Jean Baptiste Say
1767-1832

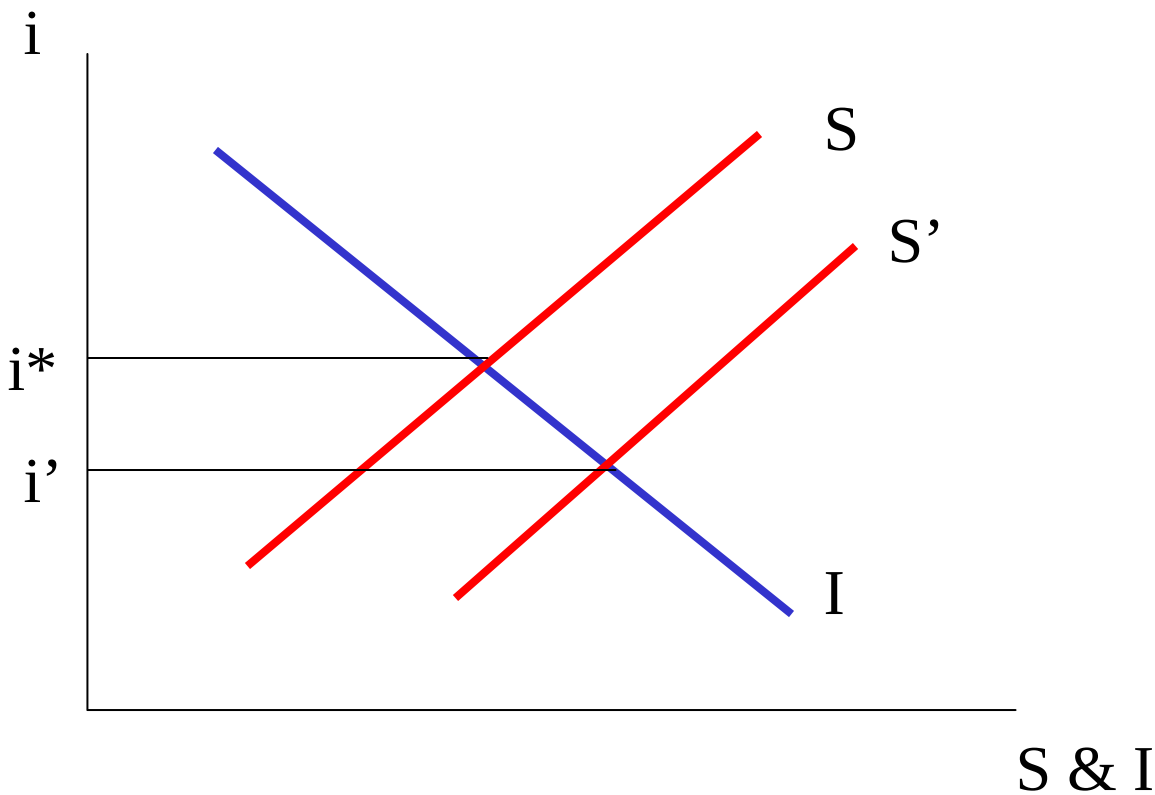
Say’s Law and Classical Monetary Policy

- Say’s law is an idea frequently found in Classical Economics
- The idea rejects the possibility of a general overproduction or “glut”
- Often stated as “supply creates its own demand”
- Involves a rejection of Malthus’ theory of gluts
- Smith, Say, Ricardo, James Mill, and J. S. Mill all supported Say’s Law

Bases of Say's Law: I

- The first idea behind Say's Law is there cannot be too much saving
- Saving becomes investment expenditure and is spent just as consumption expenditure
- Savings and investment expenditure brought into equality via real interest rate adjustments

Savings and Investment



If the amount people wish to save increases shifting S to S’ the equilibrium i rate falls

Bases of Say's Law: II

- The second basis of Say's Law has to do with the demand for money
- Generally the Classical view was that people only held money balances to undertake transactions
- Demand for money would be determined by the number of transactions planned and the average price at which these transactions were expected to take place
- People do not hold money as an asset (as it pays no interest)
- So when people find their money balance higher than they wish they either consume or save (invest)

Implications of Say’s Law

- If no one runs their money balances up or down then there is no hoarding or dishoarding of money
- All income not consumed is saved
- All saving is invested
- All income is spent
- Cannot be overproduction or underconsumption (in general)
- Full Employment Agg S = Agg D

Say’s Identity

- Classical writers sometimes say an excess of supply “is an impossibility” (J. S. Mill)
- Implies that Full Emp Agg S is *always* = Agg D
- This is known as the identity version of Say’s Law
- A demand *is* a supply; a supply *is* a demand
- This does apply in a barter economy—but does it apply in a monetary economy?

Say's Identity

- Would apply to a monetary economy only if a monetary economy behaved like a barter economy
- Money only a "veil" and has no real effects
- If I sell something my money balance goes up and I then buy something else to reduce my money balance
- If I buy something my money balance falls so I then sell something to restore my money balance

Say's Identity

- People cannot run up or run down money balances
- Dichotomizes the economy
- Real factors only determine employment, output, income and relative prices
- Monetary factors have no real effects—determine general price level only
- Is this really what the Classical economists thought?

Say’s Equality

- In many places Classical writers suggest that various disturbances may cause temporary excess supply
- J. S. Mill states “commercial crises” may lead to people wishing to run up money balances—excess demand for money or deficient aggregate demand for goods
- In this case Say’s Law expresses an equilibrium condition, not something that is always true or true by definition
- This position is called Say’s Equality

Say’s Equality

- If what the Classical Economists had in mind was Say’s Equality we should find discussions of disturbances and adjustment mechanisms
- Monetary factors can affect the real economy but there are adjustment processes back to an equilibrium at full employment
- Direct mechanism
- Indirect mechanism

Direct Mechanism

- People may wish to run up or down their money holdings
- In a “crisis” people wish to hold more money
- In this case people will try to increase their money holdings by selling goods or selling off other assets (stocks)
- Md > Ms and full employment

  Agg S > Agg D
- Price level falls until real money balances increased and people no longer wish to increase money holdings (real balance effect)
- Md = Ms and FE Agg S = Agg D

Direct Mechanism

- Or--Case of increasing money supply
- Ms > Md, people find themselves with more money than they wish to hold
- Increase consumption or investment expenditures
- Add D > FE Agg S
- Price level rises which increases demand for money (real balance effect) until Md=Ms and FE Agg S = Agg D
- Neutrality of money only as between equilibrium states. Money can be a disturbing cause.

Indirect Mechanism

- Some Classical writers also thought monetary factors could have an effect through the i rate
- Market i rate may not equal the real i rate that would give S = I
- If market i > real i, then S > I and FE Agg S > Agg D
- If market i < real i, then I > S and Agg D > FE Agg S
- Adjustment via banks adjusting i rates according to reserve position

Say’s Law--Conclusion

- Lack of clarity over what is always true and what is true in equilibrium
- The many discussions of “crises” and inflations makes it clear that the Classicals felt money could be a significant disturbing cause
- Tendency to equilibrium at FE level of output
- Say’s equality rather than Say’s identity