Cambridge Talk on Hayek

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Tonight I will talk briefly about the Keynes-Hayek relationship, then will focus on some of Hayek's insights that may be of relevance today. In the process I hope to clear up some misconceptions about Hayek, who is a frequent subject of caricature by friend and foe alike.

Keynes and Hayek are typically portrayed as intellectual rivals, and the differences between them juxtaposed in rather simplistic terms. Now though there are certainly elements of truth in such broad-brushed accounts, the actual history of their relationship is much more complicated and nuanced, and as an historian I am obliged to add, much more interesting.

The first surprise about the relationship is that when Hayek was a college student in Vienna after World War I Keynes was one of his heroes. This was because of Keynes' fiery condemnation of the "Carthaginian" terms of the Versailles Treaty in his *Economic Consequences of the Peace;* his phrase "the murder of Vienna" would have had a special resonance for Hayek during the long, cold and hungry winters that followed the war.

About a decade later, though, Hayek and Keynes crossed swords. It's a great story. In 1931 Hayek was invited to the London School of Economics to give four lectures on monetary theory. The lectures were published that year as a book with the title *Prices and Production.* People who attended later told him that he was nearly incomprehensible when he was reading the lectures, but whenever he answered questions he was quite clear. We are talking about academics here, and of course nothing impresses an academic audience like someone being mostly incomprehensible but occasionally clear, so the end result was that they offered him a job.

In the summer of that year, even before he began teaching, Hayek published a review of Keynes' new book, *A Treatise on Money,* a book that Keynes had been working on for years and which was supposed to establish his credentials as a major monetary theorist. This initiated a fierce debate over their respective theories of the cycle.

I say fierce because it really was unprecedented: one of Keynes' fellow Cambridge economists chastised him in print afterwards, likening his assault on Hayek to "body-line bowling" - this being a reference to the game of cricket, when the bowler aims for the batsman's body rather than for the wicket, a striking metaphor, I must say.

The grounds for the debate were really quite simple – both men had in their respective theories drawn upon a framework that had been developed by a Swedish economist named Knut Wicksell. Wicksell wrote in German. Hayek, of course, read German. Keynes "kind-of" read German, as he revealed in a fatally self-deprecating footnote in the *Treatise* in which he admitted "in German I can only clearly understand what I know already."

With this casual remark Keynes may as well have painted a bull's-eye on the cover of his book. Hayek's critique was that Keynes had only borrowed a portion of the Wicksellian framework, ignoring completely the capital theoretic foundations that Wicksell had developed in another book. In contrast, Hayek had incorporated Wicksell's capital theory into his own work.

Hayek's review was a polite but devastating attack: he basically said that Keynes had overlooked some important and relevant work simply because it had appeared in another language. (The Swede Gunnar Myrdal was less flattering, calling Keynes' book an example of the British penchant for "unnecessary originality.") If we recall that Keynes was a Cambridge don, the editor of *The Economic Journal*, and a major public figure in England, while Hayek, who at age 31 was 16 years Keynes' junior, a young upstart from another county, and that this was all taking place as the "Downturn of 1930" was turning into the Great Depression, we can see that the stakes were pretty high. Krugman versus Cochrane pales in comparison.

Keynes was apoplectic about the review. As is usual in the academic world, he expressed his displeasure by writing a response to it that was published a few months later. What was unusual is that Keynes used the review not simply to defend his own theory but also to attack Hayek's book. And what an attack it was! I will quote the most famous passage which will give you some idea of the general tone:

> The book as it stands seems to me to be one of the most frightful muddles I have ever read, with scarcely a sound proposition in it.... It is an extraordinary example of how, starting with a mistake, a remorseless logician can end up in Bedlam.

Body-line bowling indeed.

Both men eventually left the battle to work on new books. Keynes finished first, publishing in 1936 *The General Theory,* probably the most important book in 20th century economics, if one measures importance by the impact that it had on the thinking of economists and practice of economic policy. Hayek's book, *The Pure Theory of Capital*, published 5 years later, was almost unreadable, frankly; and in any event little read. He was to make his mark with another book, published as the war was coming to an end, *The Road to Serfdom*.

There is a final twist to the story. Once the war had begun, the Keynes-Hayek relationship improved dramatically. They were on the same side in their recommendations for war finance, with Hayek writing a strongly favorable review of Keynes' 1940 pamphlet, "How to Pay for the War." When the Battle of Britain began the London School of Economics was evacuated to Cambridge, and Keynes found Hayek rooms for a time here at Kings College. Finally, and most remarkably, after Keynes read *The Road to Serfdom* he sent Hayek a letter in which he said,

> You will not expect me to accept quite all the economic dicta in it. But morally and philosophically I find myself in agreement with virtually the whole of it; and not only in agreement with it, but in a deeply moved agreement.

Hayek for his part said in a later interview when asked to name the two people with whom he would most like to have a dinner and conversation, it was Keynes and Joseph Schumpeter. So as I said, the actual relationship between these two men was more complicated and interesting than one might first suppose.

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So what might we learn from Hayek? Let's turn first to his analysis of the causes of the business cycle.

Let me begin by clearing up a misconception. Hayek is sometimes wrongly portrayed as thinking that market systems always work just fine. Now this is a man whose first book was titled *Monetary Theory and the Trade Cycle.* Suffice it to say that Hayek was no Dr. Pangloss when it came to the workings of a market economy.

Hayek thought that a trade cycle was an unavoidable concomitant of a credit-using market economy. His description of the unfolding of a typical cycle actually maps pretty well with at least a part of what happened in the latest meltdown, especially in terms of the Fed's interest rate policy and its effects on the American housing sector. In Hayek's theory, problems start when the market rate of interest is held too low for too long. This always politically popular policy leads to malinvestment – too many investment projects get started that cannot ultimately be sustained. When people realize what has happened, investment spending collapses and a recession begins. In Hayek's theory, recessions are the painful but necessary adjustment that returns the system back to equilibrium. His policy advice at the time, simply to let the system adjust, was as popular then as it is today. His great fear was that attempts to combat the recession with expansionary policy would perpetuate the malinvestment, delay the necessary and painful process of adjustment, and set up the prospects of future inflation. This too perhaps sounds familiar.

Perhaps of more interest than his cycle theory are Hayek's views on regulation and on the limitations of economics as a discipline. Regarding regulation, two things should be noted at the outset. First, Hayek was not opposed to all regulation; more forcefully, he frequently criticized the concept of laissez faire. Second, he was no policy wonk. All of his observations were made at a very general level. This was in part strategic: when he established the Mont Pèlerin Society he found himself trying to keep together a coalition that ranged from Ludwig von Mises to Chicago School economists like Friedman and Stigler to ordo-liberals like Walter Eucken to people like Michael Polanyi and Karl Popper who, in this group anyway, might well be considered social democrats. He was not always successful: Mises walked out of one of the sessions at that first meeting muttering that everyone there was a damn socialist. In any event, given that we are trying in this conference to consider foundational issues about economics, a discussion of general principles may not be entirely out of place.

Hayek's starting point and his most fundamental insight concerned the limits of our knowledge. For Hayek knowledge was both dispersed and subjectively-held, the latter implying that some of what people think they know is wrong. The question in such a world is, what sort of system works best to coordinate people's dispersed knowledge and help people to correct their mistakes?  In coming up with an answer, Hayek talked about the crucial role of freely adjusting market prices, prices that signal individual decision-makers about relative scarcities, and movements in which inform people when they have made mistakes. To be sure, Hayek was writing before the extensive literature on the economics of information, with its emphasis on increasing returns, path dependency, and the like had been developed. That said, Hayekian inspired responses to that literature have also begun to be developed – I can recommend in particular a forthcoming book by the British academic Mark Pennington.

Hayek always insisted that, if it were to work effectively, a market system must be embedded in a complementary set of social institutions, among them a democratic polity, with well-defined and enforced property rights, with strong constitutional protections of a private sphere of activity, all operating under the rule of law. Whenever Hayek discussed legislation he always talked about it within this general system of rules, a system he believed would enable individuals to make the best use their own localized knowledge, and through the price system to share that knowledge with others. For Hayek, the market system was a means of social cooperation.

This has implications, of course, for the kinds of legislation one might wish to implement. In the first instance, he opposed policies that involved either price-fixing or constraints on entry and exit, because these interfere with the ability of a price system to reflect relative scarcities. Because it is such a big player, he also emphasized how government through its actions (and sometimes, even through its proposed actions) can interfere with ordinary people's ability to make decisions. As he wrote in *The Road to Serfdom*, "The more the state plans, the more difficult planning becomes for the individual."

Hayek worried too about whether regulators would have the requisite knowledge to keep up with the ever-changing ebb and flow of the market process. Entrepreneurs, including those who recognize that there is money to be made from devising ways of getting around regulations, are always forward-looking, while regulators are almost of necessity backward-looking. He also asked Juvenal's question, who is to regulate, or watch over, the regulators?

In addition to these knowledge problems, Hayek worried that certain types of regulation tend to increase moral hazard and to misalign incentives. He specifically warned about situations in which firms were considered to be too big too fail. For Hayek, the market process itself, when it is allowed to work, provides its own forms of regulation, namely, the market discipline that results from consumer choice, rivalrous competition, and the carrot of profits and stick of losses. The recent socialization of losses for firms viewed as too big to fail would have been viewed as anathema by that staunch anti-socialist.

Taken by itself, Hayek's message about the limits of our knowledge suggests the difficulty of securing adequate regulation. If one links it up with other arguments about the nature of the political process, for example, those that are associated with the public choice school of James Buchanan, one's confidence that the political process will yield the right policy, even if we knew what it was, is further chastened. Hayek's message regarding the prospects for effective regulation, in short, is pessimistic, sober, and sobering.

I will close with two further points.  I was initially attracted to Hayek not for his politics or his ideas about markets, but for his methodological views, and in particular for what he had to say about the limitations of economics. Hayek developed his ideas about the dispersion of knowledge during the socialist calculation debate of the 1930s. His ideas led him to reject, of course, the assumption of perfect information that inhabited most of the models of his day, but also the rationality assumption and eventually even the use of equilibrium theorizing, which is one reason he is so little taught today in the standard economics curriculum. Indeed, in terms of methodology, the Austrians have more in common with at least certain variants of post-Keynesian thought, especially that associated with George Shackle, than either of them does with the mainstream.

Hayek's takeaway message is that the economy is a complex adaptive system, and that when we confront such a phenomenon, our ability to control it is severely limited.

Often the best we can do is to make broad pattern predictions or provide explanations of the principles by which such phenomena behave.

Hayek's views, if correct, imply severe limitations on our ability to adjudicate among rival theories. This fallibalist conclusion is evident in a paper he first published back in 1955. As he put it:

> But if it is true that in subjects of great complexity we must rely to a large extent on such mere explanations of the principle, we must not overlook some disadvantages connected with this technique. Because such theories are difficult to disprove, the elimination of inferior rival theories will be a slow affair, bound up closely with the argumentative skill and persuasiveness of those who employ them. There can be no crucial experiments which decide between them. There will be opportunities for grave abuses: possibilities for pretentious, over-elaborate theories which no simple test but only the good sense of those equally competent in the field can refute. There will be no safeguards even against sheer quackery. Constant awareness of these dangers is probably the only effective precaution. But it does not help to hold up against this the example of other sciences where the situation is different. It is not because of a failure to follow better counsel, but because of the refractory nature of certain subjects that these difficulties arise. There is no basis for the contention that they are due to the immaturity of the sciences concerned. It would be a complete misunderstanding of the argument of this essay to think that it deals with a provisional and transitory state of the progress of those sciences which they are bound to overcome sooner or later.

Hayek's words explain why progress has been so slow in economics, why very bright people can still continue to disagree about the best way forward for our economy, and why it will ever be so. The hoped for effect of this is to make us all a bit more humble about our proposals, like Keynes' dentists.

My final observation is that this is the first conference ever to bring together leading lights from the economics profession with policy makers and with historians of economic thought.  I thank George Soros and Rob Johnson for this. The one thing that the leading fresh water and salt water economists gathered here this weekend share in common is that none of them, and if I am wrong I am happy to be contradicted on this, teaches in a department that offers graduate courses in the history of economic thought. Studying the history of economics can have the same effect as taking Hayek's ideas about the limits of economics seriously; it makes one humble about what one thinks one knows. This might not be such a bad thing for the economics profession.