, we need a targeted Keynesian fiscal stimulus. Keynesians believe that the size of the fiscal multiplier effect, Bigger Bang for your Buck is higher for government spending than for tax cuts.

**Animal spirits**

- John Maynard Keynes coined the notion of animal spirits which refers to the driving force that gets people and businesses going in the economy
- Animal spirits helps to explain why countries fall into a recession but also what eventually brings about a recovery. It refers to a broad mix of confidence, trust, mood and expectations and animal spirits can fluctuate very quickly as populations of people change their thinking. This focus on animal spirits helps to explain why psychology can be so important in macroeconomics and why the internet, Facebook, are so dangerous
- When animal spirits are poor then there is a risk of a slowdown or a recession. Individuals save more, businesses save more too and, because demand and profits are lower than expected, they may opt to cut back

on production and perhaps postpone or cancel capital investment projects.

- Higher saving and reduced investment both have the effect of reducing demand and incomes in the circular flow causing an economic contraction.

Keynesian economists are usually supportive of the state borrowing more money during times of weakness.

1. Government borrowing can benefit growth: A budget deficit can have positive effects if it is used to finance capital spending that leads to an increase in the stock of national assets. For example, spending on transport infrastructure improves the supply-side capacity of the economy. And increased investment in health and education can boost productivity and employment.
2. Demand management**:** Keynesian economists support the use of changing the level of government borrowing as a legitimate instrument of managing demand. An increase in borrowing can be a useful stimulus to demand when other sectors of the economy are suffering from weak or falling spending. If crowding out is not a major problem - fiscal policy can play an important counter-cyclical role “leaning against the wind” of the economic cycle
3. Low interest rates – it makes sense for the state to borrow when interest rates are low and inject extra demand into the economy, especially when private sector demand is low

Naturally, there are counter arguments to this:

1. Financing a deficit: A budget deficit must be financed through the issue of debt. If the budget deficit rises to a high level, in the medium term the government may have to offer higher interest rates to attract sufficient buyers of debt. This raises the possibility of the government falling into a **debt trap** where it must borrow more simply to repay the interest on accumulated borrowing.
2. A government debt mountain: As state debt rises, there is an opportunity cost involved because interest payments on bonds might be used in more productive ways, for example on health services or extra investment in education. Higher public sector debt also represents a transfer of income from people and businesses that pay taxes to those who hold government debt
3. Crowding-out - the need for higher interest rates and higher taxes. If a larger budget deficit leads to higher interest rates and taxation in the

medium term and thereby has a negative effect on growth in consumption and investment spending, then ‘fiscal crowding-out’ is said to be occurring.

4. Risk of capital flight: High levels of state borrowing and debt risk causing a ‘run on a currency’. This is because the government may find it difficult to find sufficient buyers of debt and the credit-rating agencies may decide to reduce the rating on sovereign debt. Foreign investors may choose to send their money overseas perhaps causing a currency crisis

Keynes Quotes:

Demand was (is?) the most important force driving the economy NOT supply.

https://www.tutor2u.net/economics/reference/keynesian-economics.
Accessed: 07/03/20

Wikipedia. Own sources.