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Demand Creates Its Own Supply

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Abstract

One of the most important conclusions reached by the classical economists is the Say's Law of Markets. According to this law, production (supply) generates income, which is used completely and instantaneously to purchase (demand) commodities, so supply creates its own demand *at all times. To prove his thesis, Say took a macroeconomic approach. The objective of this paper is to prove another thesis that* demand creates its own supply. *The arguments presented in this paper are based purely on positive economics, and the thesis is proved with the help of a simple example, and in contrast to Say's macroeconomic approach, microeconomic approach is used to prove the thesis.*

Classical economists—David Ricardo, J.S. Mill, and their predecessors—felt that there was no need for government intervention to attain a high level of employment. They held the view that the situation of unemployment cannot be permanent in an economy. According to them, if unemployment occurred in an economy, it was only a temporary abnormality that the price system would automatically cure. Their view was founded on the assertion that the invisible hand of the market system would put everything in order so that the problem of unemployment would also be solved by market mechanisms. Whenever they discussed the possibility of general unemployment, they seem to have taken the optimistic view that general overproduction of goods—and hence general unemployment—was impossible.

One of the most important conclusions provided by the classical economists is the Say's Law of Markets. This law provides a concrete formulation to the idea that general overproduction, and hence general unemployment, is impossible. Jean-Baptiste Say (1767–1832), a French economist and one of the pillars of classical economics, initially proposed this law. According to the law, production (supply) generates income, which is then used completely and instantaneously to purchase (demand) commodities, thus *supply creates its own demand* at all times.

Say's Law of Markets, commonly known as Say's Law, is a four-page chapter, "Des Debouches (Markets)", in the first edition of Say's *Traité d'économie politique*, written in French and published in 1803. After being translated from French into English, the book became one of the most popular economics textbooks in England and other countries. His fame and notoriety sprang from his "loi des de'bouches", or "law of markets" theory that was discussed in the chapter.

In this chapter, Say justifies this assertion of his law, that supply creates its own demand. Though Say does not explicitly use the phrase "supply creates its own demand" in the chapter, it is a summary of his arguments that leads to the explicit argument that "it is

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production which creates markets for goods."[2] Many English economists explicitly accepted Say's Law as the true explanation of the working of the economic system during the early part of the nineteenth century. Classical economists spoke approvingly of Say's claim that "it is production which creates market for goods", which in effect means that in reference to a nation, supply can never exceed demand.

Say's Law has been much debated in the literature of economic thoughts. Many economists put their efforts into supporting or refuting this law. Say's Law holds true in a barter economy where commodities are traded for commodities, but such is not the case in a monetized economy.

Production does indeed generate an exactly equal quantity of income. Current national income and product accounts utilize this identity. However, in a monetary economy all income may not be spent completely and instantaneously on commodities. Individuals may hence save some of their income so that current supply exceeds the demand for commodities, and a general glut occurs in the economy.

The answer offered by classical economists to the possibility of glut in an economy due to savings is that each dollar that is saved will be invested. Therefore, investment will restore to the spending stream what resource owners take out through the saving process. The classical economists believed that the amount invested would automatically equal the amount saved because the interest rate would fluctuate in such a way as to maintain equality between them. Because of the existence of a market for loanable funds, the market is in equilibrium through interest rates so that quantity of funds supplied (savings) equals the quantity demanded (investments).

Keynes (1936) accused the classical school of being gravely misled by accepting it as the pivot of their macroeconomic theory. According to Keynes, the law said that the sum of the values of all commodities produced was (always) equivalent to the sum of the values of all commodities bought. By definition, therefore, there could be no underutilization of resources—"supply created its own demand".

Keynes refutes Say's Law saying that if the law held, recessions would never occur, since demand would always be sufficient to justify full-employment output, which is also the profit-maximizing level of output. Economies, however, do not always produce maximum potential output. As argued by Keynes, the existence of recessions is sufficient evidence to invalidate Say's Law. Government spending is the Keynesian remedy for recessions. It is said that Keynes was merely echoing the charges levied earlier by Malthus and other nineteenth-century economists. Nevertheless, Say's Law, which used a macroeconomic approach to justify its thesis, has deep roots in economic literature. A comprehensive analysis of Say's Law is given in Sowell (1972).

The objective of this paper is neither to confirm nor to refute Says' Law. The objective here is to prove another thesis that argues *demand creates its own supply* (and vice versa). I have, however, taken a microeconomic approach to prove my thesis. Moreover, the terms "demand" and "supply" in this context have different connotations than those used by Say. Say used "demand" and "supply" as quantities, but I will be using these two terms as a relationship between the price and quantity demanded (and supplied), as used in

2 "C'est la production qui ouvre des debouches aux produits," as cited in Stonier and Hague (1972: 394).

microeconomics. So, demand and supply here are used differently to refer to the relationship between price and quantity variables.

I am arguing here that if we have a demand curve/schedule, it also reflects a corresponding supply curve/schedule. My arguments are based purely on positive economics, and I try to prove my thesis with the help of a simple example.

Anamika is operating a bakery shop near a college. Currently, she is operating her business in a rented space of a six-shutter complex for a monthly rent of 6,000 rupees.[3] As her business is flourishing, her shop is now getting crowded; so she would like to have more space. If she takes another shutter, she has to pay an additional 6,000 rupees because the monthly rent of a shutter in that complex is 6,000 rupees. But, she would take a second shutter only if the rent falls to 4,000 rupees. If the rent fell to 3,000 rupees, she would expand her business in three shutters; at 2,500 rupees, four shutters; at 2,200 rupees, five shutters; and at 2,000 rupees, she would be willing to take the entire complex (all six shutters). On the other hand, if the rent were above 4,000 rupees, then she would manage her business into a single shutter. If the monthly rent for a shutter rises above 6,000 rupees, she would leave the shutter because she thinks that it is not worth operating her business in the complex by paying a hefty monthly rent that is above 6,000 rupees.

The information provided in the preceding paragraph describes Anamika's demand for shutter space in that complex. It can be presented in a tabular form as Table 1.

Table 1: Anamika's Demand for Shutters

Monthly Rent (in rupees)	Number of shutters demanded	Total monthly rent
6,000	1	6,000
4,000	2	8,000
3,000	3	9,000
2,500	4	10,000
2,200	5	11,000
2,000	6	12,000

Table 1 suggests that there is an inverse relationship between monthly rent and the number of shutters demanded. If we plot the information provided by Table 1 into a graph, it will give us a downward sloping demand curve.

The demand schedule shown by Table 1 would also describe Anamika's supply schedule in the event that she purchased the complex in which she had been operating business on rent. Would she occupy all of the shutters by herself if she owned the building? The answer to this question is that it would depend on the ongoing rental rate! If she can get more than 6,000 rupees for each of her shutters, she will rent out all six shutters to other businesses, since we know that 6,000 rupees is the most a shutter is worth to her in her business. If the monthly rent were between 6,000 and 4,000 rupees, she would use one shutter by herself and rent out five to others. Similarly, if the per shutter rent fell below 4,000, she will use two and hence rent out four shutters. For a monthly rent below 3,000 rupees, she will use (demand) three and rent out (supply) three. In the same way, she will use four and supply two shutters

3 A shutter is a business space, which has a metallic pull-down shutter instead of doors.

if the rental rate falls below 2,500 rupees; use five and supply one if it is less than 2,200 rupees; and use all and rent out none at all if she cannot get even 2,000 rupees per shutter.

The information provided in the preceding paragraph describes Anamika's supply of the shutter space. It can be presented in a tabular form as Table 2.

Table 2: Anamika's Supply of Shutters

Monthly Rent (in rupees)	Number of shutters supplied
2,001	1
2,201	2
2,501	3
3,001	4
4,001	5
6,001	6

Table 2 indicates that there is a direct relationship between monthly rent and the number of shutters supplied (rented out). If we plot this information as a graph, it will give us an upward sloping supply curve.

Anamika's supply curve, if drawn, is the mirror image of her demand curve. Whether Anamika chooses to occupy an additional shutter or instead makes the shutter available for others to rent out depends upon the ongoing rent of the shutter, and not on who owns the shutter complex! Ownership of the property will only change the distribution of the rent received from the complex; it will not affect the demand for and supply of the property.

Similarly, if we have a supply schedule from the shutter complex owner's point of view we can describe her demand schedule. Therefore, we can say that *demand creates its own supply,* and vice versa.

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Book Review

Michael R. Baye and Jeffrey T. Prince, (2014). MANAGERIAL AND BUSINESS STRATEGY McGraw Hill Education (India) Private Limited, New Delhi, PP XIV +636 including Case Study, Appendix additional Readings and References, Name Index and Gender Index.

Managerial and Business Strategy is a new concept which has only been recently put on the agenda in management education. Undoubtedly, it is a result of privatization, liberalization and globalization of the developing economy in particular. In a pragmatic process of development, it has been felt that both public and private enterprises require management by professionally trained personnel. In the last few decades managerial and business strategy has rapidly expanded and diversified all over the world. National economic policies throughout the world have been increasingly aimed at developing economic development programs. This has led to a new focus on building the economy from within and linking it to both the national, regional and the global economy. Since the business world has become increasingly complex, challenging and competitive in recent years managerial economics a new branch of economics helps the business executives to solve their business and managerial problems.

It is an application of various economic theories, principles, concepts and techniques to business management in order to solve business and managerial problems. Dealing with the practical application of economic theory and methodology to decision making problems faced by private, public and non-profit making organizations managerial economics is a highly useful subject of the course of management science.

The book under review consists of fourteen chapters and case study. They are the Fundamentals of Managerial Economics; Market Forces: Demand and Supply; Quantitative Demand Analysis; The Theory of individual Behavior; The Production Process and Costs; The Organization of the Firm; The Nature of Industry; Managing in competitive, Monopolistic and monopolistically Competitive Markets; Basic Oligopoly Models; Games Theory: Inside Oligopoly; Pricing Strategies for Firms with Market Power; The Economics of Information; Advanced Topics in Business Strategy; A Manager's Guide to Government in the Marketplace; Challenges at Time Warner. Each chapter concludes with an answer to the question posed in that chapter's opening headline. The entire book painted with a broad brush begins by teaching managers the practical utility of basic economic tools such as present value analysis, supply and demand, regression, difference curves, isoquants, production, cost, and the basic models of perfect competition, monopoly and monopolistic competition.

The book is praiseworthy for its real-world examples. It includes topics like oligopoly, penetration pricing, multistage and repeated games, foreclosure, contracting, vertical and horizontal integration, networks, bargaining, predatory pricing, principal-agent problems, raising rival's cost, adverse selection, auctions, screening and signaling, search, limit pricing, and a host of other pricing strategies for firms enjoying market power. Notably, the balanced coverage of traditional and modern microeconomic tools makes the book appropriate for a wide variety of managerial economics classrooms.

Though there is no dearth of literature in this field I hope sizeable number of business schools will adopt and implement the book to use managerial and business strategies at

optimal level in a given situation. It may serve in depth materials used in teaching managerial economics and business strategy. Reference materials and case examples are arranged in a manner suitable for teaching. Sample resource materials are included to facilitate its use and are also intended to support analytical efforts designed to determine strategic requirements.

The basic features of this book that distinguish it from other books on the same subject are more frequently use has been made of illustrations, tables, and figures, that does not only make the subject more interesting to the readers but also makes the book easy to understand. All along, attempt has been to include all the relevant facts, making sure that no relevant point is left untouched. Strategies, tools, and methods are defined by the text in which they are used. At the end of each chapter, connect exercises, case-based exercises, and selected readings are given. Headline and learning objective are there in the beginning of each chapter. The book is in every sense the book of the practice. The book is arranged in a manner that will allow readers to select from the menu of ideas presented.

Baye and Prince are to be congratulated on bringing out this comprehensive book, which will undoubtedly prove invaluable to students and teachers of managerial economics and business strategy as well as private and public including non-governmental organizations will also find this an essential reference. The book certainly deserves wide reading. It is useful and thus worthy of keeping as a reference by those interested readers for managerial economics and business strategy. To the writers and publisher, congratulations and thanks.

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