

5. Say's Law of Markets: An Austrian Appreciation

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J.-B. Say's Law of Markets is one of the oldest insights in economics. It is also one of the most controversial and misunderstood. Like the proverbially classic 'text,' it is often talked about, but seldom is the source actually consulted. It also has a long association with laissez-faire policy prescriptions. That association was real to some extent during the nineteenth century, but it was also furthered by Keynes' interpretation of Say's Law in *The General Theory* (1936), which placed it at the foundation of what he called 'Classical Economics.' Contemporary macroeconomics textbooks often pick up on Keynes's claim, placing Keynes's understanding of Say's Law at the centre of the debate between the classical model and the Keynesian model. However, Say's Law can be understood as an analytical proposition about the functioning of the market, regardless of the analyst's more general conclusions about the efficacy of markets. But getting at that proposition requires that we return to Say's original text and critically assess more recent understandings of Say's Law.

One way to engage in this assessment is to explore Say's Law from the perspective of the Austrian School. Austrians are often associated with the laissez-faire position to which Say's Law is supposedly central. In addition, Austrians often look to the history of economic thought to examine how the path taken by modern economics has diverged from earlier, perhaps better, theoretical approaches to understanding the social world.¹ Despite this work in reconstructing theory and the history of economic thought, Austrians have not paid much attention to Say's Law. The most extended treatments are in chapters of books by Sechrest (1993) and Horwitz (2000).² Although he doesn't label himself as an Austrian, W. H. Hutt's (1974) book on Say's Law is effectively an Austrian perspective. As such, it is probably the most comprehensive treatment of Say's Law by anyone close to the Austrian

School, and Hutt's work will be central to the discussion below. However, because Hutt's book was written at the outset of the modern Austrian revival, there is much that can be added to his analysis from developments within the Austrian school in the intervening decades.

That task can be accomplished by bringing together insights from recent work in Austrian economics with the recent revisionist work on Say's Law by Sowell (1972) and Hutt (1974). More specifically, I wish to explore the meaning of Say's Law from an Austrian perspective for both microeconomics and macroeconomics. Say's Law, at least as Say himself described it, is about an unfolding market discovery process, not an equilibrium condition, as it is often presented. As such, it bears a strong resemblance to the Austrian emphasis on markets as discovery processes. Austrian microeconomic insights can shed light on Say's discussion. From the perspective of Austrian macroeconomics, Say's Law fits very nicely with recent work on monetary equilibrium and the loanable funds theory of the interest rate. For Austrians, monetary exchange is the common element in micro and macroeconomics, and interpreting Say's Law through the lens of monetary exchange enables us to see its Austrian elements.

SAY'S LAW: WHAT IT SAYS AND WHAT IT DOESN'T SAY

The colloquial understanding of Say's Law of Market is that 'supply creates its own demand.' There are multiple interpretations of this phrase. The most simple, and most misguided, is that the simple act of supplying a good to the market is enough to create a demand for it. Of course any sort of necessary connection between supplying an individual good and a resulting demand for it is quickly refuted by the multitude of new products and firms that fail each year. If 'supply created its own demand' in this crude sense, why would any business ever fail?

Another interpretation of the colloquial expression, and the one that Keynes seemed to believe was accepted by the classical economists, is that Say's Law is supposed to be saying that the aggregate supply of goods and services and the aggregate demand for goods and services will always be equal, and equal at full employment. This version implies that if one believes in Say's Law, then one cannot explain deviations from full employment. That is, we must always be at full employment. In one sense this interpretation of the Law is trivially true. If we compare the actual (*ex post*) quantities of goods bought (demanded) and sold (supplied) they will always be equal.

Whatever is sold by one person gets bought by another. However, it seems fair to think Keynes thought the classical economists meant something else, perhaps captured by 'market economies will never create general gluts or shortages because the income generated by sales will always be sufficient to purchase the quantity of goods available to buy.' There is a strong sense in which this understanding of the Law is true, but by itself it does not guarantee full employment, as obvious examples of significant unemployment and unsold goods are rampant through history. And, in fact, this is what critics of Say's Law, like Keynes, have done. By pointing to the various recessions and depressions that market economies have experienced, they claim to show that Say's Law was at the very least naive, and probably downright wrong.

The problem with all of these interpretations is that none of them go back to the original text to see what it was that Say was actually describing. The section of *A Treatise on Political Economy* in which the ideas that comprise Say's Law are discussed is entitled 'Of the Demand or Market for Products.' That title suggests he is attempting to explain the source of the demand for products in the broadest terms, or more generally why some products have larger markets than others. In a manner that we shall explore below, the title is also suggestive of Adam Smith's discussion of the division of labour being limited by the extent of the market. Say's goal here is in some sense 'macroeconomic' as he wants to offer an explanation at a high degree of abstraction, rather than trying to explain the particular factors that affect the demand for specific products.

His first answer as to what explains the demand for a product is worth quoting at length:

A man who applies his labour 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 products (Say 1971 [1880]: 133).

What enables us to be able to sell that which we have brought to the market? Say's answer is 'the ability of others to purchase our goods,' and that the ability to purchase must have come from some previous sale. All purchasers must first be producers, as only production can generate the power to purchase. One implication of this argument is that where there are more sellers, there will be more buyers. Where producers are numerous, there is

more demand for other products. This first cut at Say's Law might best be summarised as 'production is the source of demand.'

Say (134) expands upon this point on the next page by arguing that 'a supply of commodities or services . . . will universally find the most extensive demand in those places where the most of values are produced; because in no other places are the sole means of purchase created, that is, values.' He later provides an example to support this argument. He (137) asks, rhetorically, in which situation would an entrepreneur rather be: a monopolist in a small town in a remote part of the world, or in competition in one of the great cities of the world such as Paris or Amsterdam? The answer, he suggests, is obvious: the latter. The reason we prefer the latter is that although we must compete with numerous other sellers, many of those sellers are potential buyers of what we are offering. The small-town monopolist may be the only seller of his particular good, but his market is limited by the small number other sellers in the town. The path to riches is to be where those who can purchase are, and purchasers will be where there are numerous sellers. He further notes (137) that this process will only work where the source is 'real production alone' as someone who 'lives upon the production of other people, originates no demand for those productions; he merely puts himself in the place of the producer.' Thus, as he later concludes, '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' (139).

In his excellent book on Say's Law, Hutt (1974: 27) offers a restatement of the law as: 'All power to demand is derived from production and supply . . . The process of supplying – i.e., the production and appropriate pricing of services or assets for replacement or growth – keeps the flow of demands flowing steadily or expanding.' In a later book Hutt (1979: 160) provides a more exact definition: 'the demand for any commodity is a function of the supply of noncompeting commodities.' The addition of the modifier 'noncompeting' is important. For a computer technician, it is presumed that her demands that result from her production will be for goods and services other than computer technician or similar services. The goods or services competing with those that she sells can always be obtained by applying her labour directly, so she is unlikely to demand them. That is, she will only demand non-computer repair-related goods and services. The demand for her services as a computer technician is a result of the supplying activities of everyone but computer technicians.

What is clear from this brief look at what Say said is that he was describing a principle by which economies worked, not an equilibrium

condition of aggregate supply and demand. Say's Law is probably misnamed. It is not a law at all, rather it is an explanatory principle. It is a piece of theory that helps us render the world around us intelligible, and enables us to give good advice to policymakers and others who might be pondering various sorts of efforts to stimulate an economy. As Say noted, one must first be concerned with the conditions of production if one wishes to eventually increase people's well-being via consumption.³

SAY'S LAW IN AUSTRIAN LITERATURE

Given the strong similarities between Say's work and that of the Austrians, including their similar classical liberal outlook, one would expect to find a good deal of discussion of Say's Law in the classic Austrian literature. In fact, there is almost none. A search through Mises and Hayek reveals but one mention of 'Say's Law' and only two or three more mentions of Say. Nowhere in Hayek's work on business cycles and macroeconomic issues is Say's Law mentioned by name. It does not appear in Mises' *Human Action*, nor in any of the collections of his essays on money and related issues. The only specific mention of the law of markets is in the final chapters of *The Theory of Money and Credit* that were added in the 1952 edition. Other than that, there appears to be no discussion of Say's Law, at least by name, in the Austrian literature until the mid-1970s.

An explanation for the absence of discussion of Say's Law is not obvious. One possibility is that explicit discussions of Say's Law were not very common until after Keynes declared it central to the theory behind the classical defense of laissez-faire. Once Keynes put the ball in play, other theorists felt more obligated to respond. This might explain why Mises addressed it (although only in a paragraph) in the 1952 edition of *Theory of Money and Credit*. By that point, the Keynesian revolution had taken hold and the Austrians perhaps felt compelled to defend Say's Law. That is precisely the context of Mises' brief remarks in 1952. It is in a section entitled 'The Full-Employment Doctrine' where he is addressing fallacies surrounding government spending that Mises (1980: 464) says:

In our day [this fallacy] has been revived by Lord Keynes, and under the name of full-employment policy is one of the basic policies of all governments which are not entirely subject to the Soviets. Yet Keynes was at a loss to advance a tenable argument against Say's Law . . . The fallacies implied in the Keynesian full-employment doctrine are, in a new attire, essentially the same errors which Smith and Say long since demolished.

That brief reference is the only one, however. Even in Hayek's shorter more popular pieces on Keynes that he wrote in the 1960s, there is not a mention of Say's Law.

Since the mid-1970s, and the revival of Austrian economics, there has been more discussion of Say's Law in the Austrian, or closely related, literature.⁴ The key publication of that era was William H. Hutt's (1974) *A Rehabilitation of Say's Law*. Hutt's book attempted to understand what Say's Law means (rather than what Say meant by Say's Law) and to then demonstrate the validity of the law when it is put up against some rival theories of the time. Hutt's argument is quite Austrian, and he makes reference to several Austrian writers in the process. Hutt's argument in that book, as well as the similar if somewhat more nuanced version that appears in his 1979 book *The Keynesian Episode*, form the core of the exposition in the next section. Although Hutt is not always considered an Austrian, nor did he always define himself that way, his work certainly rests in that tradition and his own contributions have enriched it in turn.

A less well-known, but equally valuable Austrian take on Say's Law, is Tyler Cowen's (1982) paper 'Say's Law and Keynesian Economics.' Cowen's paper is partially a very careful exegesis of Say's own description of the law, and partially an attempt to explain the flaws in Keynesian economics revealed when Say's Law is linked up with Austrian and supply-side insights. Coming a few years after Hutt's work, Cowen is able to continue the Austrian dialogue with neoclassical thinkers such as Clower and Leijonhufvud who were also interested in questions surrounding Say's Law. Cowen's paper is largely backward looking, as it tries to find roots in Say for insights already being deployed by Austrians and others. Other than Cowen and a brief mention in Selgin's *Theory of Free Banking* (1988: 56), Say's Law remained fairly invisible in the Austrian literature of the 1980s.

The last 10 years have seen more in-depth treatments of Say's Law by Austrian economists. The first of these was in Larry Sechrest's (1993) book on free banking theory. He devotes an entire chapter to Say's Law, beginning with a short look at the microeconomics behind it, then integrating the Law into discussions of Austrian macroeconomics, from the business cycle to the market for loanable funds and more. In addition, he provides a brief comparative overview of Austrians, Monetarists, and Keynesians from the perspective he develops there. One of the important issues Sechrest mentions is that the implication of Say's Law that excess demands or supplies of goods must mean that there are corresponding excess supplies or demands of money (often known as Walras' Law) is of relevance for the relationship between Austrian treatments of inflation and monetarist treatments of deflation. The

unemployment of people and machines that results from excess demands for money and the misallocation and eventual unemployment of people and machines that result from excess supplies of money can both be understood by a proper understanding of the role money plays in the process described by Say's Law. This insight allows for a more in-depth integration of Austrian and monetarist (particularly monetary disequilibrium) theory.

In a series of papers (1996, 1997a, 1997b) and then as part of a book (2000), my own work has attempted to articulate further the relationship between Say's Law and Austrian economics.⁵ Say's Law is seen as vital to a 'post-Wicksellian' macroeconomics that takes seriously both a realistic conception of money and conception of capital that recognises its heterogeneity and embeddedness in time and history. More specifically, this work further integrates Say's Law and monetary equilibrium theory by exploring more completely how the Law can help to understand inflationary and deflationary monetary disequilibria.⁶ In two contributions (1997b and 2000) I also revive Hutt's work (only briefly mentioned by Sechrest) and explore the relationship between his understanding of Say's Law and the Austrian view of the microeconomic process. I also look at how the issues that concerned Hutt can be synthesised with the monetary disequilibrium concerns of the Austrians and authors such as Leland Yeager. The revival of Austrian economics in the last quarter of the twentieth century has brought with it a renewal of interest in Say's Law and the ideas surrounding it. A continued re-examination of these issues by Austrians would be a healthy development. The next two sections explore the ways in which Say's Law can be seen as integral to Austrian micro and macroeconomics.

SAY'S LAW AND THE MARKET DISCOVERY PROCESS

From the perspective of the Austrian School, the insight provided by Say's Law is highly congenial to its own understanding of the microeconomic market process. One of the core concepts of the Austrian approach is that markets can be understood as spontaneous ordering processes. Markets bring into coordination the dispersed and often tacit knowledge of the actors who comprise them. This process takes place in ways that are not the product of human design. Markets 'spontaneously' coordinate human activities in a decentralised, rather than top-down fashion. Such spontaneous orders are contrasted with what Hayek calls 'organisations,' or structures that are the product of human design. Whereas markets (and other institutions such as the law, money, and morality) are seen as having emerged through a long,

unintentional, process of human social evolution with no specific end in mind, organisations (such as firms, households, armies, and others) are created by particular people for particular purposes.⁷

As described by Hayek (1964), markets, and spontaneous orders more generally, are an example of a complex phenomenon.⁸ Complex phenomena are such that they can never be known in their complete details, as they are composed of elements that interact in ways that are complex beyond our ability to understand at that level of detail. Markets are complex in this way as they are comprised of the myriad actions of independent individuals, firms, and households. The sheer number of actions that comprise markets, along with the fact that the factors affecting these actions are often unknown, and often unknowable, to outside observers, means that in our attempts to understand markets we face significant limitations. More specifically, we cannot predict market outcomes to any real degree of detail. The knowledge necessary to do so is too voluminous and frequently tacit, preventing anyone from being able to model, and thus predict, markets in their totality.

Instead, Hayek proposes that the only way we can understand complex phenomena is through the use of 'explanations of the principle.' If we wish to understand markets, we can do so by explicating the principles by which human action is organised, rather than by predicting precise outcomes. For example, we can describe the broad contours of how iron filings will react to a magnet (they will be attracted in a certain broad pattern), but we cannot predict precisely which filing will go where. In an Austrian view, most of the 'laws' of economics are explanations of the principle of this sort. The Law of Demand enables us to say that individuals will purchase less of a good if the price rises, *ceteris paribus*. It does not allow us to make specific predictions of just how much less will be purchased.⁹ As Austrians frequently note, the limitations on our ability to predict are not a problem, as the sorts of pattern predictions that are possible with explanations of the principle still allow us to render economic behaviour intelligible. In addition, they often allow us to make 'negative' predictions of the sort that tell us that we cannot do something we might like to.¹⁰ Economics, in particular, serves the purpose of putting 'boundaries on our utopias' by telling us what the undesirable unintended consequences of our best intentions may well be.

Say's Law of Markets makes sense to Austrians in this context. It is one of the principles by which the complex phenomenon of the market operates. It can be understood in that way as an extension of Adam Smith's observation that the division of labour is limited by the extent of the market (1976 [1776]: 21–5). That principle explains the degree of specialisation and the process by which economies grow and diversify. It is in many ways an 'ecological'

organising principle for economic systems. Say's Law is another similar organising principle of the market. It explains the process by which the aggregate level of demand is determined, and what constrains individual demanders. The example of the small-town monopolist from earlier illustrates the connection between Smith and Say. The small-town monopolist is less likely to be successful because there are not enough other income earners there to support him. In Smith's terms, the extent of the market is not broad enough to generate a lot of business, and in Say's terms, there is not enough production elsewhere to be the source of much demand. Smith's 'the extent of the market' is analogous to Say's 'demand' (or what we would now call 'aggregate demand').

For this process to take place, competition is essential. As Austrians have long argued (Hayek 1978; Kirzner 1992), market competition is a discovery process. Competition enables us to discover what would otherwise be unknown. When placed in the context of a competitive process, individuals are more likely to be alert to new opportunities and better ways of using existing resources. In Kirzner's (1973) work, this alertness is the foundation of entrepreneurial behaviour, which is what drives the discovery process of the market and produces its desirable results. The greater the competitiveness of the market in question, the more 'turned on' will be actors' alertness to such opportunities, and the more knowledge that will be discovered.

Of central importance to the competitive process is the epistemological role played by market prices. Mises's famous article on the impossibility of economic calculation under socialism (1920) and Hayek's later paper on the use of knowledge in society (1945) provide the foundations for the Austrian view that prices serve as knowledge surrogates in a competitive market process. As actors make their buying and selling decisions, the movements in prices that result reflect the knowledge of those actors. Market prices are, in this way, signs that point beyond themselves to the decisions made by the myriad buyers and sellers whose actions affect them. Prices provide knowledge that would otherwise be socially unavailable. This argument suggests the importance of prices being determined competitively in the market process rather than by political fiat. Where prices are made less flexible by extra-market forces, they lose their ability to signal knowledge effectively and they disrupt the discovery process of the market.

This line of thought dovetails nicely with Hutt's work noted above. The key to Hutt's analysis of Say's Law was the way in which prices, especially wages, held above the market clearing level could trigger a downward macroeconomic spiral that was explained by Say's Law. When prices send off an incorrect signal about the underlying economic reality and human

preferences, the discovery process gets disrupted and economic discoordination occurs. Where prices cannot adjust, quantities must, and the resulting gluts identified by Hutt reflect the inability of producers and consumers to discover opportunities for mutual gain. Say's explanation of the interconnections between producers and demanders fits with the Austrian knowledge story by showing how even a small number of politically fixed prices can lead to a systemic coordination failure by blocking the market discovery process. Say's Law provides a bridge between the Austrian theory of the microeconomy and a coordination-based theory of the macroeconomy (Wagner 1999).

This linkage is even more clear in the recovery half of Hutt's story. He argues that once the sticky prices are freed up, the recovery process will ignite via the same Say's Law explanation of the interconnections between producers and demanders. Once some sales can be made, income can be earned and further demands can take place, leading to more income earned and demands made. This begins to reduce the general glut caused by the sticky prices. More important, the recovery can only take place by freeing up the prices, rather than by trying to fix them at a different level. Those who have fixed the prices cannot know what the 'right' price should be, as that is precisely what the market process attempts to discover. Of course this recovery process will take time, as markets cannot instantaneously adjust to a new market clearing price. If the observing economist thinks she knows where the market price should eventually settle and chooses to condemn the time taken by the market process to try to find it, she is simply guilty of what Hayek (1974) called a 'pretence of knowledge.'

This last point is not an idle one, as Hutt makes a similar one in his treatment of Axel Leijonhufvud's work on Keynesian economics. Leijonhufvud (1968) argues that economies stuck in an unemployment equilibrium cannot recover by themselves because workers will return to 'activity' at wage rates far less than those necessary to achieve full employment. He appears to argue that only if we can somehow jump immediately to the full-employment general equilibrium wage rates will we ever get back to full employment. Hutt (1974: 93) rightly points out that Leijonhufvud is confusing the wage rate necessary to get workers employed with the wage rate they might eventually receive when all other workers are employed. In other words, we cannot know what that eventual full-employment wage is and we must rely on the competitive market process to discover what that is through a step-by-step process that enhances employment and wages. Wages and employment will rise as the first rounds of sales translate into further demand and then further sales and yet more

demand. To expect firms to pay wages that instantaneously return an economy to full employment, and to assume that firms know what those are, are to overlook the fundamental Austrian insight that markets are discovery processes. Hutt's work, and the conception of Say's Law that informs it, explain the systemic nature of the discovery process that generates a recovery, and provides a very useful micro-macro bridge.¹¹

MONETARY EQUILIBRIUM, SAY'S LAW, AND AUSTRIAN MACROECONOMICS

One of the key elements of the Austrian view of the microeconomy is that it revolves around the use of *money* prices, and not the numeraire prices of general equilibrium theory. Entrepreneurs use money prices to inform their acts of economic calculation, which in turn lead to market actions and a new set of money prices. In the previous section's discussion of the Austrian microeconomic view of Say's Law, we noted the central role money prices play as knowledge surrogates, facilitating the production-demand cycle described by Say. It is acts of monetary exchange that comprise the market process, in both the microeconomic/entrepreneurial view and in the Austrian macroeconomic view. The centrality of money to the Austrian view of the market is what enables Austrians to have an understanding of the role Say's Law very similar to Say's own. From an Austrian perspective, Say's Law is intertwined with the monetary basis of the microeconomy and the macroeconomic implications of every act of exchange involving money.

The place of Say's Law in Austrian macro begins with the observation that virtually all exchanges in a market economy are exchanges of goods for money. That is, money is half of every exchange. As a result, changes in money can affect the entire economy in systemic ways. Excesses and deficiencies in the money supply will distort the money prices that guide economic activity by influencing, from the 'money side,' the exchanges that create those prices. The link to Say's Law is that these acts of monetary exchange are what bring together acts of production with acts of demand. In order for production to be the source of demand, sellers of products must be able to acquire money in return and then spend that money on the goods and services they wish to purchase. The Say's Law transformation of production into demand is mediated by money.

The key is that the supply of money must be 'right' in order for demand to properly reflect production. If money is not right, then gluts and shortages will occur. As was often argued in response to Say's Law, how can the

interpretation that aggregate supply will always be sufficient to match aggregate demand be valid when we have so many examples of real world excesses and deficiencies in the supply of goods? If Say's Law stated that way were true, we would never see gluts or shortages. The problem with this interpretation is, as Say himself recognised, that it ignores that mediating role of money. For example, if money is in short supply, some producers will be unable to demand, as they will be unable to sell their goods for money, given that it is relatively unavailable. The result will be a glut, as goods and labour sit unsold. Conversely, an excess supply of money will, in the short run, heighten overall purchasing power even though there has been no sustainable increase in production. That is, demand will be greater than ultimately justified by the level of production. Over time, the best that an excess supply of money can do is to redistribute purchasing power in ways that prevent it from matching up with those who have created it via production. The eventual result of all of this will be shortages, and the rising prices we associate with excess supplies of money.

This is nothing more than Walras's Law – excess supplies of money must imply excess demands for goods, and excess demands for money must imply excess supplies of goods. Walras's Law is thus an implication of Say's Law, combined with the recognition that all exchanges are monetary exchanges. If production is the source of demand, and the translation of production into demand takes place via money, then too much money will mean 'too much' demand for goods, and too little money will mean deficient demand for goods.

From an Austrian perspective, Say's Law is helpful in explaining both how the effects of excess supplies of money must eventually reverse themselves, and how the effects of excess demands for money must lead to general economic contraction. In the Austrian theory of the business cycle, excess supplies of money work their way into the economy through central banks creating additions to bank reserves. This new lending power translates into lower market rates of interest, which leads to a higher quantity of loanable funds demanded. At these lower rates, entrepreneurs find longer-term production processes to be relatively more profitable than before and begin to lengthen their structures of production. The transfer of resources made possible by the real spending power created when these reserves are first loaned out enables the entrepreneurs to begin their new production processes, despite there having been no net increase in resources. As Garrison (2001) argues, this temporarily pushes the economy above its production possibilities frontier.¹²

This position is not sustainable, however, as the longer production processes are inconsistent with the time preferences of consumers. The lower interest rate appeared to signal that consumers were more willing to wait to consume, thus supplying the savings that would make the longer production processes sustainable. However, the central bank intervention cleaved the market rate of interest from the underlying preferences of consumers (as reflected in the Wicksellian natural rate). The result is that producers are making decisions based on a market price (the interest rate) that is sending a false signal about consumer preferences. Austrians argue that as the resources originally channelled to producers make their way down to the owners of the factors of production, those owners will spend on consumption in ways out of proportion with the market rate of interest. Eventually, producers will see that the longer-term production processes that they have begun will be unsustainable, and they begin to contract, reversing the expansion.

Say's Law helps to understand why this process is unsustainable. The fundamental insight that production is the source of demand suggests that excesses in the quantity of money cannot permanently stimulate demand. The aggregate level of demand in any given economy is a function of previous acts of production, specifically the sale of assets deemed by others to be productive. At best excess supplies of money can *transfer* purchasing power away from those who have previously sold productive assets to those who happen to be 'in the path' of those excess supplies of money. The various redistributive consequences of inflation, in particular the injection effects emphasised by Austrian writers, are consistent with the Say's Law insight that real demand power is limited by prior acts of supply. The real constraint implied by Say's Law must eventually make itself known in the aftermath of an inflation. The Austrian theory of the business cycle is one example of how the ordering principle embodied in Say's Law will make itself known.

In the opposite case of a deficient supply of money, Say's Law is extremely helpful in explaining both the original downturn and the eventual reversal. Excess demands for money suggest that owners of productive assets are having difficulty selling those assets as potential buyers lack the medium of exchange they need to make their demands effective. If buyers do not have money, they cannot buy and sellers cannot sell. The sellers who cannot sell, cannot, in turn, buy, meaning other sellers cannot sell, and so forth. The recognition that production is the source of demand helps to clarify the interconnections that matter in a monetary economy facing a shortage of money.

The obvious solution to this problem is for prices to fall so that the existing nominal quantity of money will increase in real value until it matches

the demand for real money balances. If prices are (nearly) perfectly flexible, then the 'first' sellers' inability to sell will lead them to immediately cut prices, making it more likely that potential buyers will have enough real purchasing power to make the purchase. In this case, Say's Law also helps explain the recovery process by showing that the sales spurred by the fall in prices mean income for the sellers, which in turn means purchases from non-competing sellers, and so forth. The flexibility of prices cuts short the destructive cycle started by the excess demand for money. Both the downward momentum and the recovery process can be understood with Say's Law.

However, the assumption of near-perfect price flexibility is empirically questionable. Real world markets are characterised by a certain degree of price stickiness.¹³ As a result, Say's Law takes on an even more important role in showing how the imperfect flexibility of prices will cause a severe downward turn in the face of an excess demand for money. When prices find it difficult to fall in such a circumstances, the inability of sellers to sell, and thus buy, builds upon itself, resulting in what Wicksell termed the 'cumulative rot.' Falling demand with sticky prices means that quantities will bear the burden of adjustment, and fewer exchanges of both goods and labour will take place, leading to gluts of both. In addition, the recipe for recovery is that prices need to fall to re-ignite the spending process. Shah (1997) offers several reasons why prices will eventually give way, and when they do Say's Law can help explain the recovery. As prices fall, some sales take place, which in turn enable another round of purchases. These increase income to those sellers, who can now purchase, and so forth.

In a world of imperfectly flexible prices, Say's Law is even more relevant for policy considerations. The insight that production is the source of demand explains why it is so important that prices are able to move in ways that facilitate sales by those with assets that others deem valuable. Although prices can never be perfectly flexible, policy makers should avoid actions that reduce that flexibility any further, particularly during a downturn.

This section's discussion can serve as a rebuttal to those who argue that Say's Law is violated by historical episodes of recession or general gluts (see Uchitelle 2001, for example). Say's Law does not say that general gluts or shortages can *never* occur. Rather it explains a principle by which markets operate. Whether the *effects* of that principle will be beneficial or not depends on the institutions that frame the markets in question. Just as Smith's invisible hand would still operate, but produce undesirable consequences, where property rights are not protected from public or private predation, so too will Say's Law not produce desirable outcomes when certain institutional

prerequisites are not in place. This section's discussion suggests two crucial institutional prerequisites: the maximum flexibility of prices possible given that a certain level of 'stickiness' is inevitable, and the maintenance of monetary equilibrium. If those two are met, then Say's Law implies that general gluts and shortages are not possible. If they are absent, then the process Say's Law identifies will still operate, however it will not produce the benign results it would under the right institutions. Where prices are excessively sticky and/or where monetary disequilibrium is present, general gluts and shortages are possible, and their existence is a confirmation, not a refutation, of the principle expounded in Say's Law.

CONCLUSION

With respect to both Austrian microeconomics and macroeconomics, Say's Law is a natural fit. When we move beyond the colloquial 'supply creates its own demand' version of the Law, and attempt to understand it in all of its complexity, we see how Say's Law is an explanatory principle of the spontaneous order of the market, and one that crucially extends Smith's insight about the extent of the market limiting the division of labour. As such, it becomes part of the microfoundations of macroeconomics, particularly in an Austrian view that emphasises monetary exchange as the central act of an economic order. No understanding of the effect money (and, by implication, time) has on the market can be complete without coming to grips with the issues raised by Say's Law. The Austrian emphasis on the microeconomics of monetary exchange and the macroeconomics of monetary equilibrium makes for a framework well-suited to explore and integrate one of the oldest and most important insights of the discipline. As other schools of macroeconomic thought continue to pursue strategies that render them evermore esoteric and useless to policymakers, the Austrians and others will, one hopes, continue to explore the issues raised in this chapter and communicate them as widely as possible. Rather than new wine in old bottles, this re-examination of Say's Law might provide us with some old, and very drinkable, wine in some new bottles.

NOTES

1. For example, see Machovec's (1995) study of the history of competition theory. Kirzner's (1996) work on capital might be another example. Horwitz (2000) and Garrison (2001) offer such work on macroeconomics.

2. Horwitz (1996) also discusses Say's Law, but that discussion is a preview of the one in 2000. Horwitz (1997a) is a briefer discussion designed for a non-academic audience.
3. In this sense, modern-day 'supply-side' economists are simply reinventing Say. The argument that production is the source of demand is the foundation of any sort of supply-side economics, particularly in the way that it sets itself against the 'demand-side' economics of Keynes, which clearly was focused on the direct stimulation of consumption.
4. I exclude Tom Sowell's (1971) very good book on the subject as neither he nor it makes any pretensions at all to be in the Austrian tradition.
5. In the interests of historical accuracy, both Sechrest and I stumbled across many of the same insights independently. His chapter drew heavily on the manuscript version of the 1996 *Journal of the History of Economic Thought* paper of mine noted in the text.
6. The details of these explanations follow later in this chapter.
7. This distinction can be found in the earliest of Austrian work. See Menger's (1985 [1883]) use of 'organic' and 'compositive' social institutions.
8. Complex phenomena can be found in both society and nature. Hayek uses the example of the organisation of iron filings in response to a magnet as a natural world example.
9. Econometric estimates of demand elasticities are historical data at best and bear no assurance of predictive value.
10. For example, setting a minimum wage will not assure that everyone currently working will now receive a higher wage.
11. Horwitz (1997b and 2000: Ch. 6) explores these issues in more details.
12. Garrison argues that the frontier is not an absolute limit to economic activity, rather a range of production possibilities that is sustainable over any run but the very shortest. In the shortest of runs, economies can move beyond the frontier. However, the position they then occupy is not sustainable for any real length of time.
13. As the discussion below shall demonstrate, when Austrians talk of price 'stickiness,' they are not using it in quite the same way as many Keynesians and New Keynesians do. For these groups, the stickiness of prices is a normative proposition. That is, the fact that prices are sticky is a 'bad' thing, particularly in comparison to the perfectly flexible prices assumed by general equilibrium theory. The flexibility of those prices is crucial to the welfare outcomes of the markets supposedly described by the theory. If prices are less than perfectly flexible, the welfare benefits of perfect competition are dramatically reduced. For Austrians, 'stickiness' is just a fact of the world, and there is no implicit or explicit comparison to a world of perfectly flexible prices invoked. The best discussion of these issues can be found in Shah (1997).

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6. Say's Law, Growth Theory and Supply-Side Economics

Mark Skousen

'A grasp of [Say's Law] is indispensable for an understanding of the true genesis of depression and of prosperity without inflation; that attempts at dynamic treatment of the economic system which ignores it are worthless.'

– W. H. Hutt (1974: 5)

Say's law is one of those profound, subtle, and often misunderstood doctrines in economics, like David Ricardo's comparative advantage and Bernard Mandeville's fable of the bees. When I ask students at the beginning of class which statement they prefer, 'supply creates its own demand' (the common version of Say's law) and 'demand creates its own supply' (Keynes's law), the majority of student side with Keynes. Say's law seems counterintuitive. After all, as one student told the class, a crazy inventor can produce an unlimited supply of widgets, but if consumers won't buy (demand) his product, his brilliant scheme is all in vain. I point out, on the other hand, that there is demand for a transportation system to get us from San Francisco to New York in an hour, but so far no one has supplied this desirable good. Clearly, the simplified versions of Say's and Keynes's laws often fail to reflect reality, so it behoves us to go back to the original meaning of the authors.

SAY USES A SIMPLE EXAMPLE IN AGRICULTURE

In Say's case, let us examine Chapter 15 of *A Treatise on Political Economy*, where Say introduces his famous 'law of markets.' He illustrates this law using a simple example in agriculture, the case of a bumper crop. 'A good harvest is favourable, not only to the agriculturist, but likewise to the dealers