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68 The Hayek–Keynes macro debate

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The chronology

The Hayek–Keynes 'macroeconomic' debate was joined with Hayek's 'Reflections on the Pure Theory of Money of Mr. J.M. Keynes' in August of 1931. The review, a scathing attack on volume one of Keynes's *Treatise on Money*, was followed by Keynes's 'Reply' and Hayek's 'Rejoinder' in November of 1931, the second part of Hayek's 'Reflections' in February of 1932, and a series of letters from December to March.

The *Treatise*, published in December of 1930, preceded by just two months the sensation created by Hayek's University of London lectures, published the following September as *Prices and Production*. Though both dealt with issues central to business cycle theory and claimed to be building on Wicksellian foundations, they reached strikingly different conclusions. During the early 1930s economists felt obliged to decide which was right. It was by all accounts 'quite a drama' (Hicks, 1967, p. 203).

The context

Hayek and Keynes conducted their debate at a very abstract, technical level and directed it towards specialists in monetary theory. Keynes, whose earlier work in economics dealt mainly with international policy questions, intended the *Treatise* to be 'a definitive treatment of money which would confirm his stature as a serious academic scholar' (Dimand, 1988, p. 23). Hayek, the newly appointed Tooke professor at The London School of Economics, was eager to introduce to a British audience recent contributions by Swedish and Austrian economists in the theory of fluctuations. For Hayek this meant presenting the 'Wicksell–Mises' theory of the business cycle and the Austrian theory of capital.

The debate revealed deep and pervasive differences in the views of Hayek and Keynes concerning the operation of a market economy. They did not resolve these differences during their lives. Although some contemporary scholars propose a kind of synthesis of Hayek and Keynes on the grounds that they embraced 'subjectivism' and held similar theories of the cyclical downswing, Keynes (1973, p. 265) probably had it right when he remarked that between him and Hayek 'the abyss yawns'. The terrain of their debate was monetary theory, but its substance was the self-adjusting and coordinating properties of a market economy. On these foundational issues, they never

agreed. For Hayek, his cycle theory analyses the inflationary consequences of the policies he accuses Keynes and his followers of advocating.

The debate over the *Treatise*

Keynes intended the *Treatise on Money* as a contribution to business cycle theory. He believed its theoretical core involved a 'novel means of approach' that would reveal the characteristics of a monetary system in disequilibrium and uncover the 'dynamical laws governing the passage of a monetary system from one position of equilibrium to another'. Regarding the book's policy significance, Keynes simply avers that properly understood it 'is of enormous practical importance to the well-being of the world' (1971, pp. xvii–xviii).

Keynes's 'novel approach' involved using the Wicksellian savings–investment framework to claim that aggregate income would rise or fall depending on whether savings were greater or less than investment. In the *Treatise*, Keynes defines the discrepancy between ex post savings and investment as unanticipated profits (Q), and it is these positive or negative 'windfalls' that drive the economy. If Q equals zero, entrepreneurs' expectations are satisfied and no changes in planned production for the next period are called for; the economy is in steady state equilibrium with stable prices and full employment. If savings exceed investment (and thus $Q < 0$), the *Treatise*'s model calls for a cumulative contraction to occur because income will not be sufficient to purchase aggregate output at prices which cover costs. The disequilibrium persists, along with increasing unemployment and falling prices and output, unless savings are reduced, investment is increased, or 'all production ceases' (1971, p. 160). Keynes omits the role of any self-correcting mechanisms endogenous to the system or, as in the case of real balance effects, dismisses them as unimportant.

In broad outline, the argument of the *Treatise* is not unlike that of *The General Theory* and the relation between the two is what Keynes (1936, p. vi) calls 'a natural evolution in a line of thought'. The insufficiency of aggregate demand (specifically investment) and the failure of intertemporal markets to coordinate plans effectively are prominent motifs in both works (see Garrison, 1985). While Keynes introduces in *The General Theory* the consumption function (and Kahn's multiplier) and his theory of involuntary unemployment, his treatment of expectations most sharply reflects the evolution of his thought. Expectations are not absent from the *Treatise*, but their importance is played down because their instability is confined to the very short run. In *The General Theory*, on the other hand, short-run expectations are stable but long-run expectations are not. Despite these differences, Keynes's essential message and vision is clear enough: a decentralized market system is subject to chronic instabilities and does not contain sufficiently robust self-corrective market mechanisms to overcome (or neutralize) these instabilities without third party intervention.

The debate centered on Hayek's claim that Keynes's *Treatise*, especially the core chapters contained in Books III and IV, failed to provide a coherent account of the relationship between savings, investment, output and money. Hayek held that Keynes failed to treat the central problems of monetary theory because, in his use of the Wicksellian savings–investment approach, he ignores its underlying capital-theoretic base. According to Hayek (1931–2), Keynes failed to acquaint himself 'with the substance of [Böhm-Bawerk's] theory' (p. 280) – 'the most elaborate theory of capital we possess' (p. 279) – or to understand 'those fundamental theorems of "real" economics on which alone any monetary explanation can be successfully built' (p. 270). Hayek railed against Keynes's 'difficult, unsystematic, and obscure' exposition, in which 'the inconsistent use of terms produces a degree of obscurity which ... is almost unbelievable' (p. 271). It is little wonder that Hayek found it 'difficult to suppress some concern as regards the immediate effect which its publication ... may have on the development of monetary theory' (p. 271).

In Part I of the 'Reflections', Hayek's critique centers on the tools and constructs of Keynes's theory and in Part II on Keynes's explanation of the business cycle. Hayek persistently attacks Keynes's central theoretical points and conclusions, including, inter alia, the theory of investment ('the most obscure theme of the book'), the definition of saving, Keynes's 'fundamental equations' for the price levels of output and consumer goods, the theory of asset pricing and, of course, Keynes's account of the trade cycle.

Hayek argues that the *Treatise* was not only unfinished, as Keynes himself admits (1971, p. xviii), but that its theoretical superstructure was unrefined and idiosyncratic. Hayek claims, for example, that Keynes's treatment of aggregate profits as the mainspring of change is misleading. Keynes treats (total) profits as only a monetary phenomenon arising from changes in the direction of money flows and independent of underlying resource misallocation associated with 'relative demand for and supply of cost goods and their respective products' (Hayek, 1931–2, p. 273). Thus, according to Hayek, in treating the process of production as an 'integral whole', Keynes is perforce unable to analyse 'the possibility of fluctuation between ... stages' (p. 274). To illustrate that such refinements make a difference, Hayek provides an example where profits are zero in the aggregate but positive in the lower stages of production (that is, temporally closer to becoming available for consumption) and negative in the higher stages. This structural maladjustment will affect relative prices within the production structure, inducing effects that Keynes claims can only arise if (total) profits are not zero. The irony of Hayek's critique is that the macro-oriented Keynes employs a definition of profits that is suitable when applied to a single entrepreneur but

inappropriate and misleading when applied to all entrepreneurs. That 'Mr. Keynes' aggregates conceal the most fundamental mechanisms of change' (p. 277) emerges as a persistent theme in Hayek's critique of the *Treatise*.

The concept fundamental to both Keynes's and Wicksell's analyses is the natural rate of interest, that is, the rate which equates saving and investment. For both Keynes and Wicksell, the significance of the natural rate resides in the consequences of a divergence between it and the market rate. Wicksell and most of his followers examine the inflation case of a positive deviation (lagging or lowered market rate); Keynes in the *Treatise* is primarily concerned with the deflation case of a negative deviation. Keynes's attempt to align his analysis with Wicksell's draws criticism from Hayek. First, Hayek contends that Keynes employs a peculiar conception of savings, implying that Keynes's equilibrium rate had to be different from Wicksell's. Keynes alters the 'ordinary' definition of savings – the excess of money income over consumption – to also include the shortfall of income accruing to entrepreneurs relative to their 'normal' income. In short, according to Keynes, if entrepreneurs sustained negative profits, they would reduce their consumption (increase their saving) by an equal amount. Since increased saving means reduced demand for consumption goods, 'the cruse becomes a Danaid jar which can never be filled up' since 'the effect of this reduced expenditure is to inflict on the producers of consumption goods a loss of an equal amount' (Keynes, 1971, p. 125).

Hayek rejects Keynes's 'Danaid jar' account as well as the obverse 'widow's cruse' example when profits are spent on consumption goods. For Hayek, an increase in savings would result in a build-up of consumer goods inventories that would serve to maintain consumption while more roundabout production processes are put on line. In contrast to Keynes, Hayek denies that an increase in saving constitutes a net decrease in demand and that investment will not rise to maintain equality with saving. Since Keynes assumes in the *Treatise* that investment decisions depend on anticipated profits and the interest (or bank) rate, an excess of saving or deficiency of investment would seem correctable by a reduction in the market rate of interest corresponding to the now lower natural rate as indicated by the increase in savings. Keynes, however, rules out this coordinating mechanism. He contends that savings are not channeled into investments (what he calls 'securities'); instead, owing to 'excess bearishness', they are hoarded (or, in his terminology, placed in 'bank deposits'), thus impeding the required fall in the market rate of interest (see Keynes, 1971, chapter 15 and pp. xxv–xxvii).

Hayek (1931–2) recognizes the theoretical significance of hoarding and the difficulty of finding a 'practical solution to these problems' (p. 34). He also notes that 'Mr. Keynes' elaboration of this contribution of Mr. Robertson is, in many respects, the most interesting part of his theoretical analysis' and

that, in examining the 'relations between bank credit and the stock market', Keynes is 'breaking new ground' and 'has opened up new vistas' (pp. 34–5). Despite this, Hayek argues that Keynes's analysis is still 'not quite clear' and 'his solution of the problem not quite satisfactory' (p. 35) because he makes two questionable assumptions to support the proposition that the prices of securities are solely determined by hoarding. Keynes's first assumption (1971, pp. 224–5) is that the demand for securities is related to their current prices because a fall in their current prices strengthens the expectation of a future price rise. Hayek (1931–2) demurs, noting that 'any fall in the price of securities is just as likely to create a fear of a further fall as the expectation of a rise' (p. 37). Keynes's second assumption claims the banking system is able to determine the size of bank deposits (or the 'quantity of hoards'), a proposition, Hayek argues, requiring that deposits are unrelated to 'the terms on which the banking system is willing to lend' (p. 37). Thus, Hayek contends, Keynes's assumption makes the untenable claim that any 'excess deposits' created by the banking system will necessarily go into 'hoards' without affecting the market rate of interest.

Keynes's treatment carries the significant implication that 'bear speculators' will keep the interest rate above its equilibrium value, thereby depressing the value and volume of new investment. Thus the disequilibrium between the rate of savings and the rate of investment is caused by increased 'bearishness' and is unrelated to the standard Wicksellian assumption of changes in bank credit. Interestingly, in Keynes's 'Reply' to Hayek he insists there is 'no automatic mechanism in the economic system … to keep the two rates equal' (1973, p. 251). Hayek (1931), however, responds specifically to this assertion by asking if it could 'be extended to the more general contention that there is no automatic mechanism in the economic system to adapt production to any other shift in demand' (p. 401).

In the *Treatise* and *The General Theory*, Keynes's explanation of the business cycle centers on investment instability. In the *Treatise*, the fear of falling prices instigates the disequilibrating role of 'bears'. This is present in *The General Theory* (see chapter 13), but the emphasis in 1936 is on 'the dark forces of time and ignorance which envelop our future' (p. 155) in the context of modern 'organized investment markets' (p. 150) that together cause 'animal spirits' to be vented in undesirable ways. Investment insufficiency and instability complicated by 'bears' keeping interest rates too high render the system susceptible to prolonged periods of 'stable equilibrium … below full employment' (p. 30). The economy fails because it is unable to coordinate intertemporal plans effectively. While the specifics of Keynes's argument change from the *Treatise* to *The General Theory*, the essential claim in both is that intertemporal markets either do not exist or, if they do, generate perverse outcomes in the form of price deflation or aggregate output reduction.

Keynes largely ignores Hayek's critique that the *Treatise* neglects intertemporal market mechanisms. In his 'Reply' to Hayek's review, Keynes (1973) launches into a prolonged attack on *Prices and Production*, only to admit that capital theory 'would be highly relevant to my treatment of monetary matters' (pp. 252–3). Although he insists that 'there is no such theory at present', Keynes does 'substantially ... concede Dr Hayek's point' and that he will 'later on ... endeavor to make good this deficiency' (p. 253). Keynes, however, chose not to pursue seriously such questions; if anything, he drifted further away from such concerns, so that by 1936 the Wicksellian framework and its supporting capital theory are conspicuous by their absence.

The General Theory and after

Hayek did not specifically respond to *The General Theory*. This decision was based on his belief that *The General Theory* was just 'another tract for the times' whose popularity was sustained by 'momentary needs of policy' (Hayek, 1978, p. 284). But Hayek's withdrawal from the debate may also have been opportune: by the mid-1930s, Hayek's monetary theory and policy positions were losing much of their appeal with the continuing depression and the increasing clamor for more government economic activism. Even if it were true that Hayek had in the early 1930s 'largely demolished [Keynes's theoretical scheme' (ibid. pp. 283–4), it was evident that Keynes was winning decisively the policy battle. Hayek's isolation from an increasingly alien mainstream was surely a factor in persuading Hayek 'not to return to the attack' (ibid. p. 284).

The period following the publication of *The General Theory* and continuing through the postwar years was a time of great intellectual activity for Hayek. Three areas of inquiry – capital theory, 'the knowledge problem' and business cycles – may be briefly highlighted as areas of continuing interest for Hayek after 1936 that bear on questions germane to the debate with Keynes. Hayek, it will be recalled, claims that Keynes's theoretical framework in the *Treatise* is flawed because it lacks a coherent theory of capital. Hayek argues such a theory is essential to analyse the effects of monetary and real disturbances on output. During the 1930s, Hayek's debate with Frank Knight provided the opportunity to extend and refine the Böhm-Bawerkian theory of capital he first used in *Prices and Production*. The capstone of Hayek's efforts, and arguably the definitive treatment of Austrian capital theory, was published in 1941 as *The Pure Theory of Capital*. Regrettably, a planned second volume to extend the theory of capital into the monetary area was never written.

During the 1930s and 1940s, Hayek's papers on 'knowledge' argue that the price system, because it functions efficiently as an information network, enables intertemporal markets to coordinate effectively individuals' plans.

Despite the inevitability of our ignorance resulting from the decentralization of knowledge, the coordination of plans does not require complete knowledge; nor, in contrast to Keynes's view, does incomplete knowledge require markets driven by 'animal spirits'.

Hayek explicitly returns to business cycle theory in a 1939 essay, 'Profits, Interest and Investment'. The essay addresses the dynamic question of how 'cyclical fluctuations, once started, tend to be self-generating, so that the economy may never reach a position which could be described as equilibrium' (1939, p. 6). Hayek's model assumes, in contrast to *Prices and Production*, downwardly inflexible money wages, a fixed market of interest and an economy initially in recession. These new assumptions update his model without changing the theory. O'Driscoll (1977) notes that Hayek's later cycle work contributes significantly to the understanding of cyclical adjustment processes and the 'peculiarly discoordinating aspects of monetary disturbances' (p. 119).

See also:

Chapter 75: Pre-Keynes macroeconomics; Chapter 32: Austrian business cycle theory; Chapter 58: Inflation

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