Say's Law Is Wrong

J. Bradford DeLong

U.C. Berkeley

October 8, 2010

Jean-Baptiste Say

Let's start with one of the first economists, Jean-Baptiste Say. Say wanted to be a technocrat, and was well on the way--special assistant to Girondist Finance Minister Etienne Claviere in the early days of the first French Republic. His patron was fired, purged, arrested, imprisoned, probably tortured, sentenced to the guillotine, which he cheated by committing suicide the day before his scheduled execution. Say somehow managed to escape the wreck of the Gironde with not just his life but hid liberty and property as well. Thereafter it was clear to him that civil service life was too risky. So Say turned to writing treatises on political economy instead.

Say, at least in the early and middle stages of his career, was certain that the kind of "general glut" we are now undergoing--a generalized deficiency or demand for pretty much every kind of good and service and labor, and high unemployment and excess capacity across the board--was inconceivable. After all, Say wrote, people make only if they want to use themselves or to sell. People sell only if they want to buy. Supply thus creates not exactly it's own but an equal amount of planned demand.

Now this does not, Say stressed, mean that unemployment could not be elevated. Suppliers could guess wrong about where the demand would be. The example I use for my Berkeley class is one in which employers hire a lot of baristas to make half-caf double patted made half skinny and half with half-and-half, but in which what consumers want are yoga lessons. They seek inner peace rather than caffeination.

In such a situation there will be deficient demand for double latter and excess demand for yoga lessons. Baristas will be fired and collect unemployment insurance. Prices of yoga lessons and wages in the fitness sector will boom. But the market will deal with it: there is a lot of money to be made by figuring out how to retrain baristas as yoga instructors and redeploy labor from the food service to the fitness industry.

And having the government intervene will only muck things up. If the government enacts a stimulus program and taxes and borrows to spend money on public purchase and provision of red-eye lattes-- well, then: (1) We make a lot of coffee that nobody likes to drink. (2) We retard the process of retraining baristas so that they can demonstrate how to perform the downward-facing dog. (3) We run the risk of inducing a general collapse of confidence in the market economy as people begin to wonder what politician is ever going to raise taxes to pay off rising government debt and productivity falls as people seek to guard themselves against future disruptions of the monetary economy that enables our highly-productive advanced societal division of labor.

That 1803-vintage argument of Jean-Baptiste Say's is what I take to be the guts of Niall Ferguson's read on today's economic problems--that they are in essence structural and not cyclical, and are not to be alleviated but rather deepened and complicated by government attempts to put people or to artificially induce private employers to put people to work.

John Stuart Mill’s Critique

I, by contrast, take my stand with John Stuart Mill's 1829 critique of Jean-Baptiste Say. Mill pointed out that people spend less than they earn on currently-produced goods and services if they are unhappy with and want to build up their holdings of financial assets. Then you can have a general glut--an excess supply of pretty much every kind of currently-produced good and service and currently-employed labor--if you also have an excess demand for financial assets.

Monetarist and Keynesian Downturns and Their Cures

Historically, we have seen general gluts caused by three kinds of excess demands for financial assets. We have seen monetarist depressions caused by a shortage relative to demand of liquid cash money. We have seen Keynesian depressions caused by a shortage relative to demand of bonds--of savings vehicles to carry wealth through time so that you can spend it in the future. And we have our current situation, which looks to be a shortage not of money or of bonds so much as a shortage relative to demand of safe AAA high-quality assets--a financial excess demand for safety, for placed you can park your wealth and be confident it will not melt away while your back is turned.

We know how to cure monetarist downturns through standard open-market operations: have the central bank buy short-term government bonds for cash, thus increasing the stock of liquid cash money. That strategic intervention in financial markets eliminates the excess demand for money and as a consequence eliminates the deficiency in demand for currently-produced goods and services and currently-employed labor as well.

We know how to cure Keynesian downturns: induce households to save less and so demand fewr bonds or induce businesses or the government to issue more bonds. Those strategic interventions in financial markets eliminate the excess demand for money and as a consequence eliminate the deficiency in demand for currently-produced goods and services and currently-employed labor as well.

The Flight to Safety

Neither if those is likely to work terribly well if the financial excess demand is not for money or for bonds but for safety. Open-market operations that swap one government liability for another, private issues of risky bonds, issue of risky bonds by governments with shaky credit, or reductions in household saving that do not reduce desired holdings of safe assets leave the excess demand for safety unmet and the deficient demand for currently-produced goods and services and currently-employed labor unrelieved.

"Lend Freely at a Penalty Rate"

In a Minskyite downturn like the current one, the only cure is what Economist editor Walter Bagehot set out in 1868. The government must lend freely. It must meet the demand for safe assets by--as long and as much as it can--expanding the supply of financial assets that the market perceives as safe. Quantitative easing policies by which the central bank adds to the stock of its own safe liabilities that the private sector van hold by buying up risky assets. Small increases in the inflation target to diminish demand for safe assets by levying a small inflation tax on them. Treasury and central bank guarantees of risky private assets to transform them into safe ones. Public recapitalizations of banks with impaired capital to make their liabilities safe assets. Pulling infrastructure spending forward into the present and pushing taxes back into the future, and so increasing the supply of safe assets by having the government issue more of it's own safe debt. All of these have a place.

Dangers of Policy Activism

All of these have a place, that is, until the swelling of the liability side of the government's balance sheet cracks its status as a safe debtor whose promises-to-pay are credible. Then you find that you have not increased but decreased the supply of safe assets to the market, and made the problem worse and not better.

That can happen. Think Austria in 1931. Think Greece today. Think Argentina about once a decade since 1890.

That is what Niall Ferguson fears from any further expansions of the liability side of government balance sheets. And he sees no upside--for he sees our problem as not a general glut but as a structural imbalance, and government policies to boost demand as likely to cause inflation and retard needed adjustment.

Bigger Dangers of Policy Non-Activism

I, by contrast, think that the right question to ask is the question that Thomas Robert Malthus asked Jean-Baptiste Say in 1819:

> [I]nstead of this, we hear of glutted markets, falling prices, and cotton goods selling at Kamschatka lower than the costs of production. It may be said, perhaps, that the cotton trade happens to be glutted; and it is a tenet of the new doctrine on profits and demand, that if one trade be overstocked with capital, it is a certain sign that some other trade is understocked. But where, I would ask, is there any considerable trade that is confessedly under-stocked, and where high profits have been long pleading in vain for additional capital? The... [crisis] has now been... [ongoing] above four years; and though the removal of capital generally occasions some partial loss, yet it is seldom long in taking place, if it be tempted to remove by great demand and high profits; but if it be only discouraged from proceeding in its accustomed course by falling profits, while the profits in all other trades, owing to general low prices, are falling at the same time, though not perhaps precisely in the same degree, it is highly probable that its motions will be slow and hesitating...

Until we see actual, real signs that expansions of government balance sheets are impairing investor confidence in government promises-to-pay, it seems to me that it would be extremely foolish not to continue to attempt to boost production and employment by expanding government balance sheets. I want to see the money that stimulative policies are impairing confidence--and not just listen to arguments that stimulative policies ought to be impairing confidence.

J. Bradford DeLong

October 8, 2010: 1581 words