9.23: Say’s Law versus Keynes’ Law

Learning Objectives

- Differentiate between the ways that Say’s Law and Keynes’ Law explain economic behavior

Macroeconomists over the last two centuries have often divided into two groups: those who argue that supply is the most important determinant of the size of the macroeconomy while demand just tags along, and those who argue that demand is the most important factor in the size of the macroeconomy while supply just tags along.

Say’s Law and the Macroeconomics of Supply

Figure 1. Say’s law emphasizes the importance of production and supply.

Those neoclassical economists who emphasize the role of supply in the macroeconomy often refer to Say’s law: supply creates its own demand. As a matter of historical accuracy, it seems clear that Say never actually wrote down this law and that it oversimplifies his beliefs, but the law lives on as useful shorthand for summarizing a point of view.

The reasoning behind Say’s law is that each time output is produced and sold, the revenues represent an equivalent amount of income generated. This income allows the owners to purchase the amount of output that was produced. While widget workers may not want to spend their entire paycheck on widgets, they will want to buy *something*, if not what they produced then something some other workers produced. In the aggregate, supply creates its own demand, or more generally, aggregate supply drives the economy while aggregate demand responds passively.

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Keynes’ Law and the Macroeconomics of Demand

The alternative to Say’s law, with its emphasis on supply, can be named **Keynes’ Law***:* “Demand creates its own supply.” As a matter of historical accuracy, just as Jean-Baptiste Say never wrote down anything as simpleminded as Say’s law, John Maynard Keynes never wrote down Keynes’ law, but the law is a useful simplification that conveys a certain point of view.

Figure 2. Keynes’ Law emphasizes the role of demand.

When Keynes wrote his great work *The General Theory of Employment, Interest, and Money* during the *Great Depression* the 1930s, he pointed out that during the Depression, the capacity of the economy to supply goods and services had not changed much. U.S. unemployment rates soared higher than 20% from 1933 to 1935, but the number of possible workers had not increased or decreased much. Factories were closed and shuttered, but machinery and equipment had not disappeared. Technologies that had been invented in the 1920s were not un-invented and forgotten in the 1930s. Thus, Keynes argued that the Great Depression—and many ordinary recessions as well—were not caused by a drop in the ability of the economy to supply goods as measured by labor, physical capital, or technology. He argued the economy often produced less than its full potential, not because it was technically impossible to produce more with the existing workers and machines, but because a lack of demand in the economy as a whole led to inadequate incentives for firms to produce. In such cases, he argued, the level of GDP in the economy was not primarily determined by the potential of what the economy could supply, but rather by the amount of total demand.

Keynes' law seems to apply fairly well in the short run of a few months to a few years, when many firms experience either a drop in demand for their output during a recession or so much demand that they have trouble producing enough during an economic boom. However, demand cannot tell the whole macroeconomic story, either. After all, if demand was all that mattered at the macroeconomic level, then the government could make the economy as large as it wanted just by pumping up total demand through a large increase in the government spending component or by legislating large tax cuts to push up the consumption component. Economies do, however, face genuine limits to how much they can produce, limits determined by the quantity of labor, physical capital, technology, and the institutional and market structures that bring these factors of production together. These constraints on what an economy can supply at the macroeconomic level do not disappear just because of an increase in demand.

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Combining Supply and Demand in Macroeconomics

Two insights emerge from this overview of Say's law with its emphasis on macroeconomic supply and Keynes' law with its emphasis on macroeconomic demand. The first conclusion, which is not exactly a hot news flash, is that an economic approach focused only on the supply side or only on the demand side can be only a partial success. Both supply and demand need to be taken into account. The second conclusion is that since Keynes' law applies more accurately in the short run and Say's law applies more accurately in the long run, the tradeoffs and connections between the three goals of macroeconomics may be different in the short run and the long run.

Table 1 summarizes the two macroeconomic perspectives.

Table 1. Comparing Neoclassical and Keynesian Economics

Summary	Neoclassical Economics	Keynesian Economics
Focus: long-term or short term	Long-term	Short-term
Prices and wages: sticky or flexible?	Flexible	Sticky
Economic output: Primarily determined by aggregate demand or aggregate supply?	Aggregate supply	Aggregate demand
Aggregate supply: vertical or upward-sloping?	Vertical	Upward-sloping
Phillips curve vertical or downward-sloping	Vertical	Downward sloping
Is aggregate demand a useful tool for controlling inflation?	Yes	Yes
What should be the primary area of policy emphasis for reducing unemployment?	Reform labor market institutions to reduce natural rate of unemployment	Increase aggregate demand to eliminate cyclical unemployment
Is aggregate demand a useful tool for ending recession?	At best, only in the short-run temporary sense, but may just increase inflation instead	Yes

GLOSSARY

[glossary-page]
[glossary-term]Keynes' law:[/glossary-term]
[glossary-definition]"demand creates its own supply"[/glossary-definition]
[glossary-term]neoclassical economists:[/glossary-term]
[glossary-definition]economists who generally emphasize the importance of aggregate supply in determining the size of the macroeconomy over the long run[/glossary-definition]
[glossary-term]Say's law:[/glossary-term]
[glossary-definition]"supply creates its own demand"[/glossary-definition]
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