Keynes and Hayek

The Money Economy

G. R. Steele

Foundations of the Market Economy
Keynes and Hayek

In the recent history of economics:

Who are the most significant economists?
What are the most significant events?
Which are the biggest theoretical and policy issues?

Prime candidates are:

John Maynard Keynes and Friedrich Hayek
The New York Stock Exchange crash and the Great Depression
Capital theory and problems of the money economy

Keynes and Hayek inspired the economic controversy of the twentieth century: the role of the state, and of money and interest rates in an advanced capitalist industrial economy. In his work, Keynes points to high interest rates, low asset values and a negative wealth effect as the principal causes of a slump. By contrast, Hayek points to a system extended beyond its full capacity by low interest rates and high investment yields. Where Keynes argued that under-used capacity is symptomatic of deficient aggregate demand, Hayek viewed under-used capacity as symptomatic of inappropriate investments and of a demand for consumption goods that is too pressing to allow the completion of investments in current gestation.

This book relaunches Alex Leijonhufvud's controversial critique of Keynes's General Theory, examining it in conjunction with Hayek's work on capital theory and business cycles. The monetary issues discussed in this book remain both complex and contentious. In contrasting the broad features of Austrian economics with post-Keynesian economics, the book also discusses points raised by more recent protagonists in the debate. Against this background, arguments and events of the twentieth century are examined for economic policy guidance.

G.R. Steele is Lecturer in Economics at Lancaster University. He is the author of Monetarism and the Demise of Keynesian Economics (1989) and The Economics of Friedrich Hayek (1993)
A central theme in this series is the importance of understanding and assessing the market economy from a perspective broader than the static economics of perfect competition and Pareto optimality. Such a perspective sees markets as causal processes generated by the preferences, expectations and beliefs of economic agents. The creative acts of entrepreneurship that uncover new information about preferences, prices and technology are central to these processes with respect to their ability to promote the discovery and use of knowledge in society.

The market economy consists of a set of institutions that facilitate voluntary cooperation and exchange among individuals. These institutions include the legal and ethical framework as well as more narrowly ‘economic’ patterns of social interaction. Thus the law, legal institutions and cultural and ethical norms, as well as ordinary business practices and monetary phenomena, fall within the analytical domain of the economist.
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To Claire and Simon
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I was taught Keynes as an undergraduate, but I discovered Hayek much later and by accident. Then I realised that what I had been taught was not Keynes after all. In my rediscovery I was guided by Axel Leijonhufvud’s *On Keynesian Economics and the Economics of Keynes*, from which this book draws heavily. I acknowledge permission from the Oxford University Press to quote extensively from that source.

Although there are many textbooks that purport to represent Keynes, there is none that attempts to represent Hayek. This book is neither textbook, nor original contribution. Rather, its design is to serve those who – alert to criticisms of textbook representations of Keynes and to the revived interest in his great rival – seek a single source as an introduction to the issues. This might be it.

Some of the account and argument of this text have their origin in earlier publications, for which reason acknowledgement is courteously extended to: *The American Journal of Economics and Sociology; Economic Affairs; History of Political Economy; Journal of Social and Evolutionary Systems; and The Scottish Journal of Political Economy*.

I am appreciative of Lancaster University for considering it appropriate that academics have periodic study-leave to pursue special interests. For help in shaping the presentation of my arguments, I acknowledge the meticulous attention given by Glenys Ferguson to the whole of the first-draft manuscript. In respect of specific chapters, I am grateful for the helpful comments of John King and Nicholas Snowden. Of course, I alone am responsible for the many faults that remain.

I am unpersuaded by writers who – sensing ‘gender imbalance’ – believe that there is much to be gained, and little to be lost, in replacing masculine nouns and pronouns with feminine counterparts or in disfiguring their text with repetitious alternates or cumbersome twinnings. Here the traditional forms are adopted with no intention to demean.
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1 Introduction

John Maynard Keynes and Friedrich Hayek differed profoundly in their responses to the interwar world that they inhabited. Both observed a world gone mad. Keynes saw salvation in a thorough revision of the liberal order. Hayek saw it in the rediscovery of one. Their debate over this question continues to this day; it is perhaps the most important issue that democratic regimes, old or new, must address.

(Caldwell 1995: 48)

This book

In the recent history of economics: (1) who are the most significant economists; (2) what are the most significant events; and (3) which are the biggest theoretical and policy issues? Prime candidates are: (1) John Maynard Keynes and Friedrich Hayek; (2) the New York Stock Exchange crash and the Great Depression; and (3) capital theory and problems of the money economy. This book is about: Keynes and Hayek; investment decisions and the business cycle; and the nature of the money economy. Most obviously, no such book would claim to be comprehensive: The Collected Writings of John Maynard Keynes are contained in thirty volumes; and The Collected Works of F.A. Hayek are provisionally scheduled to cover nineteen volumes. Further, a vast literature has amassed since the mid-1960s on reinterpretations of Keynes's work and, more recently, on the evaluation of Hayek's contributions.

Among the recommendations on the dust-cover to volume I of the Collected Works, Roger Scruton describes Hayek as 'one of the great political thinkers of our time' and Sir Karl Popper refers to his 'work as a new opening of the most fundamental debates in the field of political philosophy'. For Keynes, the claim of the publishers of the Collected Writings is nothing less than '[n]o other writer in this century has done more . . . to change the ways in which economics is taught and written. No other economist has done more to change the ways in which nations conduct their economic and financial affairs'. In respect of each, this book attempts to show what lies behind such high esteem; and it looks for common ground between two minds that are seemingly opposed.
John Maynard Keynes was born in Cambridge on 5 June 1883; he died at his home in Sussex on 21 April 1946. He studied economics only briefly and as part of his preparation for the civil service entrance examination of 1905, when he attributed his low marks to knowing 'more about economics than my examiners' (Harrod 1951: 121). While working as a civil servant, Keynes drew upon his undergraduate studies in mathematics in an attempt to outline a theory of probability that might be applied to unique events in a social context. That dissertation was begun in 1905, submitted in 1907, and successfully resubmitted for his Cambridge fellowship in 1909. After further work on the dissertation was suspended in 1914, Keynes's *A Treatise on Probability* was published in 1920.

After two years as a civil servant in the India Office and two years as a university lecturer at Cambridge, Keynes was elected to a fellowship at King's College in 1910. Based upon his experience as a member of the Royal Commission on Indian Finance and Currency, he published *Indian Currency and Finance* in 1913. From the practicalities of monetary reform in India, Keynes might have drawn the lesson that spontaneous forces impinge upon even the best-laid plans. In this particular context, even though various committees and government bodies had affirmed their determination to enthrone a gold standard . . . India actually 'drifted' into a different and better system . . . the gold exchange standard . . . . The product of natural evolution proved to be superior to the product of the wisdom of government bodies. (Mini 1994: 48–9)

If Keynes was alerted to the supreme importance of evolving structures in the face of the complex forces that lie beyond the grasp of intellectuals, it did not inhibit his later insistence that the state had a prime role to play both in alleviating the particular economic malaise of the 1930s and in responding to 'the development of organised investment markets, which . . . adds greatly to the instability of the system' (Keynes [1936] 1973: 150–1).

Keynes worked in the Treasury during the Great War, at the end of which he became its leading authority on reparation payments. The detail of his many calculations provided the basis for the imposition of the extraordinary demands upon Germany. Any guilt of association that Keynes may have felt would have received some expiation with *The Economic Consequences of the Peace*, which was hurriedly written and published in 1919. Here, Keynes focuses upon the 'betrayal of the Wilson principles on the basis of which Germany had laid down her arms' (Mini 1994: 58). The irony is that this book – inspired by the injustice of the post-war settlement – provided a ready excuse for the subsequent appeasement of Nazi tyranny. When, 'in 1936, a German émigré expressed to Keynes the wish that he had never written *The Economic Consequences* . . . Keynes replied, “So do I”' (Mini 1994: 71).
From his activities in the arena of inter-war political economy, Keynes must have sensed the limited influence of a purely scientific approach: ‘the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest’ (Keynes [1936] 1973: 384). He certainly appears to have reached the conclusion that time is more usefully employed in persuasion that in research based upon sound analysis. Close scrutiny shows many of his theoretical innovations to be wanting. Indeed, there is a telling view of Keynes as ‘an opportunist and an operator’ to the extent that ‘theory was applied when it was useful . . . and dropped . . . when the immediate purpose had been served or had failed’ (Johnson 1975: 115).

More particularly,

[w]ithout an adequate theory of capital, expectations became the wild card in Keynes’s arguments. Guided by his ‘vision’ of economic reality . . . he played this card selectively – ignoring expectations when the theory fit his vision, relying heavily on expectations when he had to make it fit.

(Garrison 1997: 460–1)

Certainly, Keynes began to operate at two distinct levels as he combined his academic work in the 1920s with ‘at least a hundred articles and dozens of letters’ published in *The Nation and the Athenaeum* on matters of reparations and international and domestic affairs . . . [and] . . . to advance his social and cultural ideas’ (Mini 1994: 77).

From this period, Keynes is first associated with the problem of chronic unemployment, which is the characteristic feature of the UK economy in the 1920s and most of the western world in the 1930s. Undoubtedly, the loss of markets overseas, together with increased competition from recently industrialised nations and the influence of new technologies contributed to Britain’s early problem. However, domestic monetary policy decisions were the root of the problem. In 1918, the recommendation of the Cunliffe Committee – to restore sterling to gold convertibility at the pre-1914 rate of US$4.86 – was enthusiastically endorsed by Treasury and Bank of England officials. Not only was this move considered to be honourable, it was regarded as essential to re-establish London as the centre of international finance. However, the target of US$4.86 was formidable. It required the value of sterling to be raised by over 40 per cent!

In the early months of 1920, the bank rate was raised to 7 per cent, the note issue was restricted and public sector spending was reduced. There followed a precipitate downturn in the economy which caused unemployment to rise from 2.6 per cent in June 1920 to 22.4 per cent in July 1921. An epoch of high widespread chronic unemployment had begun, which was to become a more general feature as ‘[t]he Anglo-Saxon world, the wartime neutrals and Japan did what they could to deflate, i.e. to get their economies back to . . . sound finance and the gold standard . . .’ (Hobsbawm 1994: 99). Of course,
the full implications of this chosen course of deflation were not widely appreciated.

In March 1925, Keynes was one of five principal guests at a dinner party hosted by the Chancellor of the Exchequer, Winston Churchill. Those guests had been asked to respond to a memorandum (‘Mr Churchill’s Exercise’) that presented the case against a return to gold. By the end of that evening, Keynes found himself to be a minority of one against a general endorsement of the policy to resume gold convertibility. In the following month, the wartime embargo on UK gold exports expired and convertibility was restored with sterling at the US$4.86 rate. Keynes’s response to that decision was a vehement attack in the form of a pamphlet – ‘The Economic Consequences of Mr. Churchill’ (1925) – in which he warned of the damage that an overvalued sterling would do to the economy. It counted for little.

Even though monetary contraction had forced down domestic prices over the preceding years (while a booming US economy had caused prices to rise elsewhere), the restoration of the pre-1914 rate of exchange seriously impaired the competitiveness of UK goods. Domestic prices needed to fall still further and monetary deflation was continuous over the next seven years. In the long term, stable prices at a full employment level of output was the expectation; in the short term, the impact upon output and employment lay in uncharted waters. In the event, Churchill would look back on the decision as one of the greatest mistakes of his political career:

> [w]hen I was moved by many arguments and forces in 1925 to return to the Gold Standard I was assured by the highest experts . . . that we were anchoring ourselves to reality and stability; and I accepted their advice. . . . But what has happened? We have had no reality, no stability.

(Churchill 1933)

A policy founded upon conventional economic wisdom had failed; and that failure was conducive to the sympathetic reception (beyond the Treasury) that was afforded to Keynes’s alternative maverick rationalisation for an enhanced involvement of the state in economic affairs.

In a retrospective comment upon this episode, Hayek points to the failure to draw upon the scholarship of an earlier generation: in referring to ‘the surprising gaps’ in Keynes’s knowledge of nineteenth-century economic theory and economic history, Hayek recalls: ‘I had to tell him of the passage by Ricardo . . . which if he had known it, might well have helped him to win the battle against the return [of sterling] to gold at the old parity’ (Hayek 1978: 231). Hayek cites the source: in a letter to a friend dated 18 September 1821, David Ricardo wrote that ‘he should never advise a government to restore a currency which had been depreciated 30 per cent to par’. Recognising Keynes’s role as an ‘intellectual leader’ and his failure to move the authorities away from their chosen deflationary path, Hayek continues:
I ask myself often how different the economic history of the world might have been if in the discussion of the years preceding 1925 one English economist had remembered and pointed out this long-before published passage in one of Ricardo’s letters.

(Hayek 1978a: 199)

Of the academic work undertaken by Keynes in the 1920s, *A Tract on Monetary Reform* (1923) is his last major publication within the paradigm of classical monetary theory. Thereafter, dismayed by the formulation of British economic policy and the course of events, Keynes devoted himself to the formulation of arguments with a direct focus upon general patterns of economic activity. These presented themselves in *A Treatise on Money* (1930) and *The General Theory of Employment, Money and Interest* (1936).

The Wall Street débâcle of 1929 caused Keynes to take a jaundiced view of financial markets: the more organised they become, the more likely they are to be dominated by short-term speculation, as dealings in securities become further removed from ‘either active or prospective’ knowledge of ‘the business in question’. In effect, Keynes became a critic of the notion of efficient financial markets long before that concept gained popular currency:

[w]e are assuming, in effect, that the existing market valuation, however arrived at, is uniquely correct in relation to our existing knowledge of the facts which will influence the yield on investment, and that it will only change in proportion to changes in this knowledge; though, philosophically speaking, it cannot be uniquely correct, since our existing knowledge does not provide a sufficient basis for a calculated mathematical expectation.

(Keynes [1936] 1973: 152)

Keynes’s position led him to conclude that (at least, for the circumstances of the period) private entrepreneurship offered no route to full employment. Furthermore, where private entrepreneurs are preoccupied with short-term gains, Keynes asserts that the state is in a unique position ‘to calculate the marginal efficiency of capital-goods on long views and on the basis of general social advantage’ (Keynes [936] 1973: 164). Not only is this assertion at odds with the previous citation, it is – by the outcome of the ‘socialist calculation debate’, which was in full sway in the mid-1930s (chapter 10) – simply wrong.

The speed with which the new ideas of *The General Theory* came to influence the formulation of policy had no precedent:

[Under the stimulus of Keynes . . . *An Analysis of the Sources of War Finance and an Estimate of the National Income and Expenditure for 1938 and 1940* (1941, Cmd. 6261) . . . was published in time for the 1941 Budget. . . . [T]he accompanying budget speech was thoroughly
Keynesian . . . the use of national income and expenditure estimates in relation to the formulation of the budget was a major event in the history of the application of economics to policy formation.

(Gilbert 1982: 31)

Its ‘fit’ was perfect to requirements: ‘[m]ass unemployment had lasted so long that . . . a new theory of its causes that promised an easy cure was . . . virtually certain to sell, provided its author had impeccable professional credentials’ (Johnson 1975: 116). Yet its fulsome acceptance was not entirely due to Keynes. The impact of Keynesian economics upon the formulation of fiscal policy in the major western democracies owes much to the ISLM simultaneous equation national income and expenditure (SENIE) structure that was originated by John Hicks in 1937 (see p. 106, figs 6.2a–b). By this interpretation (one that is commonly referred to as the ‘neoclassical synthesis’1), Hicks represents The General Theory as a special case of the classical system:

Hicks had produced a ‘potted version’ of The General Theory which in 1967 he thought was ‘not a bad representation of Keynes’ and in a 1972 paper concluded that Keynes accepted it as a fair statement of the nucleus of his position. . . . Hicks summarized Keynes’s basic model in the form of three simultaneous equations in the Walrasian framework. Keynes’s short-period equilibrium level of income (and hence employment) and the rate of interest are simultaneously determined at the point on the ISLM diagram where the demand for money is equal to the supply in real terms and the rate of investment is equal to the rate of saving.

(Gilbert 1982: 178)

However, there is a growing consensus that Hicks’s formulation is at variance with the essence of Keynes’s General Theory; and that a heavy price has been paid for allowing the easy tractability of Hicks’s ISLM geometric (or algebraic SENIE formulation) to gain the ascendancy.2 How did this happen? Robert Skidelsky suggests simply that ‘Keynes, who, above all, sought to influence policy, did not resist this reconciling way of selling his ideas if it made them accessible and acceptable to the younger economists’ (Skidelsky 1997: 322). In short, people could make of his theory whatever they liked, so long as policy remained on the right lines!

As Hicks was formulating the neoclassical synthesis, Keynes was drafting a statement of the essence of his ideas for The Quarterly Journal of Economics (1937). The contrast with Hicks could hardly be greater: in Keynes’s elucidation ‘there is no consumption function, no investment multiplier, only vague and uncertain knowledge, fluctuating states of confidence, and courage, fears and hopes, coped with, as best they can be, by strategies and conventions’ (Skidelsky 1997: 323). Out of that re-presentation, an alternative to Keynesian (SENIE) macroeconomics was developed. Indeed,
Keynes's 1937 article may be viewed as 'the canonical statement' (Skidelsky 1997: 323) of 'post-Keynesian' economics. The fundamental concerns of the 'post-Keynesians' (chapter 9) derive from the perceived tendency of the money economy to function at a sub-optimal level of employment. This is a problem that recurs whenever – in viewing the future with growing uncertainty – individuals increase the proportion of money held within their assets portfolios. The highly complex ramifications of that abnormal 'liquidity preference' do not lend themselves to a geometrically or algebraically tractable solution. Shifting IS and/or LM schedules (chapter 6) offer no insights into disequilibrium processes.

With the outbreak of the Second World War, Keynes applied his macroeconomic conceptualisations to the problem of minimising inflationary pressures in a fully mobilised war economy. He was able to draw from the experience of the Great War, when price rises caused labour unrest and when inflated profits were expropriated to the state by ad hoc taxation and borrowing. His two articles on 'Paying for the War' (*The Times*, November 1939) were expanded and published in booklet form: *How to Pay for the War* (1940). It was by his influence that the authorities kept the long-term interest rate at 3 per cent (as compared to 5 per cent in the Great War). However, his recommendations for deferred wage payments were adopted in only a minor way.

In July 1940 Keynes returned to the Treasury, where he became heavily engaged in matters relating to funding the war effort and with proposals and negotiations in advance of the Bretton Woods exchange rate system (1944) and the loan agreement with the United States (1945). The prolonged negotiations and disappointing outcome in respect of the latter extracted from Keynes the ultimate personal sacrifice.

**Hayek**

Friedrich August von Hayek was born in Vienna on 8 May 1899; he died at his home in Freiburg on 23 March 1992. As a young man he pursued interests in genetics, psychology and psychiatry. After serving in the multinational Austro-Hungarian army (March 1917 to November 1918), Hayek attended classes in philosophy and also gained his university entry qualification. From his war experience, his interests turned to social science:

I served in a battle in which eleven different languages were spoken. It's bound to draw your attention to the problems of political organisation.

It was during the war service in Italy that I more or less decided to do economics. But I really got hooked when I found Menger's *Grundsätze* such a fascinating book, so satisfying. Even then, you see, I came back to study law in order to be able to do economics, but I was equally interested in economics and psychology.

(Hayek 1994: 48)
In the three years to 1921, Hayek participated in a wide range of cultural and intellectual activities at the University of Vienna. Although he gained a first-class degree in jurisprudence, he had divided his time ‘about equally between economics and psychology’ (Hayek 1992: 173) and had also taken time ‘to study half a dozen other subjects’ (Hayek 1994: 52).

Like many who were moved by the poverty of post-war Vienna, Hayek was inclined towards socialist ideals; but this was countered by the teaching of Ludwig von Mises which explains how the market is a prerequisite for economic calculation. In this respect, the publication in 1922 of Mises’s Die Gemeinwirtschaft (to be translated as Socialism) was a turning-point (see Hayek 1992: 133).

Between 1921 and 1923, Hayek worked as a civil servant (as Mises’s subordinate) in a temporary institution that had been set up to implement the provisions of the St Germain peace treaty. During this eighteen-month period, he also completed his doctoral dissertation in political science. Then, with letters of introduction from Joseph Schumpeter (that proved of no avail) and the ‘half-promise of a job’, he set off for the United States where, working as a research assistant at the Alexander Hamilton Institute in New York, he ‘gatecrashed’ courses at Columbia University and the New School of Social Research. The experience of his fourteen months in the United States – where the key words were stabilisation, economic forecasting, and the analysis of economic time series – caused Hayek to turn his attention to ‘the relations between monetary theory and the trade cycle’ (Hayek 1992: 37).

Hayek returned to Vienna in the summer of 1924, and took up his former occupation under Mises; at the same time, he was admitted to the ‘Mises seminar’, which met fortnightly and where concerns were with ‘problems of the methodology of the social sciences, but rarely with problems of economic theory (except those of the subjective theory of value)’ (Hayek 1992: 155). Hayek used his American experiences as the basis for his preparation for a ‘major work on monetary theory’ that he hoped would lead to a university position. In a draft account of American monetary policy, Hayek employed a theory which he attributed to Mises. After his attention had been drawn to the fact that this had not appeared in published form, he incorporated the basic ideas into an essay which appeared in 1925: ‘The Monetary Policy of the United States after the Recovery from the 1920 Crisis’ (see McCloughry 1984: 5–32). The idea that monetary expansion distorts the structure of capital in such a way that it does not correspond to real savings, and the implications thereof, was to be further developed and refined.

These efforts were interrupted in 1927, when Hayek was appointed as the first director of das Österreichische Konjunkturforschungsinstitut (Austrian Institute for Business-Cycle Research). This he ran virtually single-handed until additional American funding allowed the appointment of Oskar Morgenstern in 1929. Morgenstern’s arrival enabled Hayek to devote more time to monetary theory. Also in 1929, Hayek was admitted to the University of Vienna as lecturer (Privatdozent).
In the February 1929 report of the Institute, Hayek made his bold prediction of an impending business crisis in the United States. Whereas orthodox monetary theorists were misled by the experience of economic growth without inflation, Hayek warned that maladjustments were the inevitable consequence of monetary expansion and that a crisis was impending. To Hayek, price stability in a decade of sustained growth in real output is evidence of excessive monetary expansion. On the favourable side, US prices had not actually risen prior to 1927, so there was every reason to suppose that the (inevitable) recession would be mild. However, the US authorities succeeded, by means of an easy-money policy, inaugurated as soon as the symptoms of an impending reaction were noticed, in prolonging the boom for two years beyond what would otherwise have been its natural end. And when the crisis finally occurred, for almost two more years, deliberate attempts were made to prevent, by all conceivable means, the normal process of liquidation.

(Hayek 1935b: 162)

In 1931, Lionel Robbins invited Hayek to give a series of guest lectures at the London School of Economics where, later that same year, he was appointed Tooke Professor of Economic Science and Statistics. A feeling that the appointment was motivated, not only by a desire to boost the School's reputation in economic theory, but also 'to provide a counter-attraction to Keynes' (Robinson 1978: 2–3) seemed to be confirmed by Hayek's critical reviews of Keynes's *A Treatise on Money*, which aroused considerable anger in Cambridge. More particularly, Robbins would have felt the need of support in his disputes with Keynes on the Economic Advisory Council, set up by the Prime Minister.

Hayek spent the war years in Cambridge – the temporary location of the LSE – where Keynes was instrumental in his obtaining accommodation in King's College. Thereafter, Hayek became a frequent visitor to American universities. He remained at the LSE until 1950, when the scandal of his long yearned-for divorce and his wish to re-marry were the pressing reasons for his move to the University of Chicago as Professor of Social and Moral Sciences (see: Hayek 1994: 129; Gamble 1996: 17). By his disputes with Cambridge and by the publication of *The Road to Serfdom* in 1944, Hayek's reputation in economics had fallen so low that Chicago's economics faculty – dominated by econometricians and mathematical economists – refused to consider him. Hayek was viewed as an ideologist and apologist (or, at best, a philosopher) rather than an economic scientist.

From 1962 to 1967 Hayek was Professor of Economic Policy at the University of Freiburg im Breisgau, after which he retired and accepted an appointment as honorary professor at the University of Salzburg. In October 1974, he was awarded the Nobel Prize in Economics. The joint award was to
Friedrich Hayek and Gunner Myrdal ‘for their pioneering work in the theory of money and economic fluctuations and for their penetrating analysis of the interdependence of economic, social and institutional phenomenon’ (Machlup 1977: xv). (That citation is deceptive for, in their respective views on free trade and market competition, there is no empathy between the two economists.) In 1984, at the instigation of the British Prime Minister, Margaret Thatcher,5 Hayek was made Companion of Honour; and, in 1991, he was awarded the US Presidential Medal of Freedom.

The 1930s

With the banking failures that followed in the wake of the Wall Street stock market crash of 1929, the associated US monetary contraction exacerbated the severity of the Great Depression. In the three years to 1932, US industrial output fell by one-half; and, as British export and invisible earnings fell, the UK was left vulnerable by long-term commitments to investments overseas. As gold reserves fell, UK unemployment rose from 10 per cent in 1929 to 21 per cent in 1931.

These events raised theoretical and policy issues that demanded some immediate response. In January 1930, the UK Prime Minister Ramsay MacDonald appointed an Economic Advisory Council, to advise on the state of the economy and to recommend appropriate action. As a member of that body, Keynes brought together a small ad hoc sub-committee of economists, among whom Lionel Robbins opposed Keynes’s proposal to recommend the imposition of import tariffs. Robbins submitted a minority report in support of free trade.

The Macmillan Committee on Finance and Industry had itself met between November 1929 and May 1931. Here, too, Keynes was involved, both as a member and in submitting evidence. Within that short period of little more than two years, Keynes’s opposition, support and opposition to tariff protection gained him the infamous reputation: ‘[w]here five economists are gathered together there will be six conflicting opinions, and two of them will be held by Keynes’ (Jones 1954; cited from Caldwell 1995: 9n.). More generally, this was a bad time for economics: ‘[w]hen the most famous and articulate British economist supports first one policy, then another, the making of economic policy very quickly becomes subservient to political concerns, and principle yields to expediency’ (Caldwell 1995: 9).

Keynes’s particular involvement with the Macmillan Committee turned on the issue that Britain’s foreign earnings were no longer sufficient to cover her foreign lending. With interest rates raised to depress the domestic demand for imports and to boost the capital account, Keynes was open regarding his own position: ‘[t]he consequences of the extreme freedom for foreign lending . . . has troubled me since I first studied economics’ (Keynes [1929] 1981: 9). When pressed on the benefits from further regulation and
asked ‘whether he believed that in a closed system there was ‘no need why anyone should be unemployed’, Keynes’s answer had been an unequivocal, “Yes”’ (Mini 1994: 111).

Although he was ‘brought up, like most Englishmen, to respect free trade’ (Keynes [1933] 1982c: 233), Keynes considered that the situation had been changed by ‘[t]he divorce between ownership and the real responsibility of management’. Measures were now required to counter the effects of ‘that remoteness between ownership and operation [that] is an evil in the relations between men’ (Keynes [1933] 1982c: 236). Small open economies are too vulnerable to events elsewhere. Tariffs gain the necessary independence for domestic monetary policy. With UK investment below the level of saving, with profits and prices falling and with no abatement of unemployment, Keynes believed that the crux of the matter lay in the level set for the long-term interest rate. There is little doubt that the development of Keynes’s macroeconomic theory was shaped with an intention to bolster that conclusion. This gave rise to a series of contentious issues.

The early 1930s witnessed academic disputation the like of which had not been seen before, nor has been equalled since. The bickering is hard to exaggerate and – without invoking an ideological agenda – would be equally hard to understand. Keynes had asked Cambridge’s Piero Sraffa to review Hayek’s *Prices and Production* for the *Economic Journal*. At virtually the same time, Lionel Robbins had asked Hayek to review the two volumes of Keynes’s *Treatise on Money* for *Economica*. Hayek’s two-part review article appeared in August 1931 and February 1932, and was highly critical of Keynes for the concentration upon purely monetary effects to the neglect of the impact of monetary policy upon the structure of production processes:

Keynes’ reply to the first half of Hayek’s review appeared, together with Hayek’s rejoinder, in the November 1931 issue of *Economica*. This exchange led to a heated correspondence between Keynes and Hayek from December 1931 to February 1932, of which eleven letters survive, including a letter from Hayek to Keynes on Christmas day with a reply the same day.

(Dimand 1988: 57)

However, the full salvo of the Cambridge response came with the publication of Sraffa’s offensively hostile review of *Prices and Production* in March 1932. Hayek’s reply was published in June, alongside Sraffa’s rejoinder. Thereafter, others joined in, including Ralph Hawtrey, A.C. Pigou and Dennis Robertson. Between 1932 and 1936 Hayek wrote a further ten articles on the subject.

A sense of the passionate commitment can be given: Keynes to A.C. Pigou, ‘[t]he misunderstanding has been due . . . to your supposing that I held . . .’; to Dennis Robertson, ‘[w]hat bothers me is not so much that I should have failed to convince you that it is false, as that I should have failed
to convince you that I deny it!'; on Ralph Hawtrey, 'like arguing with a madman'; and to Hayek, 'I am left . . . in doubt as to just what you mean by . . . ' (cited from Mini 1994: 168–9). Hayek of Keynes: 'almost all his fundamental concepts are ambiguous, and . . . some are even defined in flatly contradictory ways' (Hayek 1931b: 399); 'he neglects theory, not because he thinks it is wrong, but simply because he has never bothered to make himself acquainted with it' (ibid.: 401). On Hayek: from his erstwhile collaborator Nicholas Kaldor, '[t]o argue this way, involves the same fallacy as . . .' (Kaldor 1942: 169–70); and from Keynes, '[i]t is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam' (Keynes [1931] 1973a: 252).

Such comments are typical of situations that are devoid of empathy; that is, where there are 'different (unstated) philosophical presuppositions about the nature of reality implicit in the minds of the disputants' (Mini 1994: 167). There is an incompatibility of vision. That so many issues between Keynes and Hayek were unresolved contemporaneously does not imply that none of them is resolvable. In that prospect of synthesis rests much of the fascination of Keynes and Hayek. It is beyond dispute that 'whatever we may think of the answers, Hayek at least asked good questions' (Laidler 1994: 22); and that although '[t]he effect of the Keynesian revolution was to kill capital theory . . . [t]he challenge of integrating money and heterogeneous capital . . . still remains' (Desai 1991: 54–5).

**Neoclassical and New Classical economics**

The particular instigation of this book rests upon conversational remarks made by Axel Leijonhufvud at a Hayek centenary conference in 1999. These were to the effect that an association between himself and Hayek had developed after the publication of *On Keynesian Economics and the Economics of Keynes* in 1968; and that this could be ascribed to comments made towards the conclusion of that book. Among those comments are: that 'the Keynesian revolution got off on the wrong track and continued on it' (Leijonhufvud 1968: 388); and that '[i]f one must retrace some steps of past developments in order to get on the right track . . . my own preference is to go back to Hayek' (ibid.: 401). Although this and other issues raised by Leijonhufvud remain contentious, it warrants reporting that – whatever view is taken of Keynes – few would challenge the notion that Leijonhufvud's text is a 'monumentally scholarly work of exegesis and interpretation' (Johnson 1972: 29). That text serves here as a conceptual bridge between Keynes and Hayek.

Axel Leijonhufvud cites three essays by Hayek – 'Economics and Knowledge' (1937), 'The Use of Knowledge in Society' (1945) and the 'The Meaning of Competition' (1946) – as 'masterpieces' that deal with fundamental problems. To complete the set, there must be added 'Competition as a Discovery Procedure' (1968). Leijonhufvud's citations are
prescient. By the reputation that has become securely founded upon those publications, Hayek is widely acknowledged to have pointed to a serious analytical omission. This is the failure of economics generally, and of neoclassical economics especially, to deal with the ‘knowledge problem’.

Under the late nineteenth-century neoclassical archetype of atomistic competition and perfect information, every market trader is a price-taker. In a wider perspective, competitive prices serve to gauge allocative efficiency. Here, neoclassical theory dwells upon the characteristics of markets that already have been cleared, but to the neglect of any consideration of the process whereby that clearance is achieved. Yet, if all traders were price-takers, the absence of a market-clearing process would leave price-setting in chaos. So how is market-clearing achieved?

The mid-twentieth-century emergence of New Classical economics was, in part, a consequence of the need to consider the nature of the adjustment from disequilibrium to equilibrium. The New Classical School approaches that problem by attempting to ground macroeconomic relationships in microeconomic theory. However, by its use of the device of a representative agent, New Classical economics delivers no advance, for the reason that ‘[w]hat the representative agent represents is the aggregate’ (Garrison 1997: 467). Even so, some of the characteristics of New Classical economics appear close to those of Austrian economics. Indeed, it shares the first of two important assumptions with the Austrian School. This is the assumption that movements in prices (including wages and interest rates) are a vital instrument for the coordination of economic activity. Unfortunately, its second assumption undermines the relevance of the first. The second assumption is that entrepreneurs are uniformly endowed with information, but are unable to distinguish real movements in prices (that is, those that are driven by movements in relative scarcities) from nominal changes in prices (that is, those that are purely monetary in origin). Upon the basis of this second assumption, monetary manipulations cause temporary changes to real magnitudes. This is the driving force of the New Classical ‘monetary misconception theory of the business cycle’ (Garrison 1997: 469).

The second assumption precludes the realistic contention that every economic agent is uniquely endowed with some special knowledge. In recognising the existence of those unique endowments, it follows that there can be no representative agent. In this circumstance, the problem – the ‘knowledge problem’ – is to find the most effective way of utilising a wide body of unorganised and uniquely specialised knowledge of particular circumstances and of special processes that apply at different times and in diverse locations. Here, ‘practically every individual has some advantage over all others because he possesses unique information of which beneficial use might be made’; and the ‘various ways in which the knowledge on which people base their plans is communicated to them is the crucial problem for any theory explaining the economic process’ (Hayek 1945: 78–9).
The knowledge problem

Austrian economics points to the market as the mechanism that delivers – from hoards of diverse participants – the most effective solution to the knowledge problem; but the New Classical device of the representative agent allows an equally effective solution to emerge (pace the socialist calculation debate) from a representative central planning authority. Quite simply, New Classical economics leaves no economic problem for the market to solve. In practice, however, ‘the empirical observation that prices tend to correspond to costs of production’ (Hayek 1941: 27, n. 2) must be explained as the outcome of some aspect of a coordinating process: ‘[p]rices are not only conveyors of information in the standard sense – imperfect conveyors, in fact, given that they are disequilibrium prices – they also contain the incentives to the correction of their imperfection’ (Thomsen 1992: 58). Here, cybernetics – the study of communication and control – has an application to markets. There is communication (prices give information) and there is control (prices give incentives); but, how do market prices simultaneously convey information (equilibrium prices reflecting relative scarcities) and give incentives (disequilibrium prices signalling opportunities for entrepreneurial initiative)? An analogy with scientific discovery gives the clue to that twin achievement. An entrepreneur is no more an equilibrium price-taker than a scientist is a theory-taker: ‘[i]n both cases a background of unquestioned prices or theories is relied upon subsidiarily by the entrepreneur or scientist, but the focus of the activity is on disagreeing with certain market prices or scientific theories’ (Lavoie 1985b: 83–4). This rationale has the same form as Otto Neurath’s powerful image of ‘sailors who on the open sea must reconstruct their ship but are never able to start afresh from the bottom’ (Neurath [1921]; cited from Blackburn 1994: 259). There must be some structure upon which reconstruction can take place.

Although each entrepreneur operates within the bounds of his unique understanding of a particular ‘locality’, price signals encourage apparently independent entrepreneurial activities to become harmonised. Although there is no single person who oversees the whole field, ‘limited individual fields of vision sufficiently overlap so that through many intermediaries the relevant information is communicated to all’ (Hayek 1945: 86). This formulation is in the same spirit as the eighteenth-century teaching of Adam Smith (the origin of classical economics); that is, the ‘market economy works without the market participants themselves having to understand just how it works’ (Garrison 1997: 476). As Leijonhufvud contends, the possibility of a synthesis of the most worthwhile elements of classical economics and Keynes’s macroeconomics was lost with the failure of modern analysis to incorporate the two vital functions of the price mechanism: to indicate allocative efficiency and to coordinate entrepreneurial activity.

In The General Theory, Keynes traces the implications for a market system that has already gone wrong: resources are under-used because activities have
become uncoordinated. Adjustments of price relativities are necessary, but those adjustments are compromised by the greater rapidity of quantity adjustments. Although this scenario is reflected in some small degree in the Keynesian multiplier, the multiplier mechanism is a gross simplification of a very complex dynamic problem; and it misleads by dealing only with real magnitudes of production and employment to the exclusion of market evaluations in the form of price relativities.

Yet Keynes's analysis does not entirely neglect the role of price relativities. There is, of course, the relative price of labour to that of wage goods, that is crucial to Keynes's novel concept of 'involuntary unemployment'. However, Leijonhufvud points to the particular significance of capital values (that is current 'wealth' in relation to the current value of consumption goods). This has relevance both for consumers' behaviour – 'unforeseen changes in the money-value of... wealth... should be classified amongst the major factors capable of causing short-period changes in the propensity to consume' (Keynes [1936] 1973: 93) – and for capital investment decisions: 'it is not sensible to pay 25 for an investment of which you believe the prospective yield to justify a value of 30, if you also believe that the market will value it at 20 three months hence' (Keynes [1936] 1973: 155). Thus, the pre-eminence that Keynes affords to capital assets and to the expenditures that create them; and, because capital investment expenditures represent hazardous long-term commitments, '[t]he social object of skilled investment should be to defeat the dark forces of time and ignorance' (Keynes [1936] 1973: 155). According to Keynes, this is more likely to be accomplished by the state than by private entrepreneurial initiatives.

This emphasis that Keynes gives to fundamental uncertainties is underlined by his Quarterly Journal of Economics article of 1937:

we have, as a rule, only the vaguest idea of any but the most direct consequences of our acts.... But sometimes we are intensely concerned with them.... Now of all the human activities which are affected by this remoter preoccupation, it happens that one of the most important is... wealth. The whole object of the accumulation of wealth is to produce results, or potential results, at a comparatively distant, and sometimes indefinitely distant, date.

(Keynes [1937a] 1973b: 113)

By his exegesis of The General Theory, Leijonhufvud shows the particular relevance of variations in the value of long-duration capital assets; but it is his further contention that is of special significance for this book. This is that the Keynesian revolution took a wrong track when the factors emphasised by Keynes were interpreted to be a special case of classical theory. That turning is bizarre: 'models which do not assume perfect information are "special cases" of the perfect information model!' (Leijonhufvud 1968: 394). Stated thus, the absurdity is obvious.
The relevance of Hayek – to putting the Keynesian revolution back on ‘the right track’ – takes the debate to the heart of the theory of a money economy and to the further relevance of price relativities to the kinds of investments that are undertaken:

a distortion of relative prices and a misdirection of production could only be avoided if, firstly, the total money stream remained constant, and secondly, all prices were completely flexible, and, thirdly, all long term contracts were based on a correct anticipation of future price movements.

(Hayek 1935b: 131)

Given the second and third requirements and the unlikely prospect of this ideal being ‘realized by any kind of monetary policy’, Hayek looks to an alternative regulatory function. Instead of central policy options, he analyses and propagates the importance of the market as an impartial and effective instrument for the coordination of prices and patterns of investment (chapter 8), production, consumption and even the types of money in circulation (chapter 10).

From Leijonhufvud’s viewpoint, Keynes’s departure from classical economics is ‘based principally on the importance he assigned to variations in the relative price of . . . two aggregates’ (Leijonhufvud 1968: 40); that of consumption goods and capital goods. Leijonhufvud’s examination of the relevance of that variation is detailed at length in chapters 6 and 7. However, as previously suggested, it is possible to extend Leijonhufvud’s insight. The same relativity is a crucial feature of Hayek’s business cycle analysis, which is the subject of chapter 8.

It is in the nature of a market economy that price relativities are always affected by monetary expansion. Even if, for example, Milton Friedman’s helicopter miracle were performed, so that the effects of monetary expansion were uniformly distributed throughout the economy, the balance of liquidity within financial assets portfolios would still be affected. Only if all financial assets were incorporated into that helicopter fable might there be ‘neutral money’ (or rather ‘neutral financial assets’) in the sense that ‘events . . . could take place . . . as if they were influenced only by the “real” factors which are taken into account in equilibrium economics’ (Hayek 1935b: 130). Something akin to a portfolio analysis of neutral financial assets would then be required; and that might have emerged but for the abrupt termination of Hayek’s work on The Pure Theory of Capital (see Hayek 1983: 48; Nentjes 1988: 146). Hayek’s intention had been to write a second volume, dealing with the financial counterpart to his analysis of roundabout methods of production. Perhaps this was a vision unfulfilled. Hayek has intimated as much: ‘I rather hoped that what I’d done in capital theory would be continued by others. This was a new opening which was fascinating. . . . No one has done what I hoped would be done by others’ (Hayek 1994: 97).
For Leijonhufvud, the relevance of Keynes’s *General Theory* turns upon the financial arrangements that accompany long-term commitments to capital investments within a money economy; but, although Leijonhufvud finds that Keynes’s ‘basic theoretical conception’ has an affinity with Hayek’s aspiration, he doubts that Keynes’s ‘analytical apparatus can ever be the vehicle for its development and the realization of its promise’ (Leijonhufvud 1968: 399). Rather, the ‘unclear mix of statics and dynamics’ ought to be discarded in favour of ‘Hayek’s Gestalt-conception of what happens during business cycles’ (Leijonhufvud 1968: 400–1).

Nevertheless, Keynes’s *General Theory* is instructive for the heavy emphasis that it places upon individuals’ expectations; and there is a view that, ‘in countering Keynes’s “expectations without capital theory, Hayek produced a capital theory without expectations”’ (Garrison 1997: 461). So, even though a capital-based macroeconomics may be long overdue, and even though some synthesis of Keynes and Hayek might represent a move towards that end, the full task is truly an awesome one. Perhaps this book might be regarded – in all modesty – as a prospectus for that objective.

In chapters 2 and 3, Keynes and Hayek are discussed in the context of man’s (or some men’s) vision and attention is drawn to similarities and differences in their respective philosophical disposition. While each recognises the distinction between rational action (in the strict logical sense) and reasonable behaviour (in the sense of the best practical means to secure a coherent socio-economic order), Hayek adopts an explicitly evolutionary approach to social cohesion and to the relationship between market processes and the free society. While the creativity that derives from spontaneity demands freedom for the individual, the universal tendency to err demands caution and respect for cultural taboos. Although Keynes also endeavours to use ethical principles to forge a link between a dynamic economy and the ideal of a liberal and just civilisation, his political programme – in sharp contrast with Hayek’s – remains essentially elitist and dirigiste.

Chapter 4 deals with money issues that are relevant to the workings of an advanced capitalist industrial economy. Although many of the economic ‘bads’ that are associated with business cycles and international payments disequilibria originate in monetary disturbances, by its long-term perspective, classical economics avoids all the issues that arise from non-neutral money. Although, in attempting to deal with those issues, Keynes and Hayek are both influenced by Knut Wicksell, their respective analysis diverges. In Hayek’s approach, any difference between the market rate of interest and Wicksell’s natural rate has important consequences for the choice of production methods and provides the starting point for his business cycle theory. In Keynes’s approach, the usefulness of the natural rate is rejected outright as attention is directed to speculation in financial markets that sets the market rate above a hypothetical neutral or optimal rate that is consistent with full employment.
In chapter 5, Keynes’s inauguration of macroeconomics and the characteristics of a money economy in disequilibrium are critically examined. Chapters 6 and 7 review Keynes’s *General Theory* and the interpretation that is implicit in the way it is conventionally taught. These chapters deal at length with Leijonhufvud’s exegesis of *The General Theory* and the significance of the relativity between the price of consumption goods and the price of capital goods for aggregate demand. Chapter 8 shows that same price relativity to be a crucial feature of Hayek’s business cycle analysis. Thus, chapters 6, 7 and 8 examine alternative explanations for an economic slump: Keynes points to high interest rates, low asset values and a negative wealth effect, where a surfeit of consumption goods is symptomatic; Hayek points to a system that has been extended beyond its full capacity by low interest rates and high investment yields, where a deficiency of consumption goods is symptomatic. By Keynes’s analysis, underused capacity in a recession is symptomatic of deficient aggregate demand. By Hayek’s analysis, underused capacity in a recession is symptomatic of previous malinvestments and of a demand for consumption goods that is too urgent to allow the completion of investments in gestation. These are complex issues that remain contentious. In contrasting the broad features of Austrian economics with modern post-Keynesian economics, chapter 9 discusses issues raised by more recent protagonists, who purport to draw from the work of Hayek and Keynes. Against that background, the final chapter examines arguments and events of the twentieth century for the economic guidance that might be drawn.


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