A brief look at Say's Law: Attempting to understand its relevance and meaning

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Attempting to Understand its Relevance and Meaning

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Abstract

Although little talked about in contemporary economics, the collection of principles popularly known as Say's Law were profoundly influential upon economists of the classical era. Kates (1997), who has quite a bit to say on the subject and receives much attention here, ascribes such importance to Say's Law that he sees it as the point of origin for Keynes' *General Theory,* which sought to destroy this Law through oversimplification. Preoccupied as the collaborators (Say, James and John Stuart Mill) were with causes of depression, unemployment and growth, perhaps these forgotten dictums retain some relevance to these times. This paper seeks to explore the relevance and importance of Say's Law by researching the relevant literature, and offering a tripartite point of view; 1) the author's own take on Say as a whole, 2) Say as interpreted by John Stuart Mill, and 3) a look at the equivalence of Say's definition of savings and growth with the modern interpretation of it.

Introduction

The popularly accepted definition of Say's Law, "supply creates its own demand," never appeared in the writings of Say, nor were they accepted as the normative standard until the assent of Keynes. Keynes, however, had his own agenda; as Kates (1997) points out, "where classical economists had denied the possibility of demand failure, Keynes set about trying to demonstrate that demand failure was the single most important cause of recession and unemployment" (p. 192). In forcing the course of his theorems and conclusions to fit the limitations imposed by his preconceptions, Keynes shared much with J.S. Mill, of whom more will be discussed later. Despite Keynes' purposeful distortions, Say and his classical brethren never denied the possibility of a distortion of supply, nor did they deny the possibility of market gluts (a situation in which producers provide more goods than consumers are willing to purchase). Say simply denied that this was the cause of recessions, a position that, despite more than a century of mainstream acceptance, Keynes found untenable.

It is the contention of this author that Say postulated a circular flow of supply and demand that was interrupted only by errors in production; overproduction of goods that consumers did not want, and underproduction of goods that they did. A correction in the mixture of goods produced would be sufficient to overcome any glut. As such, demand failure was not only impossibility; by definition, it could not be the cause of recession or unemployment. These deficiencies, Say believed, came about because sellers are also consumers, producing in proportion to that which they wished to obtain. As Jonsson (1997) notes, "in bilateral trade, any attempt to sell is also an attempt to buy…if, due to miscalculations, a trader's offerings are not wanted by the trader's prospective trade partners, then this will affect the trader's 'effective demand' for other products" (p. 205)". In essence, the material desires of producers sometimes cause an overproduction of undesired goods, while other goods with greater demand go unmade. A correction in proportion of goods produced will be sufficient to erase any glut and cause the circular flow to once again function properly.

Of course, any summation of Say's Law falls prey to the dangers of oversimplification. This is helped but little by Say's own failure to provide rigorous substantive definitions or defense of his principles. As Jonsson , et al, notes, "he never bent…to the task of hammering them out so that they may be recognized by everyone…he invariable mismanaged his case in controversy by replying to criticism in a desultory manner, without bestowing the requisite amount of work on it" (p. 206). This work he left to others; some of whom, like Keynes, interpreted him quite incorrectly. While this author believes his interpretation of Say's Law to be accurate in light of the best literature available to him, perhaps it is best to look into the interpretation of the classical contemporary who best clarified his principles to discover its best meaning.

The Law under the Prism of John Stuart Mill

Kates (2005) contends that while the first published instance of the words "supply creates its own demand" can be found in Keynes General *Theory of Employment, Interest and Money*, "their most likely origin is in the writings of John Stuart Mill" (p. 49). That the younger Mill undertook the task of interpreting Say's principles is in keeping with his character; as Sowell (2006) notes, it was mill's wish to "render economics accessible to generations to come" (p. 153). Moreover, the elder Mill was a proponent of Say's Law, and while his son may not have regarded him with tender affection, he viewed the man responsible for nurturing his towering intellect with a deep sense of loyalty.

In reviewing J.S. Mill's views regarding Say's Law, it is perhaps an instructive beginning to focus on James Mill's view of the matter. Sowell, et al. astutely notes that in responding to challenges regarding Say's principles, "Mill simply did not spend any time on old ideas…refuted by his father Say, and Ricardo years earlier" (p. 135-136). Mill saw it as doctrine that there was no such thing as an equilibrium aggregate income (a state in which the market has produced all the goods and services consumers will demand, thus limiting national income), and that an economy spanning glut was an impossibility. He believed this for no more reason that that his father, and his father's esteemed friend Ricardo said it was so. In no way does this diminish his work upon the subject; the eccentricities of Mill would fill volumes without diminishing the effect he had upon his era.

It is the elder Mill, James, Baumal (1977) notes, who is initially "credited with the notion that "supply creates its own demand" (p.145). This simple proposition, contends Baumal was really an aggregating oversimplification for two much more complex principles espoused by Say and the elder Mill that have come to be known as Say's Identity and Say's Equality. In these two principles, according to the author, lay the whole of says law. Say's Identity, as it were, contends that no consumer has any desire to hold money for any significant length of time; therefore, every supply of a bundle of goods represents a demand for a different bundle of items of equal value. As such, supply and demand operate in a state of equilibrium, rendering the idea of a general glut a logical impossibility.

Say and the elder Mill were not blind to the reality that gluts existed; modern scholars have credited them with formulating the second set of principles inherent in Say's Law, Say's Equilibrium. According to this tenet, there are "brief periods of disequilibrium during which the total demand for goods may fall short of the total supply, but maintains that there exist reliable equilibrating forces that must soon bring the two together" (Baumal, et al, p. 146). This is caused, according to J. Mill, by an improper reading of demand on the part of producers. In correcting goods and services produced in proportion to consumer's desires, equilibrium is restored.

To this, John Stuart Mill certainly agreed, noting "we have seen that the value of everything gravitates towards a certain medium point…at which it exchanges for every other thing in the ratio of their costs of production" (Mill, 1848, p. 417). Moreover, "the actual or market value coincides, or nearly so, with the natural value only on an average of years; and is continually either rising above, or falling below it, from alterations in the demand, or casual fluctuations in the supply: but that these variations correct themselves, through the tendency of the supply to accommodate itself to the demand which exists for the commodity at its natural value" (Mill, et al. p. 417). Mill is clearly echoing the words of his father in insisting that the purpose of goods is to buy other goods, and that this precludes any possibility of a general glut in the economy.

It was Mill's reinforcement of these beliefs, notes Kates (2007) which led him to write "'every increase of production … creates … its own demand" (p. 34).This echoes Say's assertion that "it is not the abundance of money but the abundance of other products in general that facilitates sales" (Baumal, 1977). Mill concedes that there is a point at which goods cannot be sold at cost covering prices; these are the "casual fluctuations in supply" that he spoke of. Contrary to the beliefs of others, Mill contends that such circumstances are not the cause of recessions, but instead one of their most visible effects. Such unpleasantness was "typically due to over-trading or speculation and in which the consequences were 'a derangement of markets'… aggregate demand falling short of aggregate supply was never the reason" (Kates, 2007, p.36). In essence, recession was nothing more than the result of capitalists placing the wrong bets.

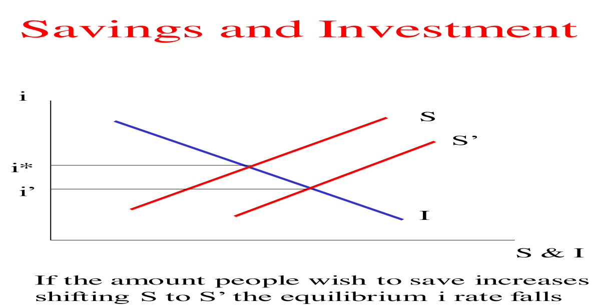
Ironically, despite his fierce advocacy of Say's Law, Mill himself postulated the possible existence of equilibrium aggregate income when he published the following; "the rate of profit is habitually within, as it were, a hand's breadth of the minimum, and the country on the verge of the stationary state" (Mill, 1848, p. 547). As profit is a function of supply and demand, an environment in which profit is at a state of static equilibrium implies that supply and demand must also be at the same; the aforementioned point at which the market has produced all the goods and services consumers will demand, thus limiting national income.

That this was a contradiction hardly seemed to bother Mill; the existence of an equilibrium aggregate income had previously been dismissed by J. Mill, Ricardo and Say, and was therefore a settled point in Mill's mind. As Sowell et al. puts it, "Mill wrote about that static declining marginal productivity of capital as if it were complete compatible with his earlier dismissal of…'the fallacy of the universal glut.' Which he regarded as among the 'refuted, and now almost forgotten errors" (p. 141). Yet, Mill was now in his own manner advocating this "fallacy" that was amongst the most refuted and forsaken of errors. In his role as the interpreter and gatekeeper of J. Mill's and Say's legacy, it was contradictions such as these which allowed later men such as Keynes to brush Mill aside and reinterpret Say to their own ends (ultimately brushing him aside as well).

On Savings: How Say's Law is Relative to Modern Economics

Were Say's Law just an intellectual curiosity, it would be well worth it to study its principles if only for their historical relevance; the economists of the classical era spend a great deal of their time either defending or refuting these principles. However, these principles have their place in the modern study of economics as well. One needs only to look to such eminent persons as Keynes and McCracken, who undertook to destroy reliance upon Say's principles to further their own beliefs regarding the operations of markets.

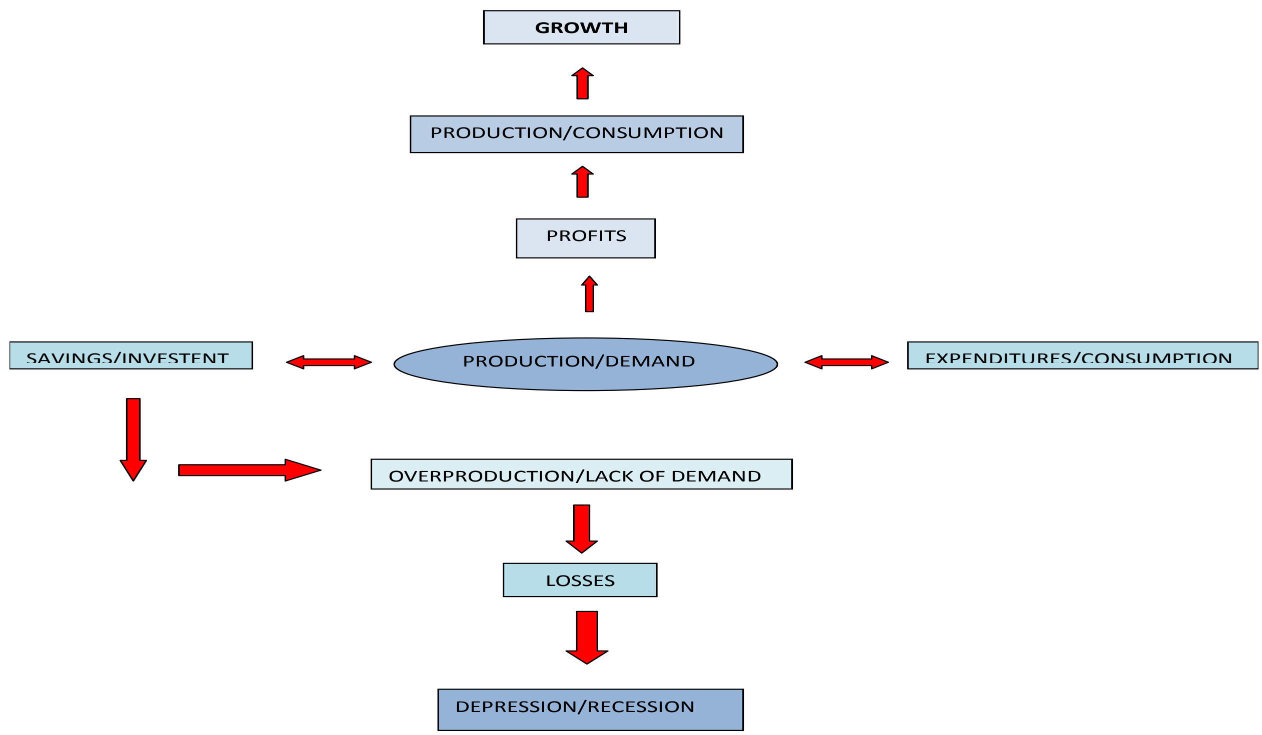
While in most instances, Say and his contemporaries viewed money as a veil, mirroring the cycle of supply and demand rather than serving as a causal agent, they did not deny that the circulation of money had some effect upon economic growth. What is especially salient in this post-recession period of slow growth is Say's belief that depressions (and to their own extent, recessions) are caused by idle (non-circulating) supplies of money. To Say, money represented investment capital for the factors of production, and was thus equal to consumption expenditure. Any disparity between savings and investment expenditure was brought into equilibrium by naturally occurring changes in the real interest rate[1]:



As Say believed that goods purchased goods, he did not believe that there was any such thing as too much savings. He held, as did the rest of his classical brethren, that "money will not be allowed to lie idle" (Sowell, et al., p. 26)While he recognized that there are periods of slow investment (gluts), the circulation of money followed the same pattern as the flow of goods; equilibrating forces would rectify this imbalance. The exception to this rule, as Mill pointed out, was imbalances in trade and unprofitable speculation. This was the rot that led to depressions.

[1] Diagram accessed from University of Victoria (web.uvic.ca/~rutherfo/mr_Econ337part9.pp)

Note that although Say did not believe that imbalances in production led to downturns, the mirror of this, imbalances in the supply of money, did. In cart form, say's logic may be aid to be something like this:



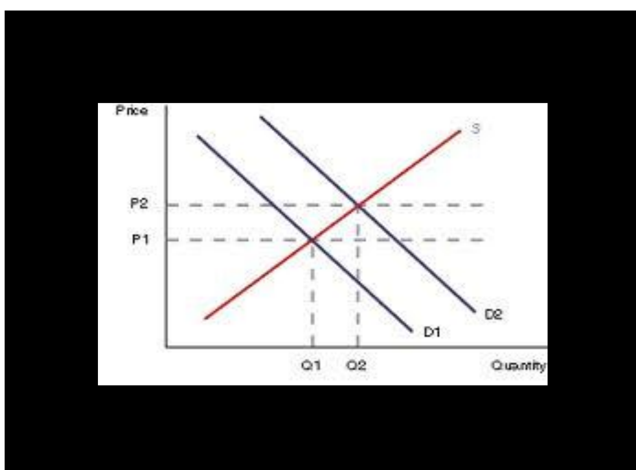
The question remains whether or not Say is correct in his belief that a high rate of savings leads to economic growth. To this, it is my belief that the modern economist must say, partially. To fully develop this contention, perhaps a definition of what Say meant by saving is in order. Like his classical brethren, he held that money was a veil, acting as a means of trade acceptable to all parties; by this definition, money is a perpetual effect with no causal properties. This stood in stark contrast to the prevailing theory favored by the capitalists of the mercantilist regimes, which held that the supply of money was the progenitor of wealth. The solution, then, to periods of overproduction and under-consumption was to artificially stimulate demand through the creation of more currency (the genesis, though in different ways, of tenets of both Keynesian and Friedmanian monetarism).

Say accepted no such principle. In the mercantilist, agricultural society of Say's time, Say believed in a circular flow of supply and demand, with goods purchasing goods, and derangements in the supply of goods being corrected by equilibrating forces. As the universally accepted means of transaction, money was meant simply to represent an investment in production, as again, goods follow goods. In order for equilibrium to be maintained in the cycle, the rate of money saved needed to be equal to the rate of investment, so that the fluctuation of interest rates would not affect the cycle. Any level of holding money higher than this, Say termed hoarding. As J.S. Mill equated, in another break with the principles he so assiduously defended, this creates excess demand for currency on the part of those who need it as a medium of exchange, creates a lack of demand for the fruits of production, and by extension, oversupply, as goods go unsold (Sowell et al, p. 39). This is the root of depression.

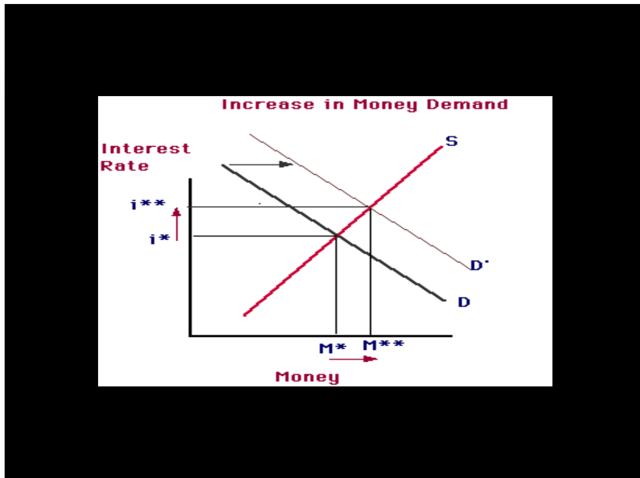
The flaw inherent in this logic is immediately visible. Were money simply a transactional tool, a hoarding of it would create no havoc in the market. Production and consumption would go on unaltered, as alternative means of trade (barter) were utilized. This represents a missing arc in Say's mirrored circular flow. What Smith, Say, Ricardo, J. Mill et al failed to realize that in creating money and accepting it as the standardized medium of trade, a commodity (good) had been fashioned that shared the same characteristic of other goods traded within the marketplace. Therefore, money is not simply a veil, but a causal agent in and of itself.

Any look at interest rates (representative of the supply of money) will verify this; high interest rates (undersupply) mute demand for money, causing the trade imbalance known as oversupply. This eventually causes a downward pressure on price, as goods buy goods, and idle inventory is worth nothing to supplier or consumer. Low interest rates potentially represent an oversupply of money, depressing values for suppliers of goods and potentially leading to undersupply. This in turn eventually places upward pressure on prices, prompting production until equilibrium is reached. This follows the same circular flow that Say's proponents noted of other commodities, with the same equilibrating forces existing to correct temporary imbalances. Notice the similarities in the following supply and demand schedules for both money and goods:

Supply and Demand: Goods



Supply and Demand: Money



The similarities between commodities need no further comment, other than to lead into discussion of the implications of Say's Law in regards to the savings rate's effect on modern growth. In contemporary terms, savings as it equates to investment relates to the deposit of consumer funds into accounts at financial institutions. A high rate of savings increases the available pool of loanable funds (goods being traded for goods), lowering interest rates and making investment in the factors of production attractive to suppliers. In turn, this promotes increased, borrowing and spending, fueling growth. A low rate of savings has the inverse effect, raising interest rates and muting both borrowing and spending. This "hoarding," in Say's terms, a "derangement" of undersupply (money) and oversupply (goods), leads to stagnation. Taken to its extreme, the result is contraction. Other things equal, contraction would correct itself in a truly free market, due to the equilibrating forces that Say, the Mills and others of their era astutely recognized.

Conclusion

While Say and his proponents proved shortsighted in their understanding of the causal effects of currency, their comprehension of growth as a result of supply and demand was truly revolutionary during what is universally held as the beginning era of modern economics. In the wake of the recent global unpleasantness fueled by the widespread trading of derivative securities packaging subprime U.S. housing notes, the younger Mill's (1848) observation that "commercial revulsions" result from "the waste of capital in periods of over trading and rash speculation" (p. 549) has certainly been proven salient. Despite the deliberate obfuscations of men such as Keynes and his cronies Say and his collaborators in no way denied the existence of gluts, recessions or cyclical unemployment (Marx, and to a lesser extent, Keynes, would probably argue that it was instead structural, but that is a matter for a different venue). To the contrary, they were all too aware of such matters, as the encroachment of the Industrial Age made them all too evident.

Proximate causes of these events were the major concern of Say and the Mills. In discovering these proximate causes, they hoped to be able to reason out the ultimate cause, thus enabling them to erect principles and policies that promoted perpetual growth and advancement. Though by failing to understand the true role of money (with the partial exception of the younger Mill) they ultimately failed, what they discovered is not so different from the tenets we hold today. As Jonsson, et al, points out, Say's "arguments to the effect that the supply of goods drives the demand for goods are really no different from modern circular flow arguments…that the productivity of the factors determines factor incomes which in turn represent expenditures on goods and services" (p. 205). Again, failure to recognize money as a commodity with causal properties did not invalidate the validity of circular flow; it merely fell short in understanding that money was part of that flow, not a mirror of it.

Moreover, as Blaug (1997) points out, in J.S. Mill's recognizing that the "utility of money" is commensurate with the possessors'' wish to purchase goods (whether immediately or deferred), Say's school came very close to originating the modern theories on marginal utility (p. 232). Also, as Sowell, et al, points out, much of Marx owed much to Say's and his proponents in his attacks on capitalism, if only to refute them; "Marx, however, was a bitter critic of Say's law…disproportionality did not end with smooth restoration of equilibrium, but precipitated further complications…Marx spotted the fatal flaw in (Say's) reasoning" (p. 173-174).

Incomplete though it may be, Say's Law not only affected a great influence upon economists of its day, but upon future generations of economists as well. That it impacted such influential men as Marx and Keynes, who sought to relegate it to irrelevance, should not go unnoted. The younger Mill's innovation concerning the role of "rash speculation" in causing imbalances and recessions has significant cultural relevance today. Understanding of the relationship between the factors of productivity and expenditures on goods and services can be found in Say's theories on the circular vent of supply and demand, which simplifies the process by eliminating money as a commodity (so long as the reader understands the oversimplification). Even his musings on savings and growth, though limited, veered towards being on the right track. In light of these considerations, the principles of Jean-Batiste Say and his brethren still retain some relevance to the study of economics today.

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