

Discussion Forum. A first contribution. Chr. Groth, 2<sup>nd</sup> of February 2012.

1. Organization: As we decided, I should have all paper titles before March 1. Then I make a list to be published here a few days after. Then within a week you decide and inform me about on what topic you want to be an opponent (here you can again do it together with a fellow student and be an opponent pair twice).

As to time and place for the seminar sessions in April and May, we postponed fixing these things until the middle of March.

2. Say's law. Some further comments:

a) I am sorry about my mistake concerning *how* old Say (1767-1832) is. He is definitely not elder than Adam Smith (1723-1790) and only slightly younger than David Ricardo (1772-1823).

b) We should be aware that Say's law, "supply creates its own demand", is not about whether the price mechanism (with fully flexible prices) can and will eliminate all excess supplies fast (this would be a discussion about the appropriateness of Walrasian theory). It is rather a claim that although in the short run, there can be disequilibrium in the different sectors of the economy, general excess supply is impossible.

c) There was a good objection from Mathias today to my argument against Say's law. The objection was: Isn't the assumption,  $C_y + I_y < 1$ , the same as rejecting Say's law by introducing a *new* premise *from the beginning*? Say's "proposition" is that  $C_y + I_y = 1$ .

Looking at it through Keynes' spectacles, my answer would be:

If so, then the problem is, first, that the claim  $C_y + I_y = 1$  does not seem supported empirically. Second, at the theoretical level we only have, by definition, that  $C_y + S_y = 1$ . A decision to save is not the same as a decision to invest in the macroeconomic sense of a decision to procure physical capital. In the real world the decision to invest is generally taken by firms rather than households. Moreover, a household's saving can take the form of an attempt to increase ownership over paper assets and other *non-produced* assets (for example land). An increase in the propensity to save *may* affect prices on financial assets (hence interest rates), but there is no guarantee that capital investment thereby adjusts fully so as to neutralize the effect on aggregate demand.

d) An afterthought of my own. Another objection to my Keynesian example of a case with excess supply in two markets without excess demand in any other market could be the following.

That Keynesian example is not directly related to Say's view because he had a *disaggregate* framework in mind (as is characteristic for most economists before Keynes). Say's view is that although

disequilibrium is possible in the short run, this can only occur in form of excess supply in some industries at the same time as there is excess demand in other industries.

The Keynesian answer could then be: Well, to check, let us suppose there are  $n$  industries, each producing a good that is used both as a consumption good and an investment good. Suppose further that consumers always consume a basket of  $n$  goods,  $(c_1, c_2, \dots, c_n)$ , where  $c_1 = c_2 = \dots = c_n$ . The size of the basket may go up or down, but the proportionate composition remains unchanged (Cobb-Douglas preferences, demand elasticity w.r.t. aggregate income,  $Y$ , less than one for all the goods).

Let firms' technology be such that firms' investment demand is composed similarly. Then, suppose that production in each industry equals effective demand in the industry. (Remember, the discussion should be in terms of *effective* demand, that is, demand based on realized and expected incomes and sales also outside equilibrium; the argument should *not* be in terms of *Walrasian* demand which is a construct based on the idea that each agent assumes that the desired supply for a any given price vector can somehow always be realized, something which cannot be true outside general equilibrium.) So we have

$$Y_i = C_i + I_i = \frac{C + I}{n} = \frac{Y}{n} = \frac{C(Y, \bar{r}^e) + I(Y, \bar{r}^e)}{n} = \frac{C(nY_i, \bar{r}^e) + I(nY_i, \bar{r}^e)}{n}, \dots, i = 1, \dots, n.$$

Then one can for each industry draw a Keynesian 45° diagram which will look similar to the one I drew on the whiteboard for the aggregate case.

Let the general degree of confidence be low so that  $C(nY_i, \bar{r}^e) + I(nY_i, \bar{r}^e) < Y_i$ . Then, again we conclude that if production is increased a little, *all* industries will experience excess supply at the same time. In addition, in the labor market there is excess supply. The asset markets clear, however.

Possible counter argument: Again you assume something *from the beginning* that you should not, namely that the inequality  $C(nY_i, \bar{r}^e) + I(nY_i, \bar{r}^e) < Y_i$  holds. In some sense I agree - *this* should be the focal point of the discussion. The Keynesian view is that this inequality is possible, the classical (and new classical) view that it is not. I think the new Keynesians have provided a micro-foundation for the Keynesian view and my understanding of the empirical literature is that the view is supported by the empirical evidence. To my knowledge, new classicals base *their* view on *Walras' law* which says that the sum of the values of excess supplies in the different markets in a given period equals zero. But Walras' law relies on *Walrasian* budget constraints which are based on *Walrasian* demands and supplies. Thereby Walras' law assumes that trade never occurs outside general equilibrium. *This* is illegitimate, however, in a discussion of Say's law which is exactly about the character of the *disequilibrium* situations.

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