Keynes and Say's Law of Markets: Analysis and Implications for Austrian Economics

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1 Introduction

In 1936, the publication of John Maynard Keynes' *The General Theory of Employment, Money, and Interest* marked a complete turnaround for macroeconomic theory. In the introduction to the French edition in 1939, Keynes identified Say's Law, or the law of markets, as a central tenet of classical economic theory that, though it had faded into obscurity, was prohibiting his contemporaries from making real theoretical progress.[1] He set out to dismantle Say's Law, which states that the demand for goods is constituted by the supply for goods; he was so successful that this principle is now a footnote in the history of economic thought. This development is simply stunning when the importance of Say's Law to classical economic thought is understood. One hundred and twenty years before *The General Theory*, James Mill wrote in *Commerce Defended*:

[1] Keynes in Kates 14

> No proposition however in political economy seems to be more certain than this which I am going to announce, however paradoxical soever it may at first sight appear; and if it be true, none undoubtedly can be deemed of more importance. The production of commodities creates, and is the one and universal cause which creates a market for the goods produced.[2]

How did such a tremendous reversal come about? The law of markets went from being totally certain and of utmost importance to a trite, outmoded idea that merits little study. The primary thesis of this paper is that Keynes was effective in his rebuttal of Say's Law via a twofold attack: first by setting up a straw man that makes Say's Law an absurdity, and then by presenting a litany of reasons as to why deficient demand, which Say's Law denied the existence of, was the cause of recessions. This paper shall not explore deeply Keynes' arguments for liquidity preference, the marginal efficiency of capital, or the marginal propensity to consume as instigators of a failure of effective demand, but rather shall focus on Keynes' straw man and the role that it plays in *The General Theory*. I am primarily indebted to Steven Kates' *Say's Law and the Keynesian Revolution: How Macroeconomic Theory Lost Its Way*; my reading of other sources has been primarily from their being referenced in Kates, and his argument is the critical pivot upon which my thesis turns. The secondary purpose of this paper is to begin to understand Say's Law in the context of the Austrian economics.

2 Early Development

2.1 Say and Mill

In 1803 Jean-Baptiste Say published *A Treatise on Political Economy*, containing his law of markets in an early form. After James Mill published *Commerce Defended* in 1807, Say revised his treatise several times, eventually resulting in the fourth edition in 1821.[3] Though Mill is more clear and less prone to error, this paper shall focus primarily on Say's fourth edition for the sake of space and in order to get at the very core of the idea expressed

[2] James Mill, *Commerce Defended* in Kates 28

[3] Kates 21-40 traces this development.

in the law of markets in its original formulation.[4]

The critical text in which the law of markets is introduced is Chapter XV of *A Treatise on Political Economy*, entitled "On the Demand or Market for Products." The reader gets a first impression of the law of markets in the third paragraph:

> A man who applies his labour to this 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 to a conclusion that may at first sight appear paradoxical, namely, that it is production which opens a demand for products.[5]

This is by no means an explanation of exemplary clarity, and it suffers in modern interpretation by several outmoded classical ideas embedded in it, notably his claim that the utility of a good is in the good itself. Nevertheless, the basic premise is one that still holds: by supplying, one is empowered to demand, demand being a combination of the desire and ability to consume; that is, demand here is demand manifest in market activity, not a mere psychological desire. A more clear expression follows a bit later in the chapter:

> 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... Thus, the mere circumstance of the creation of one product immediately opens a vent for other products.[6]

That is to say, if one produces a good, the revenue from the sale of that good constitutes the demand for the goods the producer desires. The law of markets, then, merely points out that the reason that people produce goods is for the consumption of those or other goods which can be had by exchanging what was produced.[7] Conversely, if the individual did not desire

[4]Spengler argues that this is a Physiocratic idea beginning with Turgot, but it is Say who brought it into the mainstream of classical economic thought (Kates 164-5). See also Hutt 7.

[5]Say, *Treatise* 133

[6]Say, *Treatise* 134-5

[7]Say, *Treatise* 133

more, he would not produce more. This idea seems incredibly simple, but the failure to accurately interpret it is the pivot upon which macroeconomics was radically altered.[8]

2.2 Malthus and Deficient Demand

If a misinterpretation of the law of markets is the pivot upon which the Keynesian revolution reversed the course of economic history, the force applied to it was an argument for deficient demand. Keynes made demand failure a staple of macroeconomic theory, but he was following in the footsteps of Thomas Robert Malthus.[9] Malthus argued long before Keynes that a lapse in effective demand could cause recessions, claiming that people only wanted a certain number of goods and that therefore there could be gluts in production, or an overabundance of goods. His argument is entirely psychological: people only want so many goods, therefore there can be overproduction; overproduction leads to unsold goods, and therefore recession.[10] Thus Malthus is not arguing that production does not create the means to consume, but rather that it is not necessarily a function of the desire to consume.[11]

James Mill, in *Commerce Defended*, saw that the law of markets forbade the possibility of a general glut in production.[12] As stated above, the only reason that people produce is to consume. If they do not wish to consume, they will not produce. In other words, taking the effort to afford the power to consume requires that the will to consume exists. Therefore, it is impossible for there to be a failure of demand based on the quantity of goods consumed.

This is the central focus of the law of markets: because people produce to trade or consume, there cannot be a failure of demand. Say himself saw that the law of markets is precisely what makes demand failure impossible when writing a letter to Malthus concerning his support for the notion of demand

[8] This is the central argument of Kates' book. See "The Keynesian Revolution" below.

[9] Kates 130-146 gives an extensive accounting of Keynes' dependence on Malthus in formulating his idea of effective demand, even making a case for a fairly precise dating of when Keynes made up his mind. There are others who carried this torch as well (Sismondi, for example), but Malthus is the loudest voice for effective demand in the 19^{th} century.

[10] Kates 43-52

[11] The reason that Malthus believes this is that he does not believe that savings constitutes investment (and therefore demand). Sellers may wish to hoard their money. (Malthus, *Principles of Political Economy* in Kates 54) Keynes argues for this as well, but via different means, that will be addressed below.

[12] Kates 27-29

failure.[13]

Say's Law, then, is simply the observation that it is impossible for supply to outrun demand, since the desire to demand is what creates the incentive to supply. It is simply a necessary corollary of trade as the human reaction to scarcity.[14] If a general glut is ruled out, then, as the cause of a recession, it remains to be seen what causes large numbers of goods to go unsold. Say's Law, as it turns out, is what provides the classical explanation for recessions.

3 Recessions and the Law of Markets

3.1 Production Miscalculations

Say remarks, in a letter to Malthus, that the cause for the superabundance of a particular good is based on the ignorance of the producer of "the nature and extent of demand."[15] Say does not draw out the conclusions, but this notion of miscalculation becomes the heart of classical business cycle theory.

David Ricardo takes the argument a step further. He argues that recessions are caused when goods are produced in the wrong proportions relative to what consumers desire, rather than from there being an overabundance of total goods: "Stagnation is a derangement of the system, and not too much general production."[16] Goods go unsold, then, not because consumers do not desire goods, but because they do not desire those goods that have been produced. This is a result not of demand failure, but of suppliers failing to predict what will be demanded. Miscalculation explains a partial glut (too much of a single good), but needs another step to explain a general downturn. That step is the law of markets.

3.2 Ripple Effects: Say's Law in Converse

Say explains how a businessman surrounded by competitors in a large market thrives while one with a monopoly in a smaller market may fail:

[13] Say, "Letter I," 2-3

[14] Say, "Letter I," 31 notes that trade is the central operative element, unique to mankind, that allows production to be adaptable and therefore for this to hold.

[15] Say, "Letter III," 59

[16] Ricardo, *The Works and Correspondence of David Ricardo Vol. VIII: Letters, 1819–June 1821*, 26-7, in Kates 51

> The reason is obvious: he is surrounded by people who produce largely in an infinity of ways, and who make purchases, each with his respective products, that is to say, with the money arising from what he may have produced.[17]

While Say is not thinking about recession, he is thinking about the operation of markets. The necessary converse is that if other producers fail to sell their goods then there is less demand for all the goods that those sellers would have demanded. The explicit consequence of this would develop over the next century before Keynes. Henry Clay writes in 1916:

> The separate trades are one another's customers, so that depression in one affects the others. Producers are also consumers; if therefore the producers in one trade are getting lower wages and lower profits, they can spend less on the products of other trades.[18]

The law of markets, then, becomes the mechanism by which a partial glut leads to a general downturn. One seller who is unable to sell his goods at cost-covering prices cannot demand from another seller, who therefore cannot demand a third good, and so on until it spreads through the entire economy. This domino effect will lead to high unemployment and a slowdown of economic activity. Since many goods go unsold, it is easy to mistake this for a general downturn. What really happens, however, is that some consumers do not have the will to purchase what is offered, and therefore the sellers of those goods lose their ability to buy other goods, which starts the chain reaction noted above.

4 Say's Law in *The General Theory*

4.1 Misinterpretation

Keynes first mentions the law of markets towards the end of Chapter 2. It is here that the Say's Law is given its most famous formulation: "supply creates its own demand."[19] While this statement is vague, it is not necessarily

[17] Say, *Treatise* 137

[18] *Economics: An Introduction for the General Reader* 252 in Kates 106-7; Kates goes on to discuss similar conclusions on the part of Lavington and Röpke.

[19] Keynes 18; Kates' book throughout cites possible passages in other authors from which Keynes may have extrapolated this summary statement.

a misrepresentation. However, Keynes immediately continues:

> –meaning by this in some significant, but not clearly defined, sense that the whole of the costs of production must necessarily be spent in the aggregate, directly or indirectly, on purchasing the product.

It is here that the misinterpretation is first laid out: Keynes takes Say's Law to mean that whatever is produced will necessarily be consumed. A more formal analysis follows in Chapter 3.[20] He defines Z as "the aggregate supply price of output from employing N men," or $Z = \phi(N)$, the aggregate supply function. D is the aggregate demand function, or "the proceeds that entrepreneurs expect to receive from the employment of N men," so $D = f(N)$. Their intersection is what Keynes calls effective demand, which is where the economy will equilibriate. Keynes then applies his misrepresentation of Say's Law from Chapter 2 to mean that $Z = D$ for all levels of N, since aggregate supply is constituted by aggregate demand. Effective demand is therefore not an equilibrium, but rather a range of infinite possible values. He then concludes:

> Thus Say's law, that the aggregate demand price for output as a whole is equal to its aggregate supply price for all volumes of output, is equivalent to the proposition that there is no obstacle to full employment.[21]

Keynes' misinterpretation is this: he omits that, in order for aggregate demand to equal aggregate supply, the goods produced must be those which are demanded. With this consideration out of the way, he correctly deduces that there would be no such thing as full employment. Every unit produced would be bought, meaning that there would be no limit on expansion to the point of full employment. Recessions simply would not happen, and involuntary unemployment would be nonexistent.

Hutt correctly points out what is wrong with this analysis of Say's Law.[22] However, the central point of *The General Theory* is to establish that demand

[20] The following is paraphrased from Keynes 25-6.

[21] This is the first time that Keynes refers to the law of markets as "Say's law." Hutt, in a footnote (3), thinks that Keynes originated the term, but Kates (148-157) documents that it was probably coined by Fred Taylor and came to Keynes through Harlan McCracken.

[22] Hutt 3

failures are the cause for recession.[23] Hutt does not realize that the straw man Keynes sets up has nothing to do with his arguments for failures of effective demand; his correct assessment of the misinterpretation therefore does not connect meaningfully to the rest of his book, where he proceeds to (correctly, in my estimation) argue against general gluts.

Kates recognizes this distinction; he notes that, while this formulation of the law of markets is incorrect, the rest of *The General Theory* addresses exactly the right topic.[24] Keynes consistently presents arguments as to why demand failure might occur: liquidity preference and the marginal efficiency of capital, to name two. This is an odd but cogent observation: first, the main thrust of Keynes' book is an attack on Say's Law; second, Keynes misinterprets Say's Law; however, the misinterpretation is not part of the attack. Note that his definition of Say's Law in no way serves as a premise for his arguments for demand failure; therefore, to point out this misinterpretation in no way undermines Keynes' arguments for demand failure. The question then becomes: why bother to present this definition to begin with?

4.2 The Keynesian Revolution

The central theme of Steven Kates' book is that Keynes misinterpretation of Say's Law is what allowed for the Keynesian revolution to take hold. He charts extensively how, after the publication of *The General Theory*, the real meaning of the law of markets virtually disappeared, even among Keynes' critics.[25] Keynes' "supply creates its own demand" became the standard. He was able to accomplish this because the controversy over the general glut debate had been settled and forgotten a century before.

The crucial mistake that Keynes makes is in leaving out the notion of the composition of production. When that is ignored, perpetual full employment is the natural consequence of one of the fundamental axioms of classical economics. In the midst of the Great depression, no accusation could have been more damning to a science that claims to explain commerce. In Kates'

[23] Kates 14-18

[24] Kates 18

[25] Kates 158-179 follows the use of the term in economics literature, which became so muddled that in 1952 Becker and Baumol broke down Say's Law into three competing interpretations: Say's Identity, which was Keynes' argument; Say's Equality, the closest of the three to the original meaning; and Walras' Law, which was Keynes' interpretation applied through Lange to both goods and money.

words:

> A discipline which purported to deal with economic matters, but which did not reflect the reality of economic fluctuations, or acknowledge and explain the existence of involuntary unemployment, would undoubtedly have been of little use. No criticism of it would have been too harsh.[26]

This is exactly what Keynes had to do to instigate a revolution. Had he merely argued for a failure of effective demand, it would have left other alternatives open. However, in order to make his theory as dominant as it has become, he had to make the case that demand failure is the only cause of recession.

By asserting that under classical theory recessions were impossible, Keynes wiped the slate clean on the theory of recession. If one accepts his assertion, suddenly he has the *only* explanation for trade fluctuations. In the mainstream of economics, this is precisely what happened. The linch pin of classical business cycle theory was rejected in what was the linch pin of the Keynesian revolution.

The irony of this situation has escaped most commentators. If this was an intentional deception on Keynes' part, he may have been the only economist of his generation that was "in on the joke." The very thing that classical economists used to explain recessions was now used to accuse them of not having a theory of recessions. By virtue of this turnaround, Keynes made his own theory the only show in town, for the most prominent competition for that theory had simply been assumed away.

Keynes attacked Say's Law in two ways: the whole of *The General Theory* argues that demand deficiencies are possible and are the primary cause of recessions; his misreading of Say's Law eliminates what is at once the central argument against his position and *the* contemporary orthodox theory of recession. Say's Law is at the very heart of Keynes' arguments, in two distinct but related ways. Kates' book asserts both of these points, but does not explore in detail the precise difference between each argument and its role in Keynes. He is mostly there, and merely fails to explicitly identify this as a two-pronged attack, but rather focuses on the role of the misinterpretation in light of what Keynes was trying to prove.

[26] Kates 10

5 Relevance to Austrian Economic Theory

References to "Jean Baptiste Say" or "Say's Law" appear neither in *Human Action* nor *Man, Economy, and State*. Menger mentions Say only his appendices, and only in relation to basic theories such as goods, capital, and wealth.[27] This is the law that James Mill called the most certain and most important idea of economic science, yet it is absent from the two great treatises of the Austrian school. Certainly Mill was overstating the case, but nonetheless, in relation to its historical importance, its absence is conspicuous.

There are at least two instances in which Rothbard mentions Say's Law, one of which is relevant to this question. It appears in Rothbard's biography of William H. Hutt:

> ... one of Hutt's great contributions to the history and the clarity of economic thought was his correctly titled *A Rehabilitation of Say's Law*... which rescued that great critic of underspending notions from Keynes's deliberate misrepresentation in *The General Theory* as well as from Say's inconstant friends in the economics profession.[28]

Rothbard thus understands, through Hutt, the true significance of Say's Law. Say's Law is simply the necessary corollary to the idea of mutually beneficial trade, and, being related to none of the errors of the Classical School from which it arose, is directly portable into Austrian economics. The real question, then, is its usefulness.

The first and most obvious use for Say's Law by Austrian economists is as a point of contact and dialogue with the Keynesian mainstream; Keynes himself thought it was the central issue in *The General Theory.* Thus, rather than laboriously starting from the first principles of economic science in every dialogue with a Keynesian, Austrians can go right to heart of the Keynesian fallacies.

Furthermore, I would posit that there are two areas in which Say's Law can enrich Austrian theory proper: in forming a bridge from entrepreneurial error to depressions in general and, more specifically, in clarifying the reasoning for the inevitable downturn in an inflationary trade cycle.

[27] Menger, 287-9, 291-2, 303, 306
[28] Rothbard, 376

5.1 Depressions and Entrepreneurial Error

In explaining economic depressions and the reasons for their occurrence, Austrian economic theory has focused almost exclusively on business cycles caused by a government inflation of the money supply. While this emphasis is certainly appropriate and the dominant observable form of recession in modern economies, it has resulted in a general neglect of the possibility of a recession without this kind of intervention. Austrian theory certainly allows for it, it is simply not as well developed as the theory surrounding credit inflation.

Austrian theory allows for depressions as soon as it steps away from the evenly rotating economy by introducing the possibility for entrepreneurial error. This is exactly what Say refers to when he speaks of the ignorance of the producer of "the nature and extent of demand."[29] It is a simple step to apply Say's law once a sufficiently large producer makes such an error or there is an unhappy coincidence of error on the part of several producers. The lack of revenue for these producers will in turn cause error on the part of those producers whose sales come from the initial producers, and so on.

However, while Say's law gives us an explanation as to why such a downturn might happen even without government interference, it is important to make several distinctions between this and the more common phenomenon of widespread economic depression caused by government. First, it is unlikely that a multitude of businessmen will all suddenly make these kinds of errors; they tend to be isolated on a free market. Consequently, these depressions will tend to be localized, regional affairs rather than the nation- or world-wide depressions caused by government inflation. Second, they are likely to be short if the market is given a chance to adjust; prices can be altered to reflect the miscalculations and the divide between what is produced and what consumers desire can be mended. Note that, as Say's Law properly notes, these depressions are caused by a lack of information or foresight on the part of producers. Thus, as we know from Mises' and Hayek's critiques of socialism, the government can only exacerbate the problem as it always acts with less information than actors in the market.

It is also critical to note that this theory of depression is not a simple superset of Austrian business cycle theory, because business cycle theory deals with the unique properties of money.

[29]Say, "Letter III," 59

5.2 Say's Law and Business Cycles

It is my contention that, while Say's Law *by itself* cannot capture all the nuances of Austrian trade cycle theory, especially as regards money, it can provide an important clarification in regards to the properties of the recessionary downturn in the cycle. While I believe that it is incontestable that money accounts for the universality of the recession following an expansion of credit, I think a more precise account can be given as to why the downturn spreads so quickly throughout the economy.

Different businesses have different structures of production; this is even more true from one industry to the next. That is, the roundaboutness of production processes differs from firm to firm. Thus, it seems odd that recessions would tend to quickly spread throughout the economy; one might expect it to affect each firm in some way correlative to the length of its production process. Say's Law allows us to explain why this is not the case.

For instance, let us suppose that firm A is the first to accumulate a mass of unsold goods in the downward swing of a business cycle. Firms B and C all relied on the A's employees and owners earning the income from those sales in order to purchase their products; D, E, F, and G relied on B and C, and so on. However, unlike in our localized, mild depression that might occur on the market, the mistakes throughout the economy are legion as a result of the government distortion of the money supply. As a result of the credit expansion, we see Say's Law writ large over the whole of the economy, and few if any industries go untouched. It is because of the interdependence created by trade that the effects of the government's inflationary policies are so rapidly realized. As firm B loses money because firm A's products go unsold, firm B's miscalculations are made apparent and it may feel the burn immediately when its production processes are still in mid-swing.

6 Conclusion

Say's law of markets was the most important idea to classical economic thought about the aggregate economy. It is a striking conclusion derived from a basic observation about the nature of trade as a response to scarcity: I will produce a good to be sold only if I desire to consume it or something else, either now or in the future. It was foundational for explaining the business cycle, but primarily served to rule out the possibility of demand deficiency.

That notion was absurd to classical economists, causing Ricardo to point out that the natural conclusion of a failure of demand is to contend "that an earthquake which overthrows my house and buries my property, gives value to the national industry."[30] In other words, demand failure is a denial of scarcity as the central problem of economics.

Part of the reason that this is such a critical issue is the natural policy implication. Say's Law highlights the fact that recessions are caused by a lack of foresight or information on the part of producers rather than a general malaise of consumption. Government has little or no role to play in correcting these structural issues, since it cannot collect the information necessary to help with production decisions nearly as efficiently as the market.[31] On the other hand, if one assumes demand deficiency, then the government need merely watch aggregate levels and spend appropriately. This idea is what led Malthus to advocate unproductive consumption and Keynes to advocate heavy centralization.

Indeed, the latter solution is what dominates to this day. Keynes achieved that solution with a clever dual critique: his straw man made the principle that at once explained recessions and denied demand deficiency into an absurd denial of easily observable facts, while the rest of *The General Theory* sought to establish demand deficiency as a cause of recessions. The legacy of this critique has shaped the policy of huge portions of the globe for the past sixty years; in other words, it worked. Keynes still dominates both economic theory and policy because he made his solution into the only viable one.

In regards to Austrian theory, the main point I would like to make is this: Say's Law, as a necessary corollary to the idea of an exchange economy, should not simply be an intriguing toy that Austrians dust off when they encounter arguments about deficient demand. Rather, it should be integrated into Austrian theory itself as an idea that contributes to our understanding of exchange and depressions.

References

[1] Hutt, W.H. *A Rehabilitation of Say's Law.* Athens: Ohio University Press, 1974.

[30] Ricardo, *Notes on Malthus' Principles of Political Economy*, in Kates 54

[31] Even as early as Say ("Letter I," 41) this implication was clearly drawn out.

[2] Kates, Steven. *Say's Law and the Keynesian Revolution: How Macroeconomic Theory Lost Its Way*. Cheltenham, UK: Edward Elgar, 1998.

[3] Keynes, John Maynard. *The General Theory of Employment, Interest, and Money*. 1936. New York: Harcourt, Brace, and Company, 1956.

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[5] Rothbard, Murray N. *Making Economic Sense*. Auburn, Alabama: Ludwig von Mises Institute, 1995.

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