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Say's Law and the Austrian Theory of the Business Cycle

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Abstract: Economists have tried to explain business cycles as well as fluctuations in the economy, but over the past two centuries, the explanations have fallen into two areas. The first area tries to explain business cycles as being the result of fluctuating *aggregate demand*; if overall demand for goods is strong (or to put it another way, consumers are confidently buying goods), then the economy is in a boom. However, if consumers choose *not* to spend, then the economy is in recession. The second area, as outlined by Sowell is that of seeing an economy as operating within internal proportions that are brought into imbalances. Say's Law is found in this second category, and the Austrian theory of the business cycle (ATBC) also is a proportionality-based theory. However, most economists have failed to make the connection between Say's Law and the ATBC.

1. Introduction

During the 1980 U.S. presidential campaign, many American voters for the first time were introduced to Say's Law, and while the politicians debating it managed to mangle its concepts, nonetheless a staple of classical economics for a brief moment held center stage. Today, it seems that the *zeitgeist* of political economy is moving in another direction, as those in political power today are reaching back into the 1930s to the borrow-and-spend policies that marked what governments did in the United States and Europe.

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The second area, as outlined by Sowell (1985) is that of seeing an economy as operating within internal proportions that are brought into imbalances. Say's Law is found in this second category, and the Austrian theory of the business cycle (ATBC) also is a proportionality-based theory. However, most economists have failed to make the connection between Say's Law and the ATBC, whether or not people are aware of the connection.

This article seeks to demonstrate how the ATBC and Say's Law are interrelated, and to show that in his *Treatise on Political Economy* (1803, 1826) J.B. Say anticipated the ATBC and at the same time delivered a devastating critique against the Keynesian theories that dominate the political discussion today. The economic thought that Say introduced in his *Treatise*, while not explaining (or attempting to give) what one might call a business cycle theory, nonetheless lays an important foundation for the theory that Mises (1912, 1981) and other Austrian economists would develop.

The article is organized in the following way. I first explain what is meant by "Say's Law" and how it was developed. In the next section, I briefly deal with the critics and supporters of Say's Law. I then briefly explain the ATBC and show how Say's Law explains a critical foundation of the ATBC, and afterward, I draw some conclusions.

2. WHAT IS SAY'S LAW?

Traite' d'Economie Politique or *Treatise on Political Economy* first appeared in 1803 as a general book on economic thought. Like Adam Smith (1776, 1982), Say wished to discredit the doctrines of "mercantilism," or, as called in France, "Colbertism," after J.B. Colbert, the finance minister for Louis XIV, who developed a Byzantine system of taxes, monopolies, and business regulations for France.

There is no specific "law" that Say pronounces in his book, but the concept of what we call Say's Law is developed in book one, chapter 15, which begins (from the 1826 edition):

> It is common to hear adventurers in the different channels of industry assert that their difficulty lies not in the production, but in the disposal of commodities; that products would always be abundant, if there were but a ready demand, or market for them.

> *When the demand for their commodities is slow, difficult, and productive of little advantage, they pronounce money to be scarce; the grand object of their desire is a consumption brisk enough to quicken sales and keep up prices*. (p. 132; emphasis added)

In other words, Say is describing something akin to a recession. In explaining this passage, Mises (1960) writes:

> Whenever business was bad, the average merchant had two explanations at hand: the evil was caused by a scarcity of money and by general overproduction. Adam Smith, in a famous passage in *The Wealth of Nations*, exploded the first of these myths. Say devoted himself to a refutation of the second. (p. 315)

It is important to point out that in chapter 15, Say does not attempt to explain why the condition he is describing has happened. In other words, the chapter does not contain a business cycle theory itself. Instead, he explains why the scarcity of money or overproduction/underconsumption explanations are fallacious, but in so doing, he also explains a set of conditions that find their way into the ATBC.

The explanation that Say gives is based upon what Sowell (1994, pp. 39–41) writes are the following propositions:

1. "The total factor payments received for producing a given volume (or value) of output are necessarily sufficient to purchase that volume (or value) of output."
2. "There is no loss of purchasing power anywhere in the economy." (In other words, no Keynesian "leakages.") "People save only to the extent of their desire to invest and do not hold money beyond their transactions need during the current period."
3. "Investment is only an internal transfer, not a net reduction, of aggregate demand."
4. "In real terms, supply equals demand *ex ante*, since each individual produces only because of, and to the extent of, his demand for other goods."
5. "A higher rate of savings will cause a higher rate of subsequent growth in aggregate output."
6. "Disequilibrium in the economy can exist only because the internal proportions of output differ from consumer's preferred mix—*not* because output is excessive in the aggregate."

As we shall see, the sixth proposition is important to understanding the ATBC. Not surprisingly, the sixth (and really the last three) propositions are the ones that are disputed among economists in debates about the causes (and "cures") for problems related to business cycles.

The popular definition of Say's Law is: Supply creates its own demand. In the next section, I briefly shall point out how critics have misinterpreted that statement, something that is common in economic and popular literature, but in this section I will explain what the phrase actually means.

First, and most important, nowhere in the chapter does Say make the "supply creates its own demand" statement. Instead, he applies economic logic to production and consumption and demonstrates that consumption and production are interrelated, as opposed to being two separate and random activities, as was proposed by economists like Thomas Malthus and later Karl Marx and even John Maynard Keynes.

As Benjamin Anderson (1949) writes in support of this concept:

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

Second, as Hazlitt notes, the purpose of Say's chapter is to lay out the logical case that *general* bouts of "overproduction" or "underconsumption" are impossible. In other words, an economic downturn cannot occur because an economy has produced too much of *everything*, or that consumers lack the will (Malthus) or the ability (Harrington) to purchase what has been produced. Writes Harrington (1981):

> During the 1930s, there was a glut of consumer goods because workers lacked the purchasing power to buy back what they produced. That was why government began to play a role in the economy on behalf of middle- and low-income people during the period of Franklin Delano Roosevelt's New Deal. (p. 31)

Again, we see in Harrington's statement the belief that (1) production and consumption are unrelated, and (2) unless enough workers can find the means to "buy back the product," then the overproduction/underconsumption problem reappears. Hazlitt (1979), includes a chapter that attacks the "buy back the product" viewpoint, noting that a payment to a worker also is a cost to the employer, which means that the believers in the "buy back the product" view are saying that the way to increase consumption is to increase business costs, which is easily and logically refuted.

One also must keep in mind that Say is not declaring that business downturns or recessions are impossible, something that will be discussed at greater length in the next section. Instead, he simply is attempting to counter the argument that a business downturn is *not* the result of "general overproduction" of goods within the economy. Furthermore, "Say's Law" is not a law in the sense of what economists consider a law like the Law of Scarcity, the Law of Demand, the Law of Opportunity Cost, or the Law of Supply. Instead, Say extrapolates the logic found in these other laws to point out the simple fact that production and demand are intricately related, as one cannot consume without someone producing that which is to be consumed, and that the more one produces, the more one can consume.

While not giving a business cycle theory in particular, nonetheless Say does outline some basic parameters from which to build a theory. Furthermore, these parameters are a necessary foundation for the ATBC and for understanding the boom and bust cycle in general (including the present economic troubles that exist at the writing of this article). This will be covered in more detail in the ATBC section, but I include the item here as well.

Say held that business downturns would be proportional in nature, that too many goods in one sector—more than would be able to be consumed, given the preferences and income of consumers—could be produced, at least temporarily, but that there would be a corresponding shortfall in the production of other goods. In other words, business downturns were a matter of proportional "malinvestments" (to use the Austrian term), not overall lack of consumption. As we shall see, this point is crucial to understanding the ATBC.

3. CRITICS AND SUPPORTERS OF SAY'S LAW

Say was not without his critics then and now. As Sowell (1985) points out, the contemporary critics included Malthus, Sismondi, and Marx. The most important critic of the twentieth century was John Maynard Keynes (1937, 1953), whose "refutation" of Say's Law will be examined in this section, as Keynes and the modern critics build on the earlier contemporary criticisms.

Sweezy (1947) declares about Keynes and his *General Theory*:

> Historians fifty years from now may record that Keynes' greatest achievement as the liberation of Anglo-American economics from

> a tyrannical dogma, and they may even conclude that this was essentially a work of negation unmatched by comparable positive achievements (p. 105).

However, Sweezy strikes a more ominous tone when he says that the "Keynesian attacks, though they appear to be directed against a variety of specific theories, all fall to the ground if the validity of Say's Law is assumed" (p. 105). Thus, it was important that Keynes and his followers "discredit" Say's Law.

As Hazlitt (1959) points out, Keynes "refuted" Say's Law by taking a passage from Mill in which he states that

> the means of payment for commodities is simply commodities. . . . Could we suddenly double the productive powers of the country, we should double the supply of commodities in every in every market; but we should, by the same stroke, double the purchasing power. (Quoted in Hazlitt, 1959, p. 34)

Keynes targets that passage as being false on its face because it allegedly declares that every good produced automatically will find a buyer and, thus, recessions are impossible, writing:

> Thus Say's Law, that the aggregate demand price of 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. If, however, this is not the true law relating the aggregate demand and supply functions, there is a vitally important chapter of economic theory which remains to be written and without which all discussion concerning the volume of aggregate employment are futile. (p. 26)

Harrington also makes a similar statement, declaring, "Say's Law maintains that if business can produce products, it can sell them. The Great Depression discredited Say's Law" (p. 31). Thus, the chapter that was written to explain what *did not* cause business recessions has been turned into something that was not written at all: that classical economists claimed "full employment" always was the norm.

Yet, as Hazlitt points out, Mill (1848, 1919) himself in the next passage explains the *context* of his previous statement in which he says, "It is probable, indeed, that there would now be a superfluity of certain things" (Hazlitt, 1959, p. 35). Sowell (1974, p. 43) quotes Mill (1844) elsewhere saying that "production is not excessive, but merely ill-assorted." Likewise, on that same page, Sowell quotes Ricardo who says that "it is at all times the bad adaptation of the commodities produced to the wants of mankind which is the specific evil, and not the abundance of commodities." Ricardo add, "Men err in their productions (but) there is no deficiency of demand."

In other words, the same people who recognized and agreed with Say's logic also recognized that business recessions were a possibility and that they themselves had observed them. As Hazlitt (1959) puts it:

> If you had presented the classical economists with "the Keynesian case"—if you had asked them, in other words, what they thought would happen in the event of a fall in the price of commodities, if money wage-rates, as a result of union monopoly protected and insured by law, remained rigid or rising—they would have undoubtedly replied that sufficient markets could not be found for goods produced at such economically unjustified costs of production and that great and prolonged unemployment would result. (p. 36)

Thus, the critics of Say's Law have claimed that it is absurd on its face, and that it denies something that has been observed many times in history: the business recession. Yet, as those who support Say's Law might ask, "How could a chapter that acknowledges the presence of a business recession then *deny* that such a recession actually was taking place?" Indeed, Say's Law is not about the denial of recessions or even a *partial overproduction* of goods relative to demand; it is about dealing with the claims that a recession occurs because of a *general* overproduction of goods.

4. HOW SAY'S LAW HELPS FRAME THE ATBC

The details of the ATBC are explained in Mises (1912) and Rothbard (1975) and elsewhere and will not be expounded here. However, because this article relates Say's Law directly to the ATBC, Rothbard's explanation about the economic crisis being one of proportionality is vital to understanding the relationship.

In explaining how the boom-and-bust of the business cycle occurs, Rothbard writes that the problem is in what Austrian economists call the "cluster of errors" by entrepreneurs and business owners:

> The explanation of depressions, then, will not be found by referring to specific or even general business fluctuations per se. The main problem that a theory of depression must explain is: *why is there a sudden general cluster of business errors?* This is the first question for any cycle theory. Business activity moves along nicely with most business firms making handsome profits. Suddenly, without warning, conditions change and the bulk of business firms are

> experiencing losses; they are suddenly revealed to have made grievous errors in forecasting. (p. 16)

The widest fluctuations, Rothbard notes, are not in the consumer goods industries, but rather in capital or producers' goods. In other words, the downturn does not begin by consumers suddenly deciding to purchase fewer goods, but rather because economic conditions in certain industries suddenly turn sour.

Rothbard goes on to say that in a normal, free-market economy, there will be no cluster of errors by entrepreneurs, but rather that those errors will be distributed on a more random basis. However, the combination of fractional reserve banking and aggressive efforts by the central bank to expand the supply of money in the economy will distort the structure of production. Rothbard first points out that if people change their time preferences by consuming less in the present so they can consume more in the future, then the addition of savings they add to the system will signal entrepreneurs to *lengthen* the structure of production and invest in capital goods as opposed to consumer goods, which appeal to people who prefer to spend their resources at the present time.

However, he points out that if the money that is directed toward the capital goods sectors comes because governments and their banking allies expand credit without a similar expansion of real savings, then problems begin:

> Now what happens when banks print new money (whether as bank notes or bank deposits) and lend it to business? The new money pours forth on the loan market and lowers the loan rate of interest. It *looks as if* the supply of saved funds for investment has increased, for the effect is the same: the supply of funds for investment apparently increases, and the interest rate is lowered. Businessmen, in short, are misled by the bank inflation into believing that the supply of saved funds is greater than it really is. (p. 18; emphasis Rothbard's)

From there, the dislocations begin as investments are poured into lines of production that cannot be sustained. The new "investments" alter the structure of production into a direction and scope that will not reflect the actual desires and spending patterns of consumers. Rothbard adds:

> people will rush to reestablish the old proportions, and demand will shift back from the higher to the lower orders. Capital goods industries will find that their investments have been in error: that what they thought profitable really fails for lack of demand by their entrepreneurial customers. Higher orders of production

> have turned out to be wasteful, and the malinvestment must be liquidated.
>
> A favorite explanation of the crisis is that it stems from "underconsumption"—from a failure of consumer demand for goods at prices that could be profitable. But this runs contrary to the commonly known fact that it is *capital goods*, and not consumer goods, industries that really suffer in a depression. The failure is one of *entrepreneurial demand* for the higher order goods, and this in turn is caused by the shift of demand back to the old proportions. (pp. 18–19; emphasis Rothbard's)

Rothbard continues:

> The "boom," then, is actually a period of wasteful misinvestment. It is the time when errors are made, due to bank credit's tampering with the free market. The "crisis" arrives when the consumers come to reestablish their desired proportions. The "depression" is actually the process by which the economy *adjusts* to the wastes and errors of the boom, and *reestablishes* efficient service of consumer desires. The adjustment process consists in rapid *liquidation* of the wasteful investments. Some of these will be abandoned altogether (like the Western ghost towns constructed in the boom of 1816–1818 and deserted during the Panic of 1819); others will be shifted to other uses. (p. 19; emphasis Rothbard's)

In other words, the problem with the economy is one of *incorrect proportions of production*, as opposed to being a general fall in consumption. This point is vital to understanding not only the ATBC, but also understanding how Say's Law helps lay the foundations of that theory. Sowell (1985) writes:

> Long before Engels and Marx came upon the scene, economists had divided into two main groups—(1) those who explained depressions by inadequate demand (the "general glut" theorists, let by Sismondi and Malthus) and (2) those who insisted that depressions were caused by internal disproportionalities in the composition of aggregate output—too much of A and too little of B—rather than by its total being excessive relative to aggregate demand. (pp. 92–93)

In speaking of proportionality, Say writes:

> But it may be asked . . . how does it happen, that there is at times so great a glut of commodities in the market, and so much difficulty in finding vent for them? Why cannot one of the superabundant commodities be exchanged for another? I answer that the glut of a particular commodity arises from its having outrun the total

> demand for it in one or two ways; either because it has been produced in excessive abundance, or because the production of other commodities has fallen short.
>
> *It is because the production of some commodities has declined, that other commodities are superabundant.* (p. 135; emphasis added)

To put it another way, the relative proportions are incorrect. If one accepts this proposition (as opposed to holding to an "underconsumption" theory), then the critical question is this: Why are the economic fundamentals out of kilter?

The reason, as outlined by Garrison (1984), is that the growth of new money also changes the relative prices within a structure of production. Classical, as well as Austrian, economists believed that while money served as a medium of exchange, nonetheless the real economy, that is, the relationships between real goods, was key to understanding what was occurring. For example, a barrel of oil and a meal at a good restaurant might both cost $50. While the prices are denominated in dollars, they are equal in *real* terms, at least in barter.

Yet, these relationships can change under certain circumstances. Assume that consumer preferences change over the long term and people are wishing to use more oil, thus making oil twice as valuable as a restaurant meal. Economically speaking, while it means there will be adjustments in the economy due to this change in preferences, but it does not cause dislocations. It is just that in real terms oil now is twice as valuable to consumers relative to meals at good restaurants, and consumer choices will adjust accordingly, as entrepreneurs will recognize the consumers' change in preferences and direct more resources toward oil.

However, if there is a bout of inflation, the relationships also will change, but in a very different way. The typical classroom model that tracks changes in the money supply is $MV = PY$, where M equals the stock of money, V is its "velocity," or how quickly it is dispersed through the economy, P is the "price level," or a weighted average of *all* consumer prices, and Y is national "output." If M were to double but V and Y remain unchanged, then P also would double.

Although this is a convenient model to show to students, nonetheless it does *not* accurately demonstrate what occurs during a period of inflation. Prices of consumer and producer goods do not rise equally in tandem; instead, inflation, which really is a situation in which the value of the marginal unit of money decreases relative to real goods, as pointed out by Mises (1912) and Rothbard (1993). This simple but important point often is missed by many mainstream economists who insist on defining inflation as a rise in a constructed and stylized average of consumer prices. (The government also has a Producer Price Index, but this, too, is a weighted average of selected prices, except they are prices for factors of production, not consumer goods.)

Although these statistics might provide interesting fodder for discussion, they do not explain what happens during an inflationary period. Prices for goods indeed rise, but they rise in a manner in which the *relative prices* change even though consumer preferences do not do likewise. For example, when money loses its value after its stock is expanded, the prices of commodities like oil and gold (and other such goods that are publicly traded in commodity exchanges) increase more quickly than do prices of services and some consumer items, not to mention labor prices, which often are set via contracts or other longer-term agreements.

This is not the only problem. As Rothbard earlier explained, the mechanism of injecting new money into the economy—the banking loan process—brings two dislocation problems. First, if central banking authorities hold interest rates below levels where they would naturally be due to the demand for and supply of loanable funds, then this process will favor producers' goods over consumer goods, changing that relationship *even if consumer preferences have not changed*. Second, when the new money spreads throughout the economy, it reduces the value of money, further changing relative prices of goods.

Only someone who understands how such action disturbs the real relationships of goods to one another can understand why central-bank led booms are unsustainable. At some point, the relationships of goods in an economy undergoing such injections of credit become dysfunctional and break down on their own. Economists who insist on defining inflation as a situation in which all prices rise in tandem are not going to see how increases in the supply of money via government-sponsored bank credit injections can distort the inner workings of an economy.

Indeed, that is one of the things that separates the two groups of economists as outlined above by Sowell. Economists who believe that economic recessions are caused by a sudden fall in aggregate expenditures also are going to believe that a new injection of bank credit and government spending will set matters right. However, economists who agree with Say and the Austrians that booms disturb the fundamental proportions of goods within an economy also will recognize that government policies—and especially the kind advocated by Keynes and his followers—will cause further distortions, thus making the economic downturn even worse.

It is true that Say did not give reasons as to the cause of the disproportionalities (Rothbard writes that David Ricardo developed a prototype for what would be the ATBC), and it would be a century later before Mises formally developed a theory that encompassed not only the reasons for the distortions, but also explained how the central bank usually was the originator of the crisis. However, it is clear that he and his supporters were on the right track.

5. CONCLUSION

Say's Law, often misunderstood and certainly wrongly vilified, is an important part of the ATBC. This "law" is not *sufficient*, but it is *necessary* for the ATBC to be true. Despite the fact that the ATBC is an intricate and sophisticated economics theory (as opposed to the more crude notions of "aggregate demand" and "aggregate supply" that currently are in vogue), at its heart is the simple fact that monetary intervention by government authorities ultimately distorts the relationships of economic fundamentals and throws the economy out of balance.

This is why Austrians say that a recession is a necessary part of restoring the "proper" economic relationships that are seen in the fundamentals of the economy, with both consumer goods *and* the factors of production. Say's Law provides the ATBC with a crucial reminder that there cannot be a recession without the fundamental economic relationships within an economy first being disturbed.

It is unfortunate that economists continue to misrepresent and even vilify Say's Law. At its most simple point, it is an economic tautology: one cannot consume without first producing, and what one produces becomes a basis for determining what one consumes. Say did not "discover" this fact, but he highlighted it, and two centuries later, Say's Law is as applicable as it was when *Treatise* first appeared in print.

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