Say’s Law of Markets

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SAY'S LAW OF MARKETS

- **The classical economists like Smith, Pigou, Mill, Ricardo, and J B Say developed the Classical theory of employment.**
- **Two imp features of this theory are**

1. **Assumption of full employment of labour and other productive resources. They believed that full emp is a normal feature**
2. **Flexibility of prices and wages for reaching the stage of full emp**

- **The mkt forces will maintain full emp without inflation in the long run**

THE LAW

- **Jean Baptist Say, a French economist has explained the law**
- **“Say’s law of markets”. According to the law “supply creates its own demand”**
- **This law is the foundation of the classical theory of emp**
- **As per the law, production has dual effect on the economy**

1. **It creates supply**
2. **It generates factor incomes namely- rent, wages, interest and profits**

- **The supply of a product through the process of production generates necessary income to demand the products produced**
- **income generated in the production process enables the people to demand goods and services**

ASSUMPTIONS

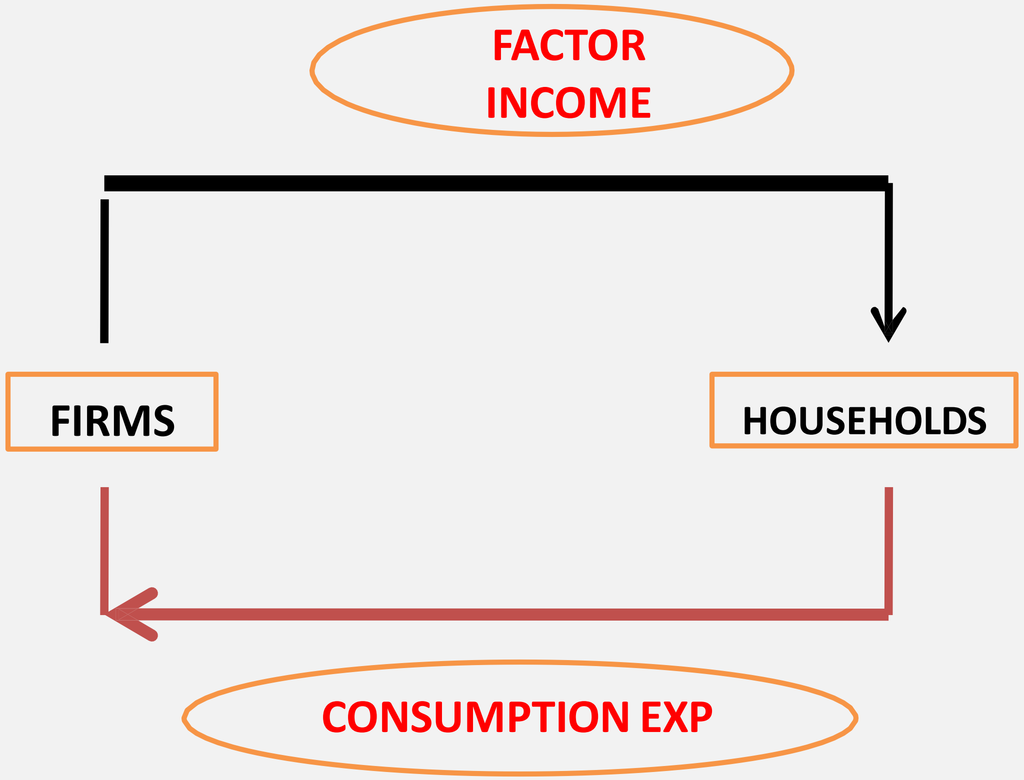
- **Perfect competition in the factor and product market**
- **Full emp of labour and other resources**
- **Wages, prices and rate of interest rate are flexible and that is the reason D=S for labour, D=S of money and savings and investment**
- **Change in money wages will cause proportional change in real wages in the same direction**
- **Free market economy which establishes equilibrium, therefore no govt interference in the economic affairs**

IMPLICATIONS OF THE LAW

- **Automatic adjustment in the economy and hence supply is always equal to demand**
- **Since supply creates its own demand, there can never be overproduction and so no general unemployment**
- **If resources are unemployed, then they can be used to produce more output, resources will earn incomes to demand whatever is produced**
- **S = I is possible because of flexibility in interest rates**
- **Wage rate flexibility will result in full emp always**
- **Money has a passive role to play – used as a medium of exchange only**

SAY'S LAW -2 SECTOR MODEL

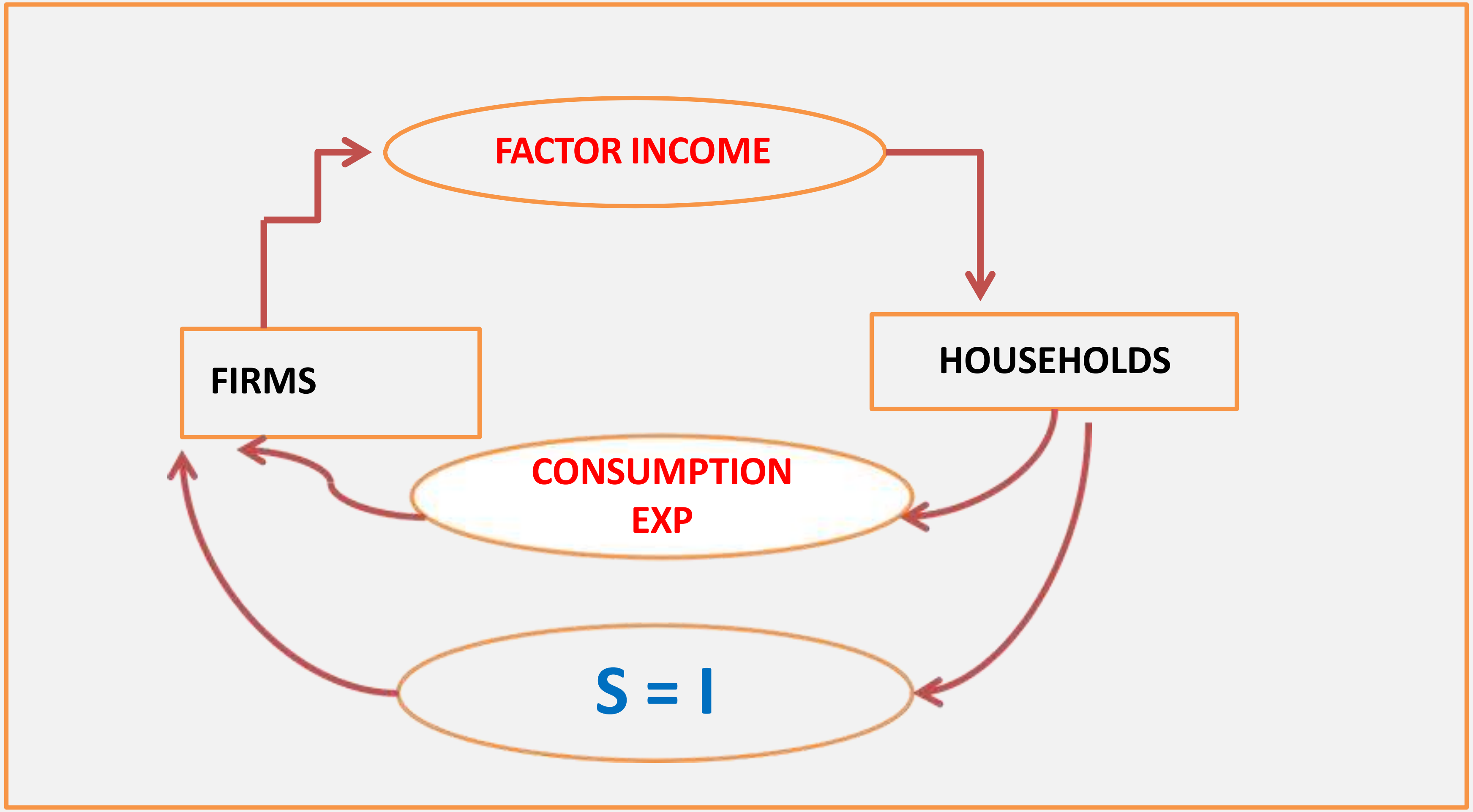
- **Circular flow of money income**
- **It is assumed in a money economy that all income received by the households is spent on consumption**



THE LAW

- **Firms hire factors of production**
- **They pay income to the factors – rent, wages, interest and profit – this is income to the households**
- **Households spend their incomes on the purchase of G & S**
- **The money goes back to the firms**
- **Absence of savings**
- **All Y = C**
- **Hence supply creates its own demand**

THE LAW – 3 SECTOR MODEL

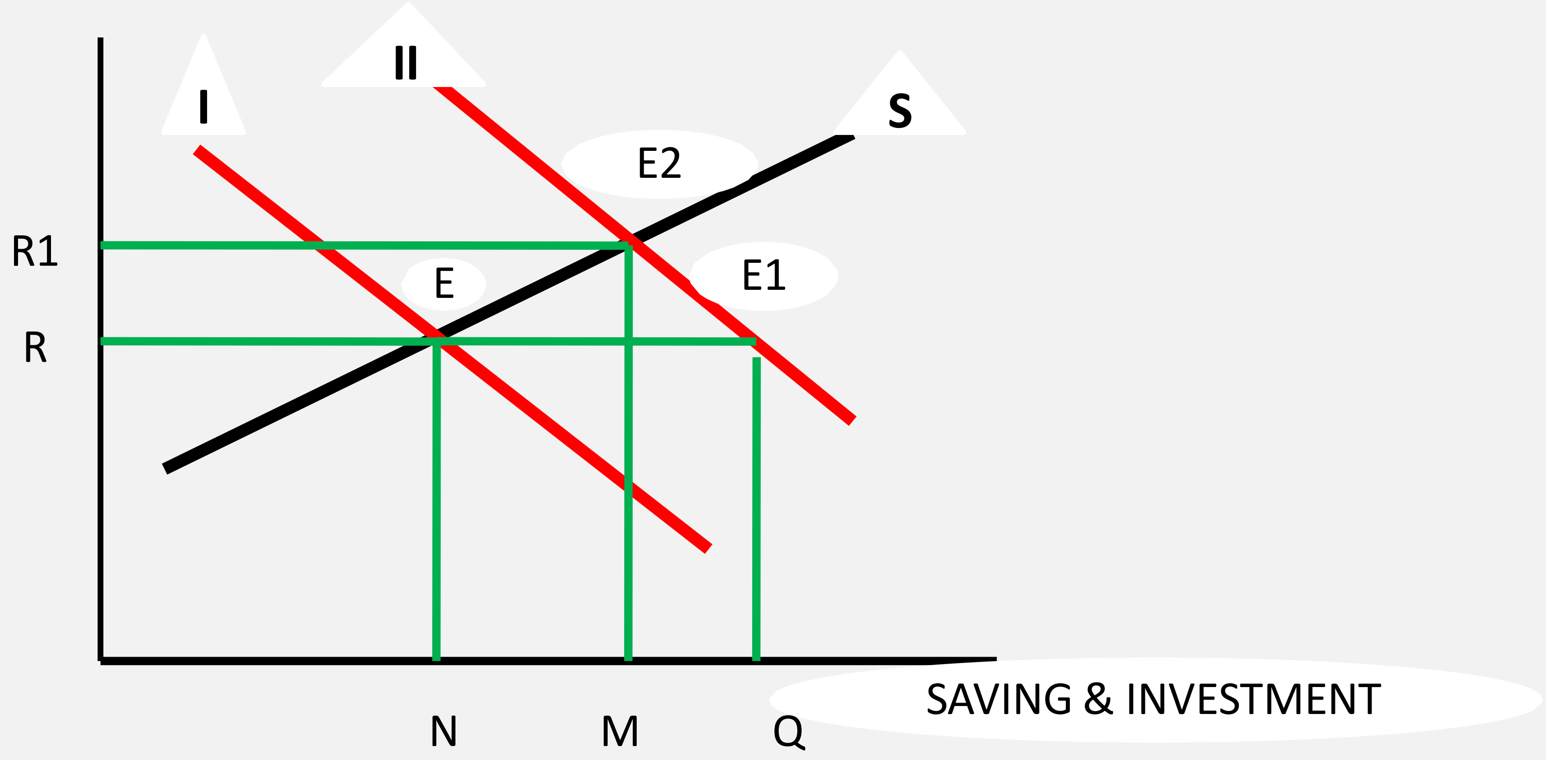


THE LAW

- **All Y = C**
- **if there is any divergence between S & I, rate of interest flexibility takes care.**
- **if I > S, rate of interest will rise**
- **S will rise and I will fall till S = I**
- **This mechanism is explained with the foll diagram**

THE LAW

- **R is original equilibrium, S = I**
- **At R rate of interest if I > S, (EE1) , rate of interest will rise to R1 and S=I**



PIGOU'S MONEY WAGE CUT POLICY AND SAY'S LAW

- Classicals believed in the "wage cut money policy" to maintain full emp levels
- Unemployment according to classicals is a result of the rigid wage structure
- If wages are reduced, then all unemployment will disappear
- If the economy encounters unemployment temporarily, the mkt forces will cause wage rates to fall till all unemployed labourers are employed
- This is explained with the help of a diagram

CRITICISMS OF SAY'S LAW

- Keynes in his book "General theory of emp, interest and money" has
- critisied the Say's law on the specific assumptions

I. Attack on money wage cut policy - he objected to Pigou's notion that

- workers will accept a cut in money wages.

a) Keynes explained that a wage cut will invite strong resistance from

- the trade unions and there will be a refusal to accept wage cuts.

b) Keynes also argued that any wage cuts will reduce the purchasing powers of the labourers and aggregate demand will decline causing oversupply of G & S
c) A general wage cut will reduce employment also
d) Volume of emp is maintained by AD and not by wage bargains

CRITICISMS OF SAY'S LAW

1. Unrealistic assumption of full emp – Keynes considers uneployment to be a more realistic situation unlike the classicals who consider the economy will always operate at full emp
2. Too much importance to long run period – "according to keynes in the "long run we all are dead"
3. Law is unrealistic- supply does not necessarily create its own demand. Its because savings may not be equal to investment. Savings and investments are done by different sets of people and they cannot be equal by virtue of the rate of interest
4. Ignored the role of money - classicals considered money to be neutral and ignored its effects on output and employment. Keynes recognised the its importance on output, income and employment
5. Economy is not self adjusting – he advocated the role of government full fledged
6. Perfect competition assumption is unrealistic