Subject – History of Economic Thought - II

Notes Unit 1 Part A

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Say's Law of Markets -

An important element of classical economics is Say's Law of Markets, after J.B. Say, a French economist who first stated the law in a systematic form.

Briefly stated, this law means that 'supply always creates its own demand.' In other words, according to J.B. Say, there cannot be general overproduction or general unemployment on account of the excess of supply over demand because whatever is supplied or produced is automatically exchanged for money.

In an exchange economy whatever is produced represents the demand for another product because whatever is produced is easily sold.

Whenever additional production takes place in the economy, necessary purchasing power is also generated at the same time to absorb the additional supply; hence, there is no scope of supply exceeding demand and causing unemployment. This law was the basis of their assumption of full employment in the economy which rested on the plea that income is spent automatically at a rate which will always keep the resources fully employed.

Savings, according to classical are just another form of spending; all income, they believed, is partly spent on consumption and partly on investment. There is no ground to fear a break in the flow of income stream in the economy. Hence there cannot be any general over-production or unemployment.

The classical economists always assumed a state of employment in the economy. The normal situation in an economy, according to them was full employment equilibrium. Less than full employment, they believed, was an abnormal situation. Classical always held that there are no lapses from full employment equilibrium and even if there are any, there is always a tendency to return to full employment. This belief of the classical economists was based on the views of a French economist, J.B. Say (1767-1832).

In his analysis of the market mechanism, J.B. Say noted down: "…a product is no sooner created, than it from that instant, affords a market for other products to the full extent of its value. When the producer has put the finishing hand to his product, he is most anxious to sell it immediately, lest the value should vanish 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 the purchase of some product or other. Thus, the mere circumstance of the creation of one product immediately opens a vent for other products."

Briefly stated, it means that "supply creates its own demand". He asserted that there cannot be any general over-production or general unemployment in the economy as whatever is produced is automatically consumed. In other words, every producer who brings goods lo the market does so only to exchange them for other goods.

Say believed that people did not work for its own sake but to obtain other goods and services that go to satisfy their wants. To be employed simply meant to work in a field or to start a shop and to sell one's own product in the market. The organisation of the economy was simple under which people spent on tools and consumer goods. Saving and investment were not separate processes.

Say believed that during the process of production necessary purchasing power is generated which absorbs the additional supply, for example, when a new car is manufactured, necessary purchasing power is simultaneously generated in the form of wages, profits etc. so that the car is used. Hence there is no possibility of the aggregate demand becoming deficient.

"Say's Law, in a very broad way, is description of a free exchange economy. So conceived, it illuminates the truth that the main source of demand is the How of factor incomes generated from the process of production itself. A new productive process, by paying out income to its employed

factors, generates demand at the same time that it adds to supply." Say, no doubt, admitted that supply of a particular commodity may exceed its demand temporarily on account of the wrong calculations of businessmen, but general overproduction and hence general unemployment is impossible.

He admitted that specific commodities might be overproduced but a general glut in the sense of a general depression was unthinkable, for the very process of production created the required effective demand necessary to absorb total output. If, however, due to some mistake, over-production comes to exist in respect of a particular industry, it will be corrected automatically when businessmen suffer losses and switch over from the production of goods, they cannot sell to the production of goods they can sell. Say was supported in his view by Ricardo and Mill for they also held the view that a general glut of the market could not occur.

Assumptions:

The orthodox statement as enunciated above is based, more or less, on the following assumptions:

(i) That the free enterprise system based on price mechanism provides a place for growing population and an increase in capital.

(ii) In an expanding economy new firms and workers find their way into the productive process, not by displacing others but by offering their own products in exchange.

(iii) The extent of the market is not limited i.e., incapable of expansion. The extent of the market is as big as the volume of products offered in exchange.

(iv) No necessity on the part of the government to intervene in business matters so that the attainment of automatic adjustment is facilitated.

(v) Flexibility of interest rates and long period were considered essential for its successful working.

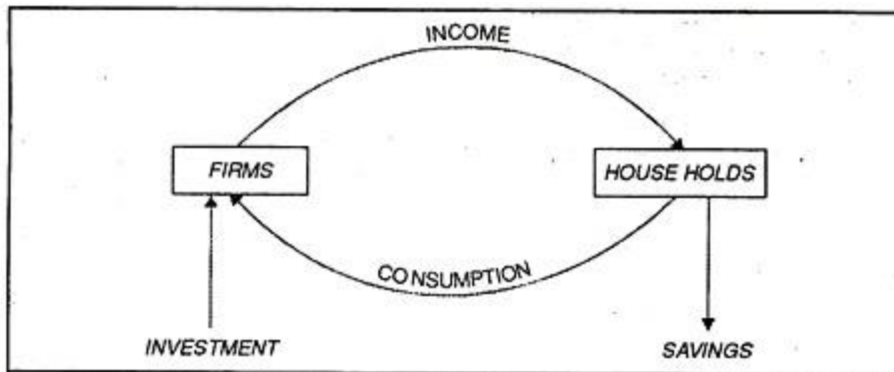

Fig: Illustration of Say’s Law through a simplified flow diagram of an economy

Critical Analysis of Say’s Law of Market:

As the depression of 1929 deepened and several years passed without signs of recovery, Say’s Law was called into question. Industries found it hard to sell all the output produced and there certainly seemed to be a general ‘glut’ in the economy.

In 1936, J.M. Keynes, a genius in several fields with an established reputation in monetary theory, worked a virtual revolution and rejected Say’s Law without qualification on the ground that aggregate demand need not be equal to aggregate supply at full employment.

Dissatisfaction with orthodox theory sprang from the fact that its conclusions failed to conform with the actual facts of the real worked. Economists had already begun doubting the universal validity of Say’s Law long before the advent of depression. Hobson criticized it much earlier, though in vain, as his tools were not so sharp as to inflict an injury on the prevailing orthodoxy, Afflation in France, J.M. Clark in U.S.A. and D.H. Robertson in U.K. assailed it.

According to Paul M. Sweezy “Historians fifty years from now may record that Keynes’ greatest achievement was the liberation of Anglo-American economics from tyrannical (Say’s Law)”

The main points of criticism of Say's Law of Markets were as follows:

1. Possibility of Deficiency of Effective Demand

2. Prolonged Depressions a reality

3. Fallacy of Aggregation

4. Misplaced Confidence in the Efficacy of Wage Cuts

5. Wrong Assumption of Interest-elasticity of Investment

6. Presence of Monopoly Element in Product and Factor Markets

7. Importance of Short-run Economics

1. Possibility of Deficiency of Effective Demand:

It was assumed in Say's Law that whatever is earned is spent either on consumption goods or on investment goods, thus, income being automatically spent at a rate which keeps all the resources employed. All this, however, was not supported by actual facts, as the income is not automatically spent on consumption and investment. Keynes pointed out that there could be a deficiency in aggregate demand as all income earned in producing an output would not necessarily be used to purchase it.

Hence, total demand would not always be such as would guarantee adequate market for the output. The stability of aggregate demand would be attained only when the gap between current income and current consumption is made up completely by the forthcoming amount of investment. Keynes, thus, found in the failure to spend the whole of current income on consumption and investment goods the cause of unemployment.

2. Prolonged Depressions a Reality:

Economic histories of capitalist economics bore testimony to the fact that it was not uncommon to experience a 'glut' in the economy such as between 1929-32. If supply creates its own demand there was absolutely no reason of stocks piling up in factories and a general slump setting in.

It was during this depression that employers faced with lack of adequate effective demand turned out large number of workers and put up ‘no vacancy’ signboards being afraid of a further fall in prices. Say’s Law stood practically discredited. This gave a rude shock to Keynes’ faith in Say’s Law and led to the discovery of his ‘General Theory’ of income and employment.

3. Fallacy of Aggregation:

Keynes pointed out that the main fallacy in Say’s Law was the belief that the principles which apply to an individual firm or industry could also apply to the economy as a whole. Keynes stressed that it was too much for Say’s Law to assume that microeconomic analysis could profitably be applied in macroeconomic analysis.

4. Misplaced Confidence in the Efficacy of Wage Cuts:

Pigou’s formulation of Say’s Law also came under heavy fire. Keynes pointed out that a general fall in wages is not likely to increase employment in the economy as a whole because wages are not only cost to the employers but also income to a large section of the population. With the purchasing power reduced, their demand of goods and services will also fall. According to Keynes, employment in the economy depends on aggregate spending (effective demand) and not on the real wage level.

5. Wrong Assumption of Interest-elasticity of Investment:

The assumption of interest-elasticity of saving and investment has also been challenged by Keynes. Say’s Law presumes that all savings are automatically invested and the rate of interest brings about the necessary adjustment Keynes, however, denied it on the ground that income and not the rate of interest is the equilibrating mechanism between savings and investment. Savings and investment are equated by changes in income and are not sensitive to the changes in the rate of interest.

6. Presence of Monopoly Element in Product and Factor Markets:

Besides there is a conventional objection to Say’s Law: that it presumed free and perfect competition in the economy. In practice, we can see that imperfect competition in the market is the rule and perfect competition only an exception because in modern capitalist economics there is a strong tendency towards monopoly. Imperfections in the factor and product markets are not temporary. They have come to stay. These hinder the working of the forces behind Say’s Law.

7. Importance of Short-run Economics:

Say's Law has been defended at times, in terms of long-run equilibrium on the ground that the long-run aggregate demand tends to be sufficient to purchase all that the economy is supplying. This long run equilibrium is brought about by the free forces of market alone. But Keynes remarked "that in the long-run we are all dead." People had waited for three or four years to see that the automatic corrective mechanism implied in Say's Law would work, but in vain. It was not clear as to what is the length of the long-run in Say's Law.

Implications of Say's Law:

1. According to Say's Law of markets there is automatic adjustment in the economy as whatever is produced is consumed. In other words, every output brings along with it the necessary purchasing power in circulation which will lead to its sale, so that there is no over-production. Hence, there is no necessity on the part of the government to intervene in business matters as that will come in conflict with the automatic adjustment mechanism of Say's Law of Markets.

2. Since supply creates its own demand, hence general unemployment and over-production are impossible.

3. Again according to Say's Law of Markets as long as there are unemployed resources in the economy it is profitable to employ them because they can pay their own way. In other words, when the unemployed resources are used, they lead to more production so as to cover their own costs.

4. Another important implication is the mechanism of flexibility in the rate of interest, which brings about equality between savings and investment. To classicals, saving is another form of spending. Therefore, whatever is saved is necessarily invested. Hence, there is no possibility of the deficiency of aggregate demand and the mechanism through which it is maintained is the rate of interest.

5. Further implication of Say's Law of Markets flows from the Pigovian formulation, i.e., wage rate is the mechanism which helps to bring automatic adjustment, i.e., a lowering of the wage rate will lead to full employment under free and perfect competition. The government should, as far as possible, ensure a free market and there should be absolutely no regulation of wage rates.

6. Because goods are exchanged for goods, money acts as a veil and has no independent role to play. Money is only a medium of exchange to facilitate transactions.

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