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Hayek and Keynes: What Have We Learned?

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Abstract
In 1932, there was an exchange of letters to the *Times* between a group of Cambridge and Oxford economists, including J. M. Keynes. A group of University of London economists, including F. A. Hayek, responded. It was a public manifestation of the Hayek/Keynes controversies that would roil the economics profession. The Hayek/Keynes debate both repeated 19th century controversies and anticipated differences of theory and policy that spilled into the 21st century. These included the role of saving, public spending, private investment, and budget deficits. The financial crisis and the emergence of large structural deficits make the debate relevant once again.

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> "The great debate is still Keynes versus Hayek. All else is footnote."
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> –Mario J. Rizzo, New York University

I. Introduction

By 1932, the world was engulfed in depression, and the economics profession was enlivened by the debate between John Maynard Keynes and Friedrich A. Hayek on the causes and cures for that depression. The debate is conventionally dated to have begun with Hayek's two-part review of Keynes' *Treatise on Money* (Caldwell, 2004, p.177). The debate was aimed at the profession and carried chiefly out in professional journals such as *Economica* and *Economic*

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Journal. As Caldwell (2004, p.176) observes, "their exchange was one episode in the much larger story of the making of the Keynesian revolution [including] the battle between Cambridge and the LSE…" The aforementioned journals were the house publications of the two schools.

The debate was held outside the view of the general public. But in 1932, it broke out with letters to *The Times* (of London) in a manner making the essential arguments accessible, if not to the general public, at least to the readers of *The Times.*[1] The policy recommendations are presented clearly by both sides. The letters are lengthy (almost mini op eds by today's standard), but the analysis is sketchy and limited by space considerations. There is little room for hedging, and conclusions are presented starkly. The reader gets the gestalt of the two sides, shorn of the complexities of their respective models. Brevity has benefits.

It is chiefly a battle of London versus Cambridge. The opening salvo was a letter dated October 17, 1932, and signed by six economists: D.H. MacGregor of Oxford and five Cambridge men: A.C. Pigou, Keynes, Walter Layton, Arthur Salter, and J.C. Stamp. The University of London response was printed two days later and signed by T.E. Gregory, F.A. von Hayek, Arnold Plant, and Lionel Robbins. The positions staked out, however, came to be most associated with Keynes and Hayek (the third and second signatories, respectively, on their sides). For shorthand, I will refer to "Keynes" and "Hayek." I do so both for ease of exposition (form), and because I believe the views in the two letters by and large represent the mature positions of Keynes and Hayek (substance). I take note where that may not be true.

II. Keynes Letter

Keynes opens with the observation that in time of war it is "a patriotic duty" of private citizens to curtail consumption to release resources to the government "for a vital national purpose." In other words, citizens must save more. The conditions of 1932 require quite the opposite. There is a "lack of confidence," and there is no

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[1] The letters are reproduced on pages 39–42 in this issue. They were retyped by Rachel Copley of Liberty Fund, Inc., from a microfiche copy in the possession of Professor Richard Ebeling of Northwood University.

guarantee that savings will be transformed into either public or private investment.

The private economy intensifies the effect of a lack of confidence, and discourages all forms of investment leading to consumption output. As a consequence, private economy cuts down national income by almost the amount of additional savings.

In a depression, the public interest requires that the public consume, not save. And citizens acting collectively should spend collectively even on projects such as a "swimming-bath, or a library, or a museum."

In this letter, we see a number of key propositions that came to be associated with Keynes. First, investment is depressed by a lack of confidence. In *The General Theory*, Keynes (1965, p.149) would write: "There are not two separate factors affecting the rate of investment, namely, the schedule of the marginal efficiency of capital and the state of confidence. The state of confidence is relevant because it is one of the major factors determining the former, which is the same thing as the investment-demand schedule."

Next there is the paradox of thrift (Keynes, 1965, pp.175–85) and the multiplier (Keynes, 1965, pp.126–28). And finally there is the view that spending of any kind may be preferred to thrift. "Pyramid-building, earthquakes, even wars may serve to increase wealth, if the education of our statesmen on the principles of the classical economics stands in the way of anything else" (Keynes, 1965, p.129).

III. Hayek Letter

Hayek identified three issues to be addressed: (1) the effects of hoarding, (2) whether it is more advisable to "spend" (consume) or invest, and (3) whether government investment "is on all fours" with private investment.

On the first issue, hoarding, Hayek concludes there is no important difference. But the language is nuanced, a point to which I return.

Hayek differs with Keynes on whether it is "a matter of indifference…whether money is spent on consumption or on real investment." Indeed, he expresses a strong preference for "a revival of investment."

Hayek also strongly disagrees with a point made in the first letter that equates a purchase of securities with money resting in idle bank balances. "A rise in the value of old securities is an indispensable preliminary to the flotation of new issues." He contends it would be "perilous in the extreme" to weaken private saving.

Hayek has his "most acute" difference with Keynes on the third issue: the equivalence of government and private investment. He criticizes "imprudent borrowing and spending on the part of the public authorities." And he contends that a large public debt imposes "frictions and obstacles to readjustment very much greater" than for private debt. He objects to the size, composition, and financing of government expenditures.

On the first issue, Hayek employs a rhetorical flourish to make two substantive points. First, he by implication accuses Keynes of equivocating on hoarding and saving. Second, he agrees that hoarding is deflationary and "no one thinks that deflation is in itself desirable."

I can only agree with Leijonhufvud (1968, p.176) that "the connection between Keynes' theory of saving (and consumption) and his Theory of Liquidity Preference is a complicated affair…." Keynes had not yet articulated his Theory of Liquidity Preference, and the issues could only be thrashed out later.

More interesting is the precise wording of Hayek's statement on deflation. It does not say that deflation is undesirable, only that it is not "in itself desirable." On the wording, this is an instance in which we should take account of the fact there were four signatories to the letter. The somewhat odd wording could reflect the more formal mode of writing in the 1930s or the possibility of disagreement among the signatories. It is in any case a nuanced wording.

Hayek (1966b, pp.123–24) advocates a policy of neutral money, which entails stabilizing MV. It is a policy of offsetting deflationary forces stemming from monetary shocks. But it is not activist anti-deflationary policy to offset secular declines in prices (Hayek, 1966b, pp.129–30).

The gravamen of Hayek's *Prices and Production* is that the natural course of prices is downward because of productivity gains. A policy to offset that decline would actually be inflationary, as analyzed by Hayek.[2] The first edition of the book was published in 1931, so Hayek the person obviously did not want to sign a letter with a blanket condemnation of deflation. The wording of the letter and the argument of the book can be reconciled as follows.

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[2] Hayek defines inflation in terms of its cause (monetary expansion) rather than its effects (a rise in the general price level).

There exist benign and malign deflation. Benign deflation occurs as the natural progress of innovation and invention. It is a natural phenomenon of free markets. Malign deflation results from monetary shocks either from the supply side or demand side. So Hayek could agree in the letter that hoarding is deflationary, and by implication not desirable ("no important difference" with Keynes on point), but he could not agree that deflation was always undesirable.[3]

Hayek the man cautioned against an activist countercyclical policy to combat cyclical declines. He proffered two arguments against countercyclical policy. In Hayek (1966a, p.21), he wrote that: "To combat the depression by a forced credit expansion is to attempt to cure the evil by the very means which brought it about…." The argument parallels one being made today: monetary policy is creating new asset bubbles in an attempt to offset the effects of the bursting of the housing bubble (O'Driscoll, 2011).

Hayek (1966a, p.23) also presented a knowledge problem inherent in activist countercyclical monetary policy: "the one thing of which we must be painfully aware at the present time…is how little we really know of the forces which we are trying to influence by deliberate management; so little indeed that it must remain an open question whether we would try if we knew more." Hayek (1991, p.76) made the same argument more than a half-century later in a broader context: "The curious task of economics is to demonstrate to men how little they really know about what they imagine they can design."

Hayek's argument anticipated one made famous by Milton Friedman (1961) against countercyclical monetary policy. Friedman's analysis of the long and variable lags in monetary policy led him to adopt a monetary rule of predetermined growth rate in the money supply. Hayek and Friedman never agreed on the particular rule, but they did agree that radical uncertainty argued for rule-governed policy.

The second point of disagreement is more complex. Hayek interprets Keynes as advocating spending of any kind. He evidently did not view the examples of public spending—"a swimming-bath, or a library, or a museum"—as investment. Hayek used spending to mean consumption and contrasted spending with investment. Hayek treats public investment as more equivalent to consumption. In any case, it is "imprudent" in large amounts.

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[3] For a history of these ideas, see Selgin (1995).

Hayek followed the classical economists in focusing on private investment as the source of economic growth. Savings funded investment. No distinction was made as to whether an economy was at full employment or less than full employment.

Meltzer (1988) argues that Keynes actually advocated private investment over government spending as a source of jobs. He repeats that point in a recent interview (Meltzer, 2010), where he contends that "Keynes didn't favor at any time that I know spending to increase consumption." Modern Keynesians might be surprised to know that. In any case, Keynes' letter clouds the issue.

Hayek's argument that purchases of existing securities are beneficial is surely correct. New money flowing into the bond market drives up the price of existing bonds and lowers their interest rates. New issuers will then be able to borrow at lower interest rates. Projects that heretofore had been uneconomic will become economic.

In his argument on confidence, Keynes focused on the height of the investment-demand schedule. (Recall the argument about confidence in the letter, restated in the *General Theory*.) Hayek focused on the possibility of moving down an investment demand schedule. It is noteworthy that Keynes never mentions either interest rates or relative prices. These are the two mechanisms for clearing markets. It is not that he invoked sticky interest rates or prices. These are simply absent from Keynes' analysis.

The third and final issue has even more resonance today than it did in 1932. Hayek was concerned about structural fiscal deficits, and those are the focus of today's debates. In 1932, the idea of activist countercyclical deficits was a relatively new idea.[4] Keynes was advocating the latter, not the former. Perhaps they were arguing at cross purposes in 1932, but Hayek is clearly relevant today. The fiscal problems of the developed world have a large structural component. We have learned, however, the degree to which heavy private sector indebtedness can impose "frictions and obstacles to readjustment."

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[4] But it was not entirely new, nor did it originate with Keynes. Davis (1971, p.144) notes "there was a remarkable consensus among American economists" favoring public spending and deficit financing for recovery (and other objectives). These included especially members of the Old Chicago School. Rothbard (2000, p.251) provides a list of 87 economists and others signing a petition favoring a 1930 public works bill. The signatories include many notables of the economics profession, including John Bates Clark, John Maurice Clark, and Irving Fisher.

Others sent letters to the *Times*, responding to a leading article (editorial) and each other. Keynes responded to one of these. But the two letters reproduced here were the exchange between Keynes (and colleagues) and Hayek (and colleagues). Levy and Peart (2011) also deal with the exchange and wider controversies surrounding it. Anyone interested in the intellectual milieu of the time should consult their paper.

IV. Assessing Keynes and Hayek

Like two fighters sparring in a ring, Keynes and Hayek in their letters connected but did not do lasting damage to each other. This was preparation for multiple rounds of intellectual battle. But the sparring presaged the serious debates of the 1930s and down to today. It is surprising how topical the issues debated in 1932 are today. Perhaps there is nothing new under the sun.

In truth, the Hayek/Keynes debate was, at least in part, a continuation of 19th century controversies. These are often subsumed under the Say's Law controversy, but the main point of contention can be dated to Adam Smith in the *Wealth of Nations,* when he wrote that, "What is annually saved is as regularly consumed as what is annually spent, and nearly in the same time too" (quoted in Sowell, 1974, p.38). One notes in this sentence many of the terminological and substantive points of controversy in the Hayek/Keynes exchange.

The 19th century controversies were complicated by the lack of agreement on basic concepts such as demand. "For the Ricardians, 'demand' was simply the quantity demanded. For Sismondi and Malthus, 'demand' meant the quantity demanded at cost-covering prices…" (Sowell, 1974, p.44). The important distinction between ex ante and ex post had not been worked out. And, finally, Ricardo and his followers characteristically transformed statements by others about short-run dynamics into long-run comparative statics.

All of these issues were at play in the Hayek/Keynes exchange, even, as already noted, to talking at cross purposes about demand. The Hayek response on the importance of the price of existing securities would be later countered by pessimism over the elasticity of investment demand.

The chief monetary questions at issue at the time of the Hayek/Keynes exchange had largely been addressed by Henry Thornton in 1802 in his treatise on *Paper Credit* (Meltzer, 2003, pp.26–31). One important issue, not cited in the letter exchange but later to gain importance in the larger debate, was the effects of inflation on interest rates. In his introduction to Thornton's works, Hayek (1978, p.56) observed that Thornton's analysis in *Paper Credit* "in all important points anticipated Professor Irving Fisher's well-known distinction between the real and nominal rate of interest." As late as 1848, in his *Principles of Political Economy*, John Stuart Mill recognized Thornton's *Paper Credit* as the clearest statement of theory of credit (Hayek, 1978, pp.57–58). Yet Thornton's contributions were all but lost to economics after that, only to be rediscovered in the 20th century.

As a consequence, the Hayek/Keynes debate commenced at square one. It was so unsatisfactory because it was so unnecessary. It went over so much old ground before it ever arrived at a new one.

One sentence in Keynes is the seed of almost the entire subsequent debate, certainly of most of Hayek's work in monetary economics. Referring to private economy (savings), Keynes wrote that "it further discourages all those forms of investment—factories, machinery, and so on—whose ultimate purpose is to make consumption goods."

That statement ignores the fact that production is multi-period in nature, and consumer output is produced not just for today but many future tomorrows. A decrease in demand for current consumption (an increase in saving) is transmitted through interest-rate movements into an increased demand for consumption in the more distant future. Keynes need not have read Hayek to understand that; he would merely have needed to read Fisher. Fisher did not analyze multi-period intertemporal equilibrium as Hayek was later to do. But the basic idea is in Fisher.

If one reads contemporary debates on spending, savings, and investment and monetary policy, there is little evidence that the monetary debates of the 19th and 20th centuries ever took place. The Hayek/Keynes debates were largely forgotten until recently, despite their relevance to contemporary issues. An example is the information problem in monetary policy advanced by Hayek and later developed in more detail by Friedman. If one focuses on technique, economics has never been so modern. If one looks at substantive knowledge in monetary theory, on some issues we are no more advanced than in the 19th century.

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