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Markets and Growth in Early Modern Europe

Victoria N. Bateman

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MARKETS AND GROWTH IN EARLY MODERN EUROPE

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BY

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PREFACE

Markets and Growth in Early Modern Europe has been designed to be accessible to a broad readership, encompassing not only economists and economic historians but also any reader with an interest in the topic. For the general reader, I would recommend the Introduction, Chapter 1 and Chapter 7 as the main areas likely to be of interest, which also convey the central messages of the work. Whilst the remaining chapters are inevitably more technical, the empirical and econometric work has been moved to endnotes and appendices wherever possible. The specialist reader will be familiar with much of the ground covered in the Introduction and Chapter 1, so I would suggest briefly glancing through these areas before moving on to the rest of the book.

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INTRODUCTION

For much of history, the standard of living was poor and subject to little improvement. For many, life was 'poor, nasty, brutish, and short', and people could not look forward to a better life for their children and grandchildren.[1] Today, we expect our incomes to rise year on year, and hope that our children will experience a life of which their great-grandparents could only have dreamed. The economic growth that has enabled this to occur began with the onset of the British Industrial Revolution in the late eighteenth century. It completely transformed the economy and the way in which we lived our lives, ushering in the near-continuous economic growth that we now take for granted.

One of the most important questions that economic historians seek to answer, is how to explain this take-off to modern economic growth: How did we go from a situation in which for centuries the average level of economic growth was close to zero, to a new era from the early nineteenth century onwards in which incomes rose year on year? And, related to this, why was Europe the first region to see this process of 'modern economic growth'? As one notable economist famously said, 'once one starts to think about [this question] … it is hard to think of anything else'.[2] That sustained long-run economic growth can lift large parts of a population out of poverty means that the benefits to understanding its causes are very great indeed. It is therefore unsurprising that economists and economic historians in particular have researched and debated the issue at great length.

One particularly popular answer to the question of what created long-run economic growth is the development of markets. This book aims to assess the validity of this assertion. Markets involve the ability to freely produce, buy and sell goods, and they lie at the very centre of economics. The advantages of markets were put forward centuries ago by Adam Smith in his *Wealth of Nations*, now so famous that, at the time of writing, he appears on the reverse side of the British twenty-pound note.[3] Writing in 1776, Smith asked us to consider a simple hunter-gatherer society, in which each person produces everything they need for themselves. In the morning, you may go out hunting, returning to cook and eat at lunch. In the afternoon, you may make clothes from the animal skins that are left over from hunting, and undertake any urgent repairs to your shelter. The problem with this arrangement is that it is not very efficient. We are not all, for example, good hunters, and it wastes time moving between the different tasks of the day. People tend to have different natural abilities. If you are not good at hunting, you may instead be good at making clothes, but you may find that you have little time left to do the sewing as you are spending all of your day hopelessly chasing deer. It therefore makes sense for the talented seamstress to find someone who is good at hunting and strike up an exchange – agree that he will hunt for you both, and you will make the clothes for both of you. It is in this way that Adam Smith argues that exchange and trade start to arise. As individuals specialize in the task at which they are most productive, each person ends up getting a greater amount of, in this example, meat and clothing, than they would if they tried to do everything for themselves. Total output is increased, and, as a result of markets, everyone is happier.

The benefits of markets do not end there, as Smith went on to show: as population expands, specialization grows ever deeper. Now there may be ten people rather than a single individual in your village performing each task, in which case some of them might start to work together and sub-divide the tasks between themselves. Some might start to form 'firms' which then draw in people from their lives of subsistence farming, stimulating the development of a labour market. To illustrate, Smith uses the example of pin-making. Rather than each pin-maker making pins from start to finish, one may draw out the wire, another cut it into pieces, another put the point on the end, and another put the head on the opposite end. Smith argues that this specialization and 'division of labour' between different tasks both raises efficiency and importantly increases the likelihood of technological advance: if you specialize in one particular task, rather than spreading your energies across a number of tasks, your abilities and understanding of this task improve. This means that you are more likely to work out ways of improving the manner in which you produce. This generates technological progress, which further raises output and incomes in the economy.

Over time, people start to conduct their trades using a medium of exchange ('money'). Early on, it may make sense to swap an item of clothing for a leg of deer – you can find a direct exchange that is mutually beneficial. As population rises, people increasingly strike exchanges in terms of a commonly accepted medium (such as silver). You may have clothes to sell, but someone who wants to buy them may not have the leg of deer that you want in return. Hence, she instead agrees to pay you in silver, which in turn you can then give to the hunter for his leg of deer – so long, of course, as he is happy to accept it, in the knowledge that he can also use it to buy what he wants in return. In this way, a money-using economy starts to arise.

With the development of money, capital markets emerge. Some people may wish to save – in other words, they may not wish to spend everything they earn at a particular point in time. They want to save the excess to spend in the future instead. At the same time, other people may wish to spend more than they currently earn, in which case they would like to borrow. If the two can come together, they can agree a mutually beneficial exchange of funds. The saver can 'invest' with the person who wants to borrow, and the borrower can then repay in the future in a way that makes the exchange worthwhile for each party (effectively agreeing a rate of interest with which they are both happy). The borrower gains by getting access to the funds he desires, and the saver gains by getting a return on her savings. Initially, it may be necessary to strike the exchange with someone you know and trust (who will not run off with your money!). Alternatively, there may be a friend in common who can act as an intermediary in the exchange. Over time, banking institutions – more formalized intermediaries between savers and investors – start to develop to facilitate these types of exchange. Hence, once goods and labour markets have developed, so by logical progression do capital markets.[4]

As specialization grows deeper and banks start to emerge, the economy becomes increasingly complex. R&D and machinery can be funded, improving the efficiency of production and thereby expanding output, goods become increasingly sophisticated – through both the process of specialization and technological advance – and new goods start to appear.[5] Whilst the economy and its productive ability becomes more complex, life for each person becomes, in many ways, simpler. Each person produces just one type of product, and yet is able to obtain access (through exchange via the market) to a whole host of varied and sophisticated products and services. The supposed beauty of the market is that whilst each person does what is best for themselves – 'maximizes their own utility or profit' in economists' language – this does not lead to chaos. People's different consumption and production requirements are made consistent through the market force that is the price mechanism.[6] If there is an excess supply of a particular good, the price of the good will fall – discouraging its production and encouraging its consumption until demand and supply of the good become equal. If there is an excess demand for a good, the price will rise – sending a signal for producers to produce more, and putting off those who might not value the good as highly as others. If the market is allowed to function, prices will therefore naturally reach the point at which supply is equal to demand. It is on this basis that economists suggest that the market is 'informationally efficient' – the only thing that people need to know in order for their desires to be made consistent with each other is the price of the good they produce and the price of the goods they may wish to consume.[7] The market looks after the rest. According to pro-market economists, individual desires do not, therefore, lead to chaos, but to order. Without a market, the state would have to develop a plan, predicting what people want to consume, and then direct the associated production. Pro-market economists note that this would require the state to collect a great deal of information on what everyone wants and what everyone is capable (or willing) to produce. On top of that, the state would then have to create the necessary incentives for production, rather than leaving it to prices to signal and incentivize producers to produce exactly what people want. As many communist governments have found, this can be very difficult to successfully achieve.

Given such advantages of a market economy, it is unsurprising that a number of authors have suggested that the reason why economies were poor for so much of the past was that markets were virtually non-existent or were prevented from functioning.[8] Markets, it has been hypothesized, were held back by poor institutions, which raised the costs of exchange and trade (i.e. increased 'transaction costs'). These included inadequate property rights, government regulations and a lack of competition (e.g. guilds and monopoly trading privileges). Property rights are necessary to underpin the market – one cannot buy and sell goods in which one has no rights or certainty of ownership. As Adam Smith conjectures, 'commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property'.[9] In history, these property rights were supposedly undermined by absolutist leaders and monarchs who expropriated private property, used taxation and the courts to unfairly extract wealth, and defaulted on their debt. The standard historical explanation is that improvements in institutions only took place in Europe from the seventeenth and eighteenth centuries onwards, enabling greater use of and reliance on the market. The Glorious Revolution in England in 1688 led to reduced power of the monarch and, in its place, greater power of the elected parliament: with this shift came greater enforcement of property rights. Policy also increasingly moved away from a 'mercantilist' interventionist approach to a Smithian laissez-faire approach, with greater freedom for the market. Regulations concerning capital markets (e.g. 'Usury laws')[10], labour markets (e.g. Statute of Artificers)[11] and goods markets were increasingly relaxed. The monopoly power of producers, merchants and guilds was being further undermined as a result of the rise of production of manufactured goods outside of established cities, which introduced greater competition into the market. The power of merchants to control international trade in goods was also diminished by a movement towards free trade. Altogether, Polanyi posits a *Great Transformation* to a market economy in the eighteenth and nineteenth centuries, seemingly correlating well with the start of economic growth.[12]

Clearly, this market-based explanation of western economic growth has been very popular amongst economists as it fitted well with their capitalist political leanings. The fall of communism in the Soviet Union in the 1980s and the success of more market oriented policies in China and India added greater credence to this view. It has also greatly influenced the development advice given by western powers to the poor economies of today. As summed up in the 'Washington Consensus', developing economies are told that by putting in place market-based policies, and integrating into the world market, they can follow the west on the route to riches.[13] The fortunes of large parts of this planet, and the ability of populations to rise out of extreme poverty, therefore hinge on the argument that markets explain economic growth. If this is not the case, billions of people are condemned to the life of poverty, and billions of aid are being wasted.

Economists do, of course, accept that markets are not always perfect. Even if they function well, raising the overall level of output in the economy, they do little to guarantee that the output is distributed equitably amongst the population. This is something that is particularly visible, for example, in the contrast between the slums of India and the growing number of Indian billionaires. Recognizing this fact, many governments have created systems of redistribution, which work through the taxation and benefit system, to transfer income from those with more to those who have little, guaranteeing at least a minimum standard of living for all. Through state-provided education in many countries, emphasis is also placed on creating opportunities for all, allowing each person to exploit their natural ability and talents and so raise their future income.[14] Clearly, however, there is a trade-off; the more the government tries to redistribute, the more it risks reducing total output in the economy, by lowering incentives to produce for those who are facing taxation. According to free-market economists, if we significantly harm wealth-creation in the economy through 'excessive' redistribution, there will be substantially less to redistribute to those without. In other words, everyone will be poor. It is argued that only if we were not disincentivized to produce upon having the fruits of our labour redistributed to others would it be possible to ensure that everyone is equally well off. Given that as human beings we are at least partly self-interested, most economists argue that such a redistribution of wealth is a rather romantic and idealized (and ultimately futile) goal; there are limits to the extent to which inequality can be reduced.

Aside from the question of how the pie of output is distributed, economists also recognize that markets do not always maximize the size of the pie in the first place: 'market failures' may naturally occur. For markets to function in the best possible way, we need to live in a world in which, for example, individuals face the full consequences of their decisions on what to produce and consume (there are no 'externalities'), where they are also not able to strategically hide information from another party to an exchange, and where there are enough market producers and consumers for people to be able to 'shop around'.[15] Each of these and other assumptions which need to be made for markets to be shown to be 'efficient' is violated in the real world, meaning that markets can create inefficiencies, or 'fail'. Pollution and congestion are obvious examples of situations in which individuals' self-interested decisions create spillover effects on others. A further case is the reduced incentive to innovate when an inventor cannot reap the full benefits of his invention due to the possibility of imitation by others.[16] However, free-market economists have pointed out that this first example of market failure actually arises from missing markets, and that these can be created by establishing, for example, property rights for knowledge (through patents), thereby limiting the need for government intervention.[17] In that sense, it is not really a market failure at all – rather it is the failure of a market to be established. Asymmetries of information between individuals in the market is the second situation in which markets can fail, leading to 'moral hazard' and 'adverse selection'. An example of this problem can be seen in insurance. By insulating a person from risk, insurance protects individuals from experiencing the full consequences of their behaviour, which is hidden from the insurer, and so may lead them to be less careful (creating 'moral hazard'). Banks who behave in too risky a manner in the belief that governments will bail them out if things go wrong is a similar example. An example of the third source of market failure is monopoly power, such as cases in which one firm has command over the market for a particular good. In this type of situation, one side of an exchange has the ability to 'take advantage' of the other side. Finally, markets are not well equipped to produce exactly the types of 'public goods' that they need to be able to function, including transport infrastructure, a legal system to support property rights, and defence to minimize the risks of invasion.[18]

Pro-market economists have, however, worked hard to demonstrate how the market might naturally find solutions to many of these problems and, where it cannot, how the costs of failure are relatively minimal compared with the longer-run advantages of the market.[19] They suggest that even if in theory a case can be made for state intervention, such interference risks replacing market inefficiency with inefficient government officials and, according to Hayek, may even put us on a slippery slope in which the market is disposed of altogether.[20] On this basis, their recommendation is to leave markets to their own devices and for the state to intervene only where absolutely necessary, such as in the provision of some public goods.

Perhaps the greatest critique of leaving the market to its own devices came with John Maynard Keynes's *General Theory*, written during the Great Depression, which argued that free markets may, at times, generate mass unemployment and economic instability (in the form of boom and bust).[21] If correct, this is a potentially much more serious problem than many of the 'micro' level inefficiencies considered above. To understand Keynes's argument we need to begin by noting that the value of everything that an economy produces will always be paid out to workers and capitalists (through wages, rents and profits), meaning that in theory there should be enough spending (or demand) in the economy to 'mop up' all of the goods that are being produced. This spending will consist of both consumption and investment. Whilst some consumers might save some of their income (which detracts from spending), 'Classical' free-market economists tell us that there is no need to worry as these savings make their way through the banking system (as discussed earlier) into the hands of people wanting to borrow to invest. This supposedly works through the natural adjustment of the interest rate, which will move to ensure that savings equal investment. If, for example, there is an excess of savings (and so too little spending and demand in the economy), this will put downward pressure on interest rates, which encourages more investment and puts people off saving, creating demand. Hence, total spending (consumption plus investment) will never fall below the value of what is being produced – the economy will never have goods that it has produced going unsold. Furthermore, Classical economists tell us that the amount that the economy will be producing will always be exactly equal to that which ensures that everyone who wants a job has a job. This works through the adjustment of wages in the economy. If a significant number of people are unemployed, this will place downward pressure on wages, meaning that firms are willing to employ more people.

However, Keynes was unconvinced on both counts. Observing the desperately poor unemployed workers waiting in dole queues in Britain in the 1920s and 30s, he reasoned that something must be wrong with Classical free-market economic theory. He argued, firstly, that workers may not be able to 'price' themselves back into work by accepting lower wages. If a worker accepts a lower wage (in money terms) in the midst of a recession, firms may pass on the lower wages to consumers in the form of lower prices, the result of which is that the real cost of employing the worker (the money wage relative to the prices at which goods are sold) is no different to before. The second point he made was that not all saving makes its way into investment. If the economic future looks gloomy, even very low interest rates may not be enough to induce firms to invest an amount equivalent to the savings in the economy. As a result, spending remains too low and so ouptut and incomes fall. He therefore proposed that governments need to be on hand ready to make up the difference, in the form of government spending, to get the economy out of recession.

According to Keynes, therefore, the 'visible hand' of state intervention may be required alongside the 'invisible hand' of the market to ensure that recessions are avoided. Recognizing Keynes's arguments, governments after World War Two followed demand management policies, aiming to ensure that demand was strong enough to 'mop up' the supply of goods at which the economy would be fully employed. However, despite seemingly following Keynes's advice, the scourge of mass unemployment returned in the 1970s and 1980s. By that time, Keynesian expansionary policies seemed only to raise prices, rather than lower unemployment – a situation called 'stagflation' (stagnation and inflation combined). Those with a pro-market view came back to the fore and argued that Keynesian policies were misplaced, building a new theory of the economy that accepted that mass unemployment and indeed the 'business cycle' could occur, but which argued that they were the result of voluntary decisions on behalf of workers – i.e. of workers choosing not to work – and so were not a failure of the market in the sense that Keynes had suggested. This 'Real Business Cycle Theory' showed that if the economy suffers a productivity shock (such as the type of oil shocks occurring in the 1970s), and so firms cannot afford to pay the same wage as before, workers will choose to take time out of their jobs because work is no longer worth the loss of leisure time. Furthermore, even if workers are not directly choosing to be made unemployed, they may indirectly be choosing to be so by preventing firms from cutting wages in response to the shock (as a result of trade unions or through voting for minimum wages and benefits). In other words, unemployment was a result of choice and/or interferences in the free workings of the labour market. Were firms free to cut wages, unemployment would not occur except where workers voluntarily opted for it. Based on such theory, Keynesianism was declared dead and stories of the Great Depression were retold in which trade unions and benefits were to blame rather than any failure of the market to create sufficient demand. In the words of one paper, 'The army of unemployed standing watch in Britain at the publication of the *General Theory* was largely a volunteer army'.[22] Influenced by this theory, the policies in the 1980s of Thatcher (in the UK) and Reagan (in the US) deregulated, privatized and liberalized markets. Those who believed in the new theory – including a President of the American Economic Association – predicted that we would never have another deep and concerning recession, that economic growth would rise and that unemployment would stay low.[23] Against these optimistic predictions, the global recession of the late 2000s to the present day has come as a great shock. It is much to the surprise of many eminent economists that the economy now faces, at best, the gravest situation since the Great Depression of the 1930s. Few of them predicted it: in fact, they expected the opposite.

For the first time since Keynes in the 1930s, economists' faith in the market is once again being tested. Since the market is at the root of economics, this current debate has the potential to create a revolution in our understanding of the economy and the policies we design. Now more than ever we need to ask how much markets really contribute to economic growth. If markets really are strong enough to guarantee long-run economic growth, then a case can be made that their long-run advantages offset any shorter term disadvantages: without them, we could all still be living as hunters and gatherers. If so, we should be wary of 'throwing the baby out with the bath water' when considering responding to the current recession with what free-marketeers would argue is a knee-jerk reaction of clamping down on free markets and imposing regulation.

So, what is the evidence that markets were key to the arrival of long-run economic growth from the nineteenth century onwards? Rather surprisingly, the link has scarcely been tested using the long spanning historical data that would be required to do so.[24] The view that markets sowed the seeds of economic growth has simply been assumed to be correct by most economists, perhaps driven more by ideology rather than empirical evidence. This represents a major gap in the discipline that this book aims to fill.

In order to examine the link between markets and economic growth, it is necessary to first of all establish the path of market development in history. According to the market based view, markets were poorly developed throughout much of history, only becoming developed in the seventeenth and eighteenth centuries in the run up to the Industrial Revolution, coinciding very neatly with the start of economic growth. Seemingly confirming this story, most studies conducted by economic historians tend to show that markets moved from a state of under-development to one of high development between the seventeenth century and the early-nineteenth century.[25] However, whilst attractive to economists, this vision is not consistent with other available evidence. Firstly, the work of medieval (and even ancient) historians suggests that markets were already relatively well developed in earlier times and that economies were much more 'commercial' early on than has typically been thought.[26] If correct, the fact that modern economic growth did not begin in these earlier times – despite their well-developed markets – implies that markets are simply not enough for sustained economic growth. Secondly, the work of authors such as Ha-Joon Chang (*Kicking Away the Ladder*) and David Ormrod (*The Rise of Commercial Empires*) suggests that *non* free-market policies may have played a crucial role in the sustained economic growth of the west. They have argued that the now rich economies (Britain, US, Germany, East Asia) became rich by going against the market – by using tariffs and other anti-market policies to carve out for themselves a place in the world economy. Thirdly, comparative work on China and Europe suggests that markets were as well developed in parts of the east on the eve of the Industrial Revolution as those in Europe and yet, despite this, the east did not begin to industrialize until the twentieth century.[27]

Given these inconsistencies, together with the significance of the issue for economics and policy-making, this book aims to build a more complete and consistent story of markets in the long span of European economic history. This then forms the basis for examining whether markets were responsible for the emergence of modern economic growth in the nineteenth century. Chapter 1 pieces together recent research by economic historians on markets from Roman times to the present day, presenting a long-run history of markets. The vision of markets suggested is one at odds with that of many economists, but is in need of more formal and empirical testing. In an effort to provide this, Chapters 2–4 formally measure markets from the perspective of both the individual countries of Europe and the two major regions of Europe (the Mediterranean and the north-west), before aggregating the results to calculate the Europe-wide trend. The common method for measuring market development (or, 'market integration') is to gather information on prices from various locations and look for evidence as to whether these prices have been converging over time. In theory, this should be the case if markets are becoming increasingly developed, as price differences between locations will be arbitraged out through the process of trade: if the price of a good is high in location A and low in location B, then traders will buy the good in the cheaper location and ship it to the more expensive location, guided by the incentive of making a profit. This process increases the supply of the good in the more expensive location (pushing the price there down) and does the opposite in the cheap location, therefore acting to converge the prices. Furthermore, if markets are becoming better developed, we would expect that they can better deal with shocks, meaning that prices become less volatile and the speeds at which prices adjust increase. This gives us three good ways of measuring markets: price convergence, price volatility and the speed of price adjustment.

Once market development has been measured, Chapter 5 is in a position to explain the trend it has taken over time. The results enable us to understand how certain parts of Europe entered a virtuous circle resulting in the development of markets far earlier on in history than the eighteenth century, whilst others either failed to do so (having to wait for the transport revolution of the nineteenth century) or even experienced the opposite: disintegration. Geography, institutions and population density are shown to be the key factors at work. Chapter 6 builds on the previous chapters, using the market estimates of the earlier chapters to empirically test the connection between markets and economic growth from 1400–1900. This represents, to date, the longest historical test conducted of the link between markets and growth in history. It considers various measures of economic performance – urbanization, agricultural productivity, population density and real wages – alongside each of the three measures of market development. It argues that whilst markets might be a necessary precondition for growth, they are in no way sufficient. The state and the Enlightenment – rather than markets – were what triggered the beginning of continuous economic growth in the nineteenth century, and these involved important non-market elements. Chapter 7 summarizes the findings and considers how they can help us to understand why so many economies are still poor today, and what policies can be used to encourage their escape from poverty. In light of the current economic turmoil, it aims to contribute towards a new agenda for economics and policy not only in the poorer, but also the richer, economies.