The Duality of Say's Law

A Restoration of J.B. Say's Original Intentions

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I. <u>INTRODUCTION</u>

The concept known as "Say's Law of Markets" has been challenged many times over the centuries but the actual theory remains to be disproven. During every economic depression, businessmen and economists proclaim it null due to "underconsumption," "overproduction," and the presence of "general gluts." Jean-Baptiste Say, a *laissez-faire* economist who wrote on the subject of gluts casually and without revolutionary intentions, is traditionally understood to have proved these phenomena impossible. In turn, history is supposed to have proved Say wrong, and his law is now widely considered refuted. The alleged law, however, has only been attacked on the terms of its hecklers, and has always been straw-manned as a vulgar apologia. Economists act as if there are *two* Say's Laws; the first, (Say's original insight) arguing that, provided a functional free market with sound money, general gluts will not occur; the second (a vulgar creation considered to be the "disproven" Say's Law) declaring that general gluts are always and everywhere impossible.

Say's Law has been challenged, among others, in two famous episodes, first by Reverend Thomas Malthus in 1820, and more famously by John Maynard Keynes in 1936. There can be no denying that general gluts *did* appear in 1816-1823 and in 1929-1941; doing so would be to advocate the *vulgar* Say's Law. The crucial point is that prolonged gluts were *not* caused by the *free market*, but by the rampant *government* interventions in the market during these historic episodes, acquitting Say by default. Both detractors observed largely circumstantial evidence which provided the impetus for them to attempt pure "theories of underconsumption" contra Say's Law. They observed that there were gluts, but failed to fully comprehend *what had caused them*. Both Malthus and Keynes were attacking a straw man, blaming the free market for the problems of government, and ironically appealing to the latter to fix the former.

II. INVOCATION OF THE LAW

Any debate over Say's Law and its applicability only comes up during times of economic stagnation and recession. During every downturn, demand for products declines, inventories tend to remain too high, and large-scale unemployment tends to result. Thus, it appears entirely commonsensical for both the layman and many professionals to conclude that there is general "overproduction" and/or "underconsumption," and that it falls to the government to stimulate consumption. Here is exactly where Say's Law is challenged, as there is a demonstrable "general glut" of unsellable products, which the *laissez-faire* market appears to have failed to remedy. The law serves as the frontline for the battle against free markets; since it is alleged to be the very foundation of *laissez-faire*, if the law is disproven, so too is the desirability of free markets. It is proclaimed that if Say's Law exists *at all*, it is no longer applicable to reality, as the "rules of the game" have changed. The calls rapidly escalate for various government programs to correct an inherently unstable market, especially when this process appears to repeat itself cyclically.

Few concepts in economic thought have been as polarizing as Say's Law. The stakes could not possibly be higher. Say's Law is the no man's land between the Keynesian and neoclassical trenches. Lord Keynes laid the very foundation of his system on the ashes of Say's Law. If the law is proven to hold, then the Keynesian superstructure implodes upon its false foundations. Free markets will win the day and government intervention must be curtailed. If it is falsified in *any* scenario, then neoclassical economists must grant Keynesians a seat at the academic table and concede the necessity of an active government offsetting the instabilities of the market. The debate over the law has created a zero-sum game between macroeconomic theorists: only one side can triumph, and the other side must lose nearly everything.

III. THE GOSPEL ACCORDING TO JEAN

What exactly is Say's Law? It is best to begin with the words of M. Say himself. French economist Jean-Baptiste Say included the law that would later bear his name in his 1803 opus, the *Traité d'Économie Politique* (Treatise on Political Economy). Chapter XV of the *Treatise* contains the quintessential discussion regarding "the law:"

> A man who applies his labor to the investing of objects with value by the creation of utility of some sort, can not expect such a value to be appreciated and paid for, unless where other men have the means of purchasing it. Now of what do these means consist? Of other values of other products, likewise the fruits of industry, capital, and land. Which leads us to a conclusion that may at first sight appear paradoxical, namely that *it is production which opens a demand for product*. (Say, 1855, I.XV.3, emphasis added)

Here, Say is describing how the act of production necessarily stimulates demand. One may demand a Ferrari until the world ends, but his demand might never be met. The simple act of desiring will not, in itself, bring a good to market. To have a Ferrari requires the prerequisite production of the Ferrari; it does not spontaneously appear to satisfy a demand for one. Such existence requires the transformation of land into the desired product with one's labor and capital—in short, *production*. Any man can demand, not everyone can produce. Say continues:

> It is worth while to remark, that a product is no sooner created, than it, from that instant affords a market for other products to the full extent of its own value. When the producer has put the finishing hand to his product, he is most anxious to sell it immediately, lest its value should diminish in his hands. Nor is he less anxious to dispose of the money he may get for it; for the value of money is also perishable. But the only way of getting rid of money is in the purchase of some product or other. *Thus, the mere circumstance of the creation of one product immediately opens a vent for other goods*. (Say, 1855, I.XV.8, emphasis added)

As above, the simple act of demanding, or desiring, a good is not sufficient for any economic transaction to take place. One must have the purchasing power or some means of payment to exchange for the demanded product (except in the off chance it is a gift). The combination of

desire and purchasing power results in "demand" in the economic sense, and is often called *effective demand*.[1]

Since every profit-motivated producer produces his goods with the intention to sell, his clients must have some means of purchasing his product. A newly produced Ferrari must be purchased with the product of one's labor. One must work in order to accrue the money needed to purchase the Ferrari. Through production on the part of *both* producer and consumer, the demand for Ferraris is met. Production and demand are thus two sides of the same coin; for the seller must produce to make demand possible, and the buyer must produce in order to exchange for the good which will satisfy his demand.

Say anticipates the crux of the debate by addressing the problem of gluts—an excess of unsellable goods on the market—head on:

> But it may be asked, if this be so, how does it happen, that there is at times so great a glut of commodities in the market, and so much difficulty in finding a vent for them? I answer that the glut of a particular commodity arises from its having outrun the total demand for it in one or two ways; either because it has been produced in excessive abundance, or because the production of other commodities has fallen short. (Say, 1855, I.XV.10)

Say illuminates how the key to solving the mystery of gluts is *proportionality*. Certainly it is entirely plausible that a glut of any good may appear—it is simply the result of an entrepreneur's error in forecasting and producing too much. It is the result of temporary discoordination between production of various goods and consumers' demands. Say notes that, "at precisely the same time that one commodity makes a loss, another commodity is making excessive profit," (Say, 1855, I.XV.12). The profit-motive will draw entrepreneurs into high-profit markets and

[1] C.f. Malthus:

> But those who are acquainted with the nature of effective demand, will be fully aware that…the desire of any individual to possess the necessary conveniences and luxuries of life; however intense; will avail nothing towards their production, if there be nowhere a reciprocal demand for something which he possesses. (Malthus, 1820, p.294)

away from the low-profit markets with gluts. The prices of excessive goods must fall to match the demands of customers, so that the market may reach a new equilibrium where all inventories are sold and proportionality is reestablished. Under such logic, the proportions of goods against each other will even out; Say argues it is not plausible for a *general* glut, of overproduction of *all* goods, to occur. If one does occur, it is a sure sign that proportions are seriously out of whack, and something must be critically wrong with the price-system and *a fortiori,* the economy.

IV. ECONOMIC BLASPHEMY – SAY'S LAW AND "VULGAR SAY'S LAW"

Say's discussion of the relation between production and demand was the spark that lit the conflagration of exegeses over what he actually meant, when his law comes into effect, and a whole literature of relevant discussions. It seems every economist has a different take on what Say's law truly "means." Many attempts have been made to encapsulate the law into a small aphorism, such as John Stuart Mill's "commodities are paid for by commodities," (Mill, 1909, III.XIV.6) and most popularly by Keynes' "supply creates its own demand," (Keynes, 2007, p.18). Many economists who have an opinion on Say's Law, favorable or not, often suggest qualifications for the law's applicability. There are many such assumptions in the literature, but they may be subsumed into two *primary* requisites for Say's Law to come into operation: (1) Markets must be free from government intervention to allow them to clear any gluts. (2) Money must be sound, so to minimize monetary distortions preventing market-clearing.

(1) Markets must be free of intervention in order to clear. This qualification is often packaged as the assumption that "prices are flexible." Such an aphorism is no more meaningful than a tautology, for *why* are prices flexible? And when would they *not* be? Any form of government intervention—price and wage controls, compulsory cartelization of industries,

production quotas, unemployment subsidies, compulsory unionization, licensing fees, entry restrictions, and any other State grant of monopolistic privilege—will inhibit the adjustment process by definition.[2] If it is *illegal* to lower the price of goods for which there is an excess of supply, then *of course* the sellers will be stuck with gluts. Empirically, such regulations appear *en masse* during depressions, guided by the politically popular flavor of the time, hinting at the connection between such interventions and prolonged gluts. It is plainly obvious that there are many instances in reality where prices indeed are *not* flexible (due to the presence of such smothering regulation), and this empirical fact must be taken into account for any cogent application of Say's Law.

Often, many neoclassical economists take the flexibility assumption too seriously, easily exposing themselves to Keynesian potshots. Such a weakness is the result of the neoclassical preoccupation with equilibria. If the economy is *not* pristinely at equilibrium, or "full employment," (which is conceptually impossible), then it must necessarily be in *disequilibrium* and "less than full employment." An Austrian approach, providing an antidote to the mechanistic and calculus-driven poisons, provides a view of economics as a dynamic system of perpetual *dis*equilibrium. Prices are *never* perfect, but are always adjusting towards the emerging final equilibrium – which is never realized since the economic "data" is always changing.[3]

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[2] The act of intervention is necessarily defined as committing an action that would *not* otherwise occur between market participants.

[3] See Kirzner:

> [T]he efficiency of the price-system in [the Austrian] approach, does not depend upon the optimality (or absence of it) of the resource allocation pattern at equilibrium; rather it depends on the degree of success with which market forces can be relied upon to generate spontaneous corrections in the allocation patterns prevailing at times of disequilibrium. (Kirzner, 1973, p.6)

(2) Money must be stable to prevent distortions in the clearing process.[4] This qualification captures the traditional assumptions of economists that "money must be neutral" and that "savings equals investment." It has often been said that Say's Law applies only to a barter economy. As will be seen below, this was one of Keynes' greatest arguments. It is true that, if requirement (1) is met, the law will hold in a barter economy. However, if this were the only requirement, the law would be an irrelevant anachronism, as the universal acceptance of *money* has elevated the economy above pure barter.

The crux of the matter, however, is how money affects the role of market clearing. Any understanding of Say's Law is essentially intertwined with an understanding of the role of money. Say himself argued that money was a commodity serving only as a medium of exchange between other commodities.[5] With money, there is now another phenomenon to take under consideration, for goods now exchange for *money* which exchanges for other goods. Roger Garrison describes an appropriate metaphor coined by F.A. Hayek as to the role of money in an economy, especially in context of Say's Law:

> In the closing pages of *The Pure Theory of Capital*, Hayek provides a piece of imagery that hints about how the "pure theory" might be qualified with monetary considerations. Money is conceived as the "loose joint" in the self-equilibrating market system. The fact that money is a *joint* linking the ability to demand with the willingness to supply gives meaning to Say's Law correctly understood. The fact that the joint is a *loose* one keeps Say's Law from being true in the vulgar sense. The play in the system associated with the use of money allows for deviations between the quantities of nonmonetary goods supplied and the quantities demanded. Recognizing money as the loose…focuses attention on the looseness between the supply of an assortment of capital goods and the subsequent demand for the corresponding consumer goods. It is this looseness that gives rise to the most common macromaladies, such as "overinvestment," or what the Austrian writers call "malinvestment." (Garrison, 1984, p.4)

[4] "Stability" here refers not necessarily to the general level of prices but to (changes in) the *money supply*.
[5] See Say, 1855, I.XV.4.

The loose joint metaphor describes the effects of money quite well. Money's main function indeed is as a medium of exchange, to "grease the wheels of trade." However, the transmission mechanisms of money do play an enormous role in coordinating supply and demand. If money is not stable, and the money supply is constantly tinkered with, so called "Cantillon effects" occur: New money is not simply poured from a helicopter; those individuals who print or receive the new money first obtain an advantage of buying before prices are bid up. Eventually, prices are bid up, and new access to cheap credit induces a boom of investment through artificially low interest rates, inciting the business cycle, according to Austrian theory. Although via a very different approach, Say himself anticipated the fallacies of monetary cranks:

> [To] say that sales are dull, owing to the scarcity of money is to mistake the means for the cause…[money] appears to vulgar apprehensions the most important of commodities, and the end and object of all transactions, whereas it is only the medium. Sales cannot be said to be dull because money is scarce, but because other products are so. There is always money enough to conduct the circulation and mutual interchange of other values, when those values really exist…It is a good sign when the business is too great for the money; just in the same way as it is a good sign when the goods are too plentiful for the warehouses. (Say, 1855, XV.5)[6]

Both of these qualifications are equally necessary, for they provide the context and notions of proportionality. Benjamin Anderson explains:

> The great producing countries are the great consuming countries. The twentieth-century world consumes vastly more than the eighteenth-century world because it produces vastly more…Supply and demand in the aggregate are thus not merely equal, but they are identical, since every commodity may be looked upon either as supply of its own kind or as demand for other things. *But this doctrine is subject to the great qualification that the proportions must be right; that there must be equilibrium*. (Anderson, 1949, p.390, emphasis added).

Failure for either or both conditions to be met *will* result in prolonged general gluts.[7]

Market forces will attempt to remove the excess production, but further hampering of both

[6] C.f. Footnote 8 below.

[7] Empirically, if one condition is broken, the other tends to be as well, as both fiscal and monetary policies affect the function and operation of money in society.

conditions will prolong the length of the glut. Throughout this process, it cannot be denied that it is entirely possible in reality for general gluts to occur, and for a length of time. A lengthy period of general gluts will occur *because* the above conditions have been violated.

To flat out deny that gluts are ever possible, or that they will never remain for more than a brief period of readjustment is to assert what might be called the *Vulgar Say's Law*. Since the twilight of the classical school, Say's Law has been conflated with this Vulgar Law. The latter is in turn conflated with the entire Ricardian system: as Ricardo's system fails, Say's Law no longer becomes holds, and vice versa. The vulgar law proponents would assert that gluts are conceptually impossible, and that no economy could experience anything like them other than ephemerally. Their critical mistake is believing that Say's Law is still fully applicable when it is not. Markets will ultimately resolve the glut, but government spending programs, subsidies, compulsory cartelizations, union wage controls, and inflationary printing of money excruciatingly grind the process to a halt. The vulgar law advocates fail to assert that it is government action that is precisely *preventing* Say's Law from exerting its dominance. Instead of traditional Say's Law defenders who say "gluts, if they appear, will be quickly removed if government does not hinder the process," the vulgar advocates stubbornly make no exception and assert "no gluts allowed."

V. SAY'S MOTIVATIONS

Why did J.B. Say include the law in his *Treatise*, especially if he did not explicitly claim it as his eponymous law or the keystone of his system? Say was a strong proponent of the Smithian and *laissez-faire* traditions of economics. Adam Smith had laid his economic foundations upon the ashes of the fallacies of others that he had exploded in *The Wealth of Nations*. He dedicated a great portion of his magnum opus to bulldozing through the sophisms

of the mercantilists. Once the false doctrines of government-granted monopoly, trade barriers, and bullion accumulation were destroyed, Smith could create the theoretical edifice praising *laissez-faire*, free trade, and capital accumulation.

J.B. Say did not stray far from this path, inheriting the keys to his own bulldozer. The law that would later bear his name was not the foremost thing on Say's mind, or the keystone of classical political economy. Say never conceived of either as such, nor did he ever refer to it, even retroactively, as "his law." Instead, it was meant to be a necessary hurdle to jump before he could focus on making a name for himself with his great *Treatise*. Ironically for Say, he was best known for the hurdle.

Thus, Say's Law was meant to refute the common fallacies of the day. As Austrian economist Ludwig von Mises wrote:

> Whenever business turned bad, the average merchant had two explanations at hand: the evil was caused by a scarcity of money and by general overproduction. Adam Smith, in a famous passage in The Wealth of Nations, exploded the first of these myths. Say devoted himself to a thorough refutation of the second. (Mises, 1974, p.64-65)[8]

Say's Law, then, was meant as an uninteresting truism, if not an outright tautology. But in his day, as in Adam Smith's, it was a necessary tautology to point out and explain. Mercantilist fallacies on money, production, and employment persisted in various forms (and still do), and Smith did not adequately address all of these economic sophistries with his own work. Thus

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[8] Smith's "famous passage" begins:

> No complaint, however, is more common than that of a scarcity of money. Money, like wine, must always be scarce with those who have neither wherewithal to buy it nor credit to borrow it. Those who have either will seldom be in want either of the money or of the wine which they have occasion for. This complaint, however, of the scarcity of money is not always confined to improvident spendthrifts. It is sometimes general through a whole mercantile town and the country in its neighbourhood. Over-trading is the common cause of it. (Smith, 1904, p.404 ff.).

came Say's turn to take on the economic ignoramuses and progress forward in the science of political economy. Henry Hazlitt provides an appropriate analogy for Say's intentions:

> Mathematicians seldom stop to assert that two and two do not make five. They do not explicitly build elaborate solutions of complicated problems upon this negative truth. But when someone asserts that two and two make five, or that an existing depression is the result of a general overproduction of everything, it is necessary to remind him of the error. (Hazlitt, 1959, p.41)

In order to refute such a common fallacy, it is necessary to begin by reiterating the first principles of the economic problem: man has unlimited desires and limited resources. Thus, he must produce goods (and exchange his goods with goods produced by others) to consume in order to satisfy those desires. The day that production is no longer necessary—and thus any such act results in excessive "*over*production"— is the day that the economic problem no longer exists.[9] Say discusses this elsewhere in his *Treatise* when discussing real changes in prices:

> For argument's sake…[imagine] the charges of production are at length reduced to nothing; in which case, it is evident there can no longer be rent for land, interest upon capital, or wages on labor…What then? Why then, I say, these classes would no longer exist. Every object of human want would stand in the same predicament as the air or the water…In like manner as everyone is rich enough to provide himself with air, so would he be to provide himself with every other imaginable product…Political economy would no longer be a science; we should have no occasion to learn the mode of acquiring wealth; for we should find it ready made to our hands. (Say, 1855, II.III.21-22)

In other words, the central irony of Say's Law is that if there ever *is* a general overproduction of goods naturally occurring in the market, it is not a time to lament, but to *rejoice*; for mankind has overthrown scarcity and resolved the economic problem once and for all! Of course, scarcity remains ubiquitous, and it is difficult, if not impossible, to conceive of such a Garden of Eden actually existing. Thus, any economic good can never be said to be overproduced; it is not superabundant, it is simply difficult for the producers to sell the good. This, almost always, is

[9] The term overproduction here is precisely synonymous with *superabundance*.

the result of the selling price being greater than the willingness to pay of the consumers, which can easily be remedied by lowering the price.

VI. MALTHUS' OBJECTIONS—"NOT ENOUGH TO BUY BACK THE PRODUCT"

Reverend Thomas Malthus, already famous for his dismal population thesis, was one of the first major figures to question the validity of Say's Law. Malthus observed the existence of general gluts as he was writing his *Principles of Political Economy*, published in 1820. He sought a theoretical explanation for the existence of such gluts, and suggested, among others, one plausible reason: the value of the product is greater than its labor cost.[10]

Malthus' argument anticipates the classic Marxist cry that the workers' wages are always less than the product's selling price, so they do not "earn enough to buy back the product."

> From want of demand, such commodities may be very low in price, and a large portion of the whole value produced may go to the labourer, although in necessaries he may be ill paid, and his wages, both with regard to the quantity of food which he receives and the labour required to produce it, may be decidedly low. (Malthus, 1820, p.299)

The largest problem with such an observation is that it relies on the Labor Theory of Value, tracing all product values to its component labor. History and experience has rejected the LTV in favor of the subjective utility of consumers as the root of all value. Malthus fails to consider (among other concerns) that labor is not the only factor of production – but it necessarily cooperates with land and capital (and arguably entrepreneurship). Therefore, it is *impossible* for labor to be paid the "whole of its product" because labor alone (except perhaps as in a direct consumer service) does not constitute production.

[10] Malthus certainly contributed greatly to the debate over Say's Law, and the importance or originality of his objections should not be discounted. However, for the present paper, it is redundant to address many of Malthus' other concerns, as they were largely captured and popularized by his intellectual descendent - John Maynard Keynes, whose objections will be addressed at greater length.

It is also instructive to note that the very act of production, through the payment of the factors of production, provides wealth for the laborers to purchase other goods. Since the laborers are paid for their labor services, they gain purchasing power to spend on other products. It may not necessarily be the product that *they* produce, but they now gain the purchasing power to purchase other goods, and aggregated across all industries, all factors of production now acquire the purchasing power to purchase the entire economy's produce.

Adjusted for LTV naiveté, the claim boils down to a fear that prices will fall below their natural cost of production. J.B. Say is one of the first to proclaim that value comes neither from labor nor any objective notion of "natural cost of production" but the selling price dictated by the *utilities* of consumers:

> The value that mankind attach to objects originates in the use it can make of them…To this inherent fitness or capability of certain things to satisfy the various wants of mankind, I shall take leave to affix the name of utility…Production is the creation, not of matter, but of utility. It is not to be estimated by the length, the bulk, or the weight of the product, but by the utility it presents. (Say, 1803, I.VI-VIII)

Since entrepreneurs set the price they can anticipate sales at, the solution for gluts again is simply to lower the price and pay the factors less, in proportion to the decline in selling price.

Malthus continues his argument by noting that:

> It has appeared then that, in the ordinary state of society, the master producers and capitalists, though they may have the power, have not had the will, to consume to the necessary extent. And with regard to their workmen, it must be allowed that, if they possessed the will, they have not the power. (Malthus, 1820, p.305)

Malthus conclusion from this line of reasoning, combined with others, is that an unproductive class of consumers is needed to "sop up" excess demand. In Malthus' day, this could have fallen to the government (as Keynes largely agreed with), or to Malthus' own idle landowning class.

VII. GENERAL GLUT #1: 1816-1823 BRITAIN

Thomas Malthus published his *Principles of Political Economy* in 1820, writing it during the 1810s – one of the most chaotic decades for the European continent during the 19th Century. Europe had been in turmoil for an entire generation – from 1789 to 1815, with the reactionary monarchist forces in a prolonged conflict against the French Revolutionaries and Napoleon Bonaparte. The fury of war obviously caused great economic strain on Europe. National governments amplified their expenditures on troops and war materiel, inflated their money supplies, and burgeoned their debts & deficits in order to pay for such a great struggle. Amidst this economic chaos were numerous international economic sanctions in the form of blockades, tariffs, and other mutual trade-barriers between belligerents.[11]

Following the war's close in 1815, the economic climate still worsened. There was wide-scale unemployment and economic stagnation as sales grew to a halt. In addition to redrawing the political map of Europe, governments had to repair the economic damages of war: addressing war veterans' pensions, severe fiscal imbalances, interest payments on soaring national debts, and currency devaluations. Most governments had suspended the convertibility of their currency into gold specie during the war—implicitly declaring national bankruptcy—in order to inflate the money supply to pay for their abnormally large expenditures. In Britain, the Bank of England launched the "Great Recoinage" in 1816, which unadvisedly reestablished the parity of the pound to the *pre*-war level, prompting a painful deflation. With the poor monetary situation also came further price controls and the repressive political acts to forcefully ensure compliance.[12]

[11] Prominent examples include the French "Continental System," the British *Orders in Council* (1807) and *Corn Laws* (1791, 1815), the United States' *Embargo Act* (1807), almost creating national autarkies. See Tom Holmberg, 2003.
[12] The *Importation Act* (1815) further raised the price of wheat. 1816 was known as the year without a summer due to continental crop failures. In response to mass rioting and radicalism, Parliament suspended the *Habeas Corpus Act* in 1817 and passed the *Six Acts* (1819). See Tom Holmberg, 2003.

From such circumstances, it is easy to see that Say's Law clearly was not able to come into effect. Both conditions had been severely violated. Condition (1) was violated by the massive government expenditures and tariffs during the war, but more importantly by the controls imposed in the post-war recession, preventing high prices from adjusting downwards. Condition (2) was broken when the British government tampered with the money supply, first inflating it during the war (making the prices artificially high), breaking the gold standard, and then redefining it at an unsound rate causing chaotic deflation. Malthus was keen to observe that general gluts *had* appeared, but had taken the businessman's siren song of "overproduction" as the true disease, not a mere symptom of it. Thus, Malthus could only attack the *Vulgar* Law for ignoring the possibility of gluts, for a free market was not existent for Say's Law to properly run its course. Not coincidentally, Malthus' ephemeral interest in writing on gluts ended with their disappearance—as the hampered market finally cleared and the depression ended in 1824.

VIII. KEYNES' LAW VS. (KEYNES') SAY'S LAW

John Maynard Keynes, in full Malthusian tradition, used the ashes of Say's Law as the fuel for his "revolution" in economics. He is said to have once and for all refuted the archaic Say's Law, which, over all of his other contributions, is chalked up as his greatest achievement. While Say and Malthus argued contemporarily, the 1930s saw the largesse of the economics profession too enticed by the Keynesian Revolution to examine Say's Law honestly. Keynes began *The General Theory* by introducing the law as the "postulate of classical economics:"

> From the time of Say and Ricardo the classical economists have taught that supply creates its own demand; – meaning by this in some significant, but not clearly defined, sense that the whole of the costs of production must be spent in the aggregate, directly or indirectly, on purchasing the product. (Keynes, 2007, p.18)

Labeling it as a core postulate, Keynes feels justified in saying, "it still underlies the whole classical theory, which would collapse without it," (Keynes, 2007, p.19). Conversely, if Say's Law is proven to be true, then the Keynesian system must necessarily falter upon its own assumptions. Keynes proceeds so boldly and nonchalantly about refuting Say's Law that he dedicates not even four pages to the task.[13] He commences his broadside by quoting J.S. Mill:

> What constitutes the means of payment for commodities is simply commodities. Each person's means of paying for the production of other people consist of those which he himself possess. All sellers are inevitably, and by the meaning of the word, buyers. Could we suddenly double the productive powers of the country, we should double the supply of commodities in every market; but we should, by the same stroke, double the purchasing power. Everybody would bring a double demand as well as supply; everybody would be able to buy twice as much, because every one would have twice as much to offer in exchange. (Mill, 1909, III.XIV.6)

And Keynes simply stops there, considering this to be the "essence" of Say's Law for him to take to task. If Keynes had quoted only three more sentences of Mill's same paragraph, he would understand the context and qualifications Mill placed on the law:

> It is probable, indeed, that there would now be a superfluity of certain things. Although the community would willingly double its aggregate consumption, it may already have as much as it desires of some commodities, and it may prefer to do more than double its consumption of others, or to exercise its increased purchasing power on some new thing. If so, the supply will adapt itself accordingly, and the values of things will continue to conform to their cost of production. (Mill, 1909, III.XIV.6)

This (intentionally?) neglected passage connotes the critical notions of balance and proportionality in Say's Law. It requires free markets and sound money so the adjustment process will ensure that no goods need remain unsold. This equilibrating process is often hampered by government policies, and as a result, this notion of self-correcting equilibrium is forgotten, and Say's Law is misinterpreted as the Vulgar Law. Thus, Keynes here attacks only those vulgar apologists, (by his own implications, the entire classical school of economics) who

[13] *Op. cit.* pp.18-21.

allegedly make the absurd assumption that thanks to Say's Law, depressions are impossible, and markets will always and everywhere clear promptly.

Keynes' first step in replacing Say's Law was attacking the proposition that "saving equals investment," which he considers "a corollary of the same doctrine," (Keynes, 2007, p.19). The classical economists had argued that a decision to save is a decision to invest.[14] Keynes, anticipated by Malthus, argued that many times money functions not only as a medium of exchange, but moreso as a store of wealth. He criticizes proponents of the law for, "fallaciously supposing that there is a nexus which unites decisions to abstain from present consumption with decisions to provide for future consumption; whereas the motives…are not linked," (Keynes, 2007, p.21). Essentially, Keynes is saying that a decision to save is *not* necessarily a decision to invest; they may be two mutually exclusive decisions.

Keynes observes that savings is not always matched by an investment decision, that there are people who keep their money in *hoards* and refuse to invest.[15] This money "leaks" from the circular flow of spending decisions. No matter how much savings are channeled into investment decisions, certainly it is true that there will always be people who will hoard. In depressions, it is more than just the miser who hoards; nearly everyone does out of fear. What will happen economically? According to the Misesian cash-balance theory of money, a general increase in (hoarded) cash balances will reduce the general level of prices for all goods, raising individuals' *real* cash balances, and the market will ultimately clear again, (Mises, 1953). Keynes instead fears that if everyone saves/hoards and prices deflate, profits will fall and continue the

[14] David Ricardo, countering Malthus, "Mr. Malthus never appears to remember that to save is to spend, as surely as what he exclusively calls spending." Saving is merely "spending" by other means – investment.
[15] What constitutes a "hoard," of course, is entirely defined by *A*'s arbitrary opinion that *B* is holding "too much."

depression further. He labels this concept the "paradox of thrift;" that a positive act for an individual yields damaging results for society.

To solve such problems, Keynes, like Malthus, turned to the State for economic leadership. Government policies would "stabilize" the inherently chaotic free market, which incessantly wobbles at the tipping point of a see-saw between inflation and unemployment. Keynes believed that the State, through monetary and fiscal policy, ought to "fine tune" the economy, pumping spending in when spending is low (and unemployment is high), and siphoning spending out before the economy overheats (and experiences inflation). In a depression, when Keynes was writing and recommending public policy, it is the function of the government to encourage spending wherever possible to provide outlets for jobs and production, be it real or imaginary:

> Unemployment develops…because people want the moon; —men cannot be employed when the object of desire (i.e. money) is something which cannot be produced and the demand for which cannot be readily choked off. There is no remedy but to persuade the public that green cheese [government printed money] is practically the same thing [as real money] and to have a green cheese factory (i.e., a central bank) under public control. (Keynes, 2007, p.235)

The government, in collaboration with the central bank, must print money and provide outlets to increase spending through whatever outlet. This gives rise to the (often misquoted) Keynesian burlesque of having the government pay people to dig ditches and fill them up again:

> If the Treasury were to fill old bottles with banknotes, bury them at suitable depths…and leave it to private enterprise…to dig the notes up again…there need be no more unemployment, and…the real income of the community…would probably become a good deal greater than it actually is. (Keynes, 2007, p.129)

Keynes' fears, on which his policies are founded, beg the question—*why* do people hoard? He was absolutely correct in asserting the role of uncertainty and psychological confidence crises in the economy, but he failed in identifying where and how they occur. Much of the fear of uncertainty is caused by chaotic inflation and deflation; people will not spend if they think prices

will continue to fall, and will drive the economy into a bubble if prices continue to rise. The not-so hidden irony is that such inflation (and its subsequent deflation) is fueled by the very money that Keynes wants the government to print, in hopes of achieving the ultimate Keynesian fantasy of a "permanent quasi-boom," (Keynes, 2007, p.322). Thus the trade cycle of booms and busts, according to the Austrians, is fueled by such generous access to "liquidity." The greater paradox at work is that if Keynes believes that there is too much saving, how will printing more money to "act" as "real" savings solve the problem of over-saving?

Say had reserved harsh words in advance for such government make-work schemes:

> The encouragement of mere consumption is no benefit to commerce; for the difficulty lies in supplying the means, not in stimulating the desire of consumption; and we have seen that production alone furnishes those means. Thus, it is the aim of good government to stimulate production, of bad government to encourage consumption. (Say, 1855, I.XV.20 and *passim*.)

The remainder of Keynes book makes the case not that "supply creates its own demand," but that "demand creates its own supply." The absurdity of such claims is captured best by Hazlitt:

> How marvelous is the Keynesian world! The more you spend the more you save. The more you eat your cake, the more cake you have. (Hazlitt, 1959, p.375)

IX. GENERAL GLUT #2: 1929-1941 UNITED STATES

All of Keynes' economics are is predicated upon the observation that wages and prices are "*sticky*," or even "*rigid*," that is they are almost incapable of change at many levels. The observation was certainly astute and important, but what was lacking was a full theory of *why* they were sticky and *what had caused* their stickiness.

Perhaps the most famous and severe glut in modern times is the Great Depression, during which Keynes published the *General Theory*. Double-digit unemployment, bank failures, and

other economic maladies plagued the world for over a decade. The policies and regulations in place during the depression did much to prolong it, tampering with the ability of the market to offset and clear away any gluts. In America, President Hoover, largely blamed for sitting idly by during the early stages of the depression, is straw-manned just as often as Say's Law. The reality of Hoover's interventionism stands in stark contrast to the public-school myth of Hoover being "Mr. Laissez-faire."[16] Hoover launched policies designed to keep wages up at all costs through strong-arming industries to promise not to cut wages, and to expand projects. "Hoover was insistent that the first shock of the depression must fall on profits and not on wages—precisely the reverse of sound policy," (Rothbard, 2000, p.211). The "Hoover New Deal" is greatly eclipsed by the sheer size and scope of the FDR New Deal, but it is often forgotten that it provided the critical precedent and regulatory momentum for Roosevelt's programs.

Roosevelt's programs further expanded the scope of government intervention into the economy. The National Recovery Act of 1933 attacked unemployment from multiple flanks with the purpose of keeping wages high. Labor unions backed by the full force and power of the federal government were able to coerce wages higher at the expense of unemployed nonunion workers. Compulsory cartels were created to restrict output and raise prices to achieve high profits. The Glass-Steagall Act institutionalized additional financial moral hazard in the form of the FDIC. Executive Order 6102 confiscated the gold of the American public at $20.67 an ounce, bringing America into an era of unstable fiat banknotes and away from gold, which the government then proceeded to revalue at $35 an ounce and reap seignorage at public expense to

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[16]For a dispellation of the "Hoover myth," and an analysis of the Great Depression (and the inflationary boom of 1921-1929) from an Austrian perspective, see Murray Rothbard, *America's Great Depression*. From Hoover's own acceptance speech for the 1932 Republican National Convention:

> [W]e might have done nothing. That would have been utter ruin. Instead we met the situation with…the most gigantic program of economic defense and counterattack ever evolved in the history of the Republic...We determined that we would not follow the advice of the bitterend liquidationists…(Rothbard, 2000, p.187)

boot. The slew of governmental policies, perhaps despite honest intentions, were misconceived economically, mistaking effect for cause and making the cure worse than the disease.

This is an obvious indication that neither condition of Say's Law were met. The market clearly was not free, but hampered by inflationary factors during the 1920s, and then dense regulation during the 1930s. It was clearly obvious that the "stickiness" of wages that Keynes observed were caused by the coercive influence of legally-backed labor unions, compulsory cartelization, and almost direct oversight of the economy by the White House. Prices simply were not allowed, *by law*, to adjust. The market was also driven by unsound money, as demonstrated by the 1920s inflation and attempts to "stabilize" the price level to prevent deflation during the 1930s. The final severance of the gold standard in favor of complete government-monopolized fiat money was the icing on the cake of unstable money.

Given this context, Keynes' discussion of Say's Law is a classic straw man argument. He first confused Say's Law for the Vulgar Law, declaring explicitly that conditions (1) and (2) have *not* been met and thus that the law fails. To add insult to injury, he explicitly advocated breaking the two conditions by calling for extensive government intervention and tinkering with the money supply, and *then* had the effrontery to proclaim the failure of Say's Law.

X. CONCLUSION

Say's Law of Markets has suffered from an unfortunate duality for almost two centuries. It has often been confused for a vulgar refusal to acknowledge the conceptual possibility of gluts on the market. The market, aided and abetted by a lack of regulation or unstable money, will clear any gluts from the marketplace. It will cease and desist in this process under the penalty of law—government regulations distort and prolong the process to a painful depression. Detractors,

such as Thomas Malthus and John Maynard Keynes have often asserted that Say categorically rejected gluts, but mistake the purposes and intentions of Say's law. Their arguments boil down to the basic syllogism:

1. If Say's Law is true, there can be no gluts.
2. There are gluts.
3. Therefore, Say's Law is not true.

The error is not in logic, but in thinking that premise one is true. It only is for the Vulgar Law, which unlike the real law, does not ever allow for gluts. Thus, Malthus and Keynes have laudably observed that gluts have existed, but were unable to satisfactorily discuss *why* Say's Law did not apply, or *what had caused* the prolonged gluts. Say's Law is not the grandiose foundation of the classical system it is said to be; it is the bungee cord that protects sound economists from falling into the pitfalls of monetary crankdom. As Hazlitt puts it best:

> There is still need and place to assert Say's Law whenever anybody is foolish enough to deny it. It is itself, to repeat, essentially a negative rather than a positive proposition. It is essentially a rejection of a fallacy. (Hazlitt, 1959, p.41)

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