Unemployment and Monetary Policy

Government as Generator of the "Business Cycle"

Friedrich A. Hayek

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Government as Generator of the "Business Cycle"

by Friedrich A. Hayek

With a Foreword by Gerald P. O'Driscoll, Jr.

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FOREWORD

The fallacy of the nonexhaustive choice

It is now widely recognized that the concepts and methodology of traditional macroeconomics can be related only with the greatest difficulty (if at all) to general economic theory. Macroeconomics deals with such aggregate concepts as national income, aggregate demand, total employment, velocity, etc. Until comparatively recently, macrotheorists have not focused on the microfoundations for macrotheory. Instead, a good deal of professional effort has been devoted to the "Fiscalist vs. Monetarist" or "Keynesian vs. Friedmanite" debates.

That these debates directed attention away from the microfoundations problem is only part of the problem. These debates were largely futile. The issues separating the protagonists were generally neither what they perceived them to be at the time,[1] nor what textbook writers portrayed them to be. Further, the juxtaposition of the two alternatives—the neoquantity theory vs. Keynesianism—involves the fallacy of the nonexhaustive choice. Standard monetarist and Keynesian models represent a very small range in the spectrum of approaches to the problem of economic fluctuations. The views of Professor Hayek and other proponents of the "Austrian" theory of fluctuations always represented a genuine alternative to macro orthodoxy. That their views were almost never mentioned in macroeconomic discussions surely reflects, at least in part, the fact that to have included them would have meant both redefining the contours of the debate and recognizing the sterility of earlier discussion.

The macro orthodoxy is, of course, now shattered. It is trite but

[1]For an illustration of the difficulties economists have had in specifying what the issues were, see the symposium on Milton Friedman's monetary theory in the *Journal of Political Economy* 80 (September/October 1972).

accurate to observe that Keynesianism as we knew it is dead intellectually, however long its ideas may survive in textbooks and books by popular writers. It is true that there are a great number of "neo-Keynesian" (or "post-Keynesian") models. In this context, I agree with Professor Yeager's cogent argument that recent "Keynesian" theorists show undue modesty in ascribing their original contributions to Keynes.[2]

Likewise, for better or for worse, monetarism is being supplanted by the new Rational Expectations theory, about which more will be said shortly.

Hayek rediscovered

The renewed interest in Hayek's views reflects a search for alternative formulations. Hayek, Keynes's early and most effective intellectual opponent, dissented from Keynes's formulation of the problem of economic fluctuations in terms of aggregative concepts of the emergent macrotheory. Hayek argued vigorously that these concepts were mere mental constructs, not meaningful empirical categories. He pointed out that general economic theory forcefully demonstrated the impossibility of stable functional relationships among such macro variables as consumption and investment, or total employment and investment. **Not only the magnitude of the coefficients but also their algebraic signs** must **change over the course of a business cycle.**

Hayek's critique of Keynes's system paralleled his earlier critique of the quantity theory for lacking micro foundations.[3] Indeed, by implication Hayek identified the strong connection between the quantity theory and its supposed opposite, Keynesianism. If one were to pursue this connection, one would go a long way toward explaining the futility of macro debates.[4]

[2]Leland Yeager, "The Keynesian Diversion," *Western Economic Journal* 11 (June 1973):150-63.

[3]See Friedrich A. Hayek, *Prices and Production,* 2d ed. (London: Routledge & Kegan Paul, 1935), pp. 1-31 and *passim.*

[4]For a preliminary attempt to do this, see Gerald P. O'Driscoll, Jr., and Sudha R. Shenoy, "Inflation, Recession, and Stagflation," in *The Foundations of Modern Austrian Economics,* ed. Edwin G. Dolan (Kansas City: Sheed & Ward, 1976), pp. 185-211.

This interpretation also explains why Hayek's approach was not integrated into textbook discussions. In *Monetary Theory and the Trade Cycle,* Hayek called for an integration of monetary and price theory.[5] In *Prices and Production,* drawing on the monetary theory of his teacher Ludwig von Mises, he outlined a theory in which monetary disturbances alter the array of relative prices by affecting market interest rates and the pattern of investment. Monetary injections constitute an additional source of demand for goods and resources; the market signals (i.e., prices) generated by this additional source will be reacted to as though real factors (e.g., savings preferences) had changed. Transactors respond to market signals, and the relevant signals indicate that the underlying functions have changed.

Indeed, for a time, the effects of monetary expansion could be the same as that generated by a shift of savings preferences in favor of future as opposed to current consumption. An "investment boom" and high employment would result. Crucial to Hayek's analysis is the observation that resources will be attracted into productive activities that would not otherwise have existed. The resources can remain so employed only as long as the monetary expansion continues. The rate of increase in the money stock must accelerate to maintain the (disequilibrium) pattern of employment. *

It is not true that high employment either depends upon or can be sustained permanently by monetary expansion; the contrary is an implication of Hayek's analysis, as he explains in the first essay. But once monetary expansion has produced real effects, the resulting pattern of resource allocation can only be maintained, if at all, by accelerations in the rate of growth of the money stock. As Hayek notes in the first essay, unemployment is not a means of combating inflation (as Keynesian macrotheory erroneously suggests), but the result of slowing the rate of growth of the money stock. Once the money-augmented demand for resources is reduced in the sectors in which it previously expanded, entrepreneurs will begin reallocating resources, including labor services.

[5] Friedrich A. Hayek, *Monetary Theory and the Trade Cycle* (1933), trans. N. Kaldor and H. M. Croome (New York: Kelley, 1966).

What is perceived as a problem of *aggregate* unemployment by those who impose mental constructs of macroeconomics upon the world, is in reality a *sectoral* unemployment problem. In turn, sectoral unemployment in one period is, in this instance, the result of overemployment in these sectors in previous periods. (Symmetrically, there has been underemployment of resources elsewhere.)

It is important to note that it is in expansions, *generated by money creation* (as opposed to genuine saving), that misallocations and entrepreneurial errors occur. What is termed a "recession" merely reveals previous allocational errors, and it is in the recessionary phase that corrective reallocations occur. This insight explains why recessions are necessary to restore equilibrium; the recession *is* (the beginning of) the restoration of equilibrium. For policy-makers to commit themselves to ending inflation without a recession of some kind is to commit themselves to the impossible; but this commitment ensures continued and accelerating inflation, along with economic stagnation. There are no "soft landings" for an economy in which the coordination of economic activities has been disrupted by inflation.

Though Hayek's first and third essays build on his early theoretical work, they are applications for the seventies and eighties, with particular reference to Britain. There is little in these essays, written in 1975, that is dated. References to labor union power as the ultimate reason for money creation will, however, strike many U.S. readers as odd. Whatever may be true of Britain, it is difficult to saddle U.S. labor unions with being the cause of monetary expansion in the United States. Regardless, however, of the source of pressures for monetary expansion, resource allocation is affected by monetary policy. Even if monetary expansion is no longer substantially directed to stimulating private investment, as Hayek suggested it was in 1931, economic coordination and the allocation of resources is interfered with.

Recent theoretical developments

The Rational Expectations theorists sounded the death knell of Keynesian macroeconomics. Indeed, in pointing out the reasons why macroeconometric models *must* fail in simulating the effects of alternative macro policies, Professor Robert Lucas and others were echoing points made by Hayek forty years ago.[6] In fact, in his Nobel Memorial Lecture (the second essay), Hayek restates his position forcefully and provides methodological foundations for his positive analysis.

While recognizing that in their critiques of conventional macroeconomics, Rational Expectations theorists repeat Hayekian insights, one must not overlook fundamental differences between Hayek and the new monetary theory. Hayek always emphasized that markets operate with an economy of information, and that they are characterized by decentralization and dispersion of knowledge.[7] This insight explains both the efficiency of markets *and* their vulnerability to monetary disturbances. The structure of the economy is revealed to no one. Expectations are formed because complete knowledge is lacking. In their emphasis on the homogeneity of knowledge sets and transactors' knowing the structure of the economy, Rational Expectations theorists diverge radically from Hayek's approach.[8]

One should surely be heartened by recent developments in monetary theory. But monetary theory has yet to rediscover the specific contributions of Mises, Hayek, and the other "Austrians" to our understanding of economic fluctuations. Theirs is a tradition, beginning with Cantillon and tracing through classical political economy, that has been ignored. This *Cato Paper* serves as an excellent introduction to that tradition.

February 1979

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[6]See Robert E. Lucas, Jr., "Econometric Policy Evaluation: A Critique," in *The Phillips Curve and Labor Markets,* ed. Karl Brunner and Allan H. Meltzer (New York: North-Holland, 1976), pp. 19-46.

[7]Friedrich A. Hayek, "Economics and Knowledge" and "The Use of Knowledge in Society," in his *Individualism and Economic Order* (Chicago: University of Chicago Press, 1948).

[8]In his recent criticism of the Rational Expectations approach, Professor Arrow adopts the Hayekian position. See Kenneth J. Arrow, "The Future and Present in Economics," *Economic Inquiry* 61 (April 1978): 157-71.

A NOTE ON AUSTRIAN CAPITAL THEORY

Austrian capital theory views capital not as a homogeneous stock but as a network of interrelated goods: a diversified structure of complementary elements, rather than a uniform lump. The process of production is seen as occurring in a series of "stages," extending from final consumption to stages successively further removed. To take a simple example: A steel mill *by itself* cannot produce final consumption goods, like cars or washing machines. In order to produce such consumer goods, a whole intervening chain of complementary investments is required: in factories, machinery, stocks of raw materials, etc. The steel mill's output passes into the next stage of production as an input, together with other inputs (raw materials, etc.), and is used in the factories in this stage to produce various intermediate goods. These goods in turn serve as inputs for the next stage of production, until final consumption is reached.

Thus, investments in wholesale and retail distribution, in this view, are complementary to investments in previous stages of production; they are an integral part of the capital structure as a whole necessary to bring goods to the final consumption stage. Particular capital goods may be specific to one stage of production, or they may be adaptable to several stages.

In other words, a miscellaneous jumble of nonconsumption goods will *not necessarily* raise final output. Individual capital investments (whether in plant, machinery, raw materials or semi-finished goods) must fit into an integrated capital structure, completed to the final consumption stage, if they are to add to final consumption output. Investments that do not form such an integrated structure are (or become) *mal*-investments yielding capital and operating losses.

The "filigree" (i.e., composition) of capital goods forming a coordinated capital structure changes with circumstances. Thus a factory, once profitable, becomes unprofitable as the circumstances in which it was originally built are themselves altered. Equally, new investment opportunities open up with changing circumstances; investments once useless may become profitable again. In short, capital is *not* automatically maintained intact; neither is any investment automatically profitable in all circumstances.

The essential role of prices (and of rates of return on individual goods) emerges from this brief outline. Only if there exist markets in which prices reflect (changing) relative scarcities of the different sorts of capital goods involved can the capital structure as a whole be integrated, and mal-investments be revealed.

Sudha R. Shenoy

PREFACE

The present unemployment is the direct result of the shortsighted "full employment policies" we have been pursuing for the past twenty-five years. This is the sad truth we must grasp if we are not to be led into measures that will only make matters worse. The sooner we can find our way out of the fool's paradise in which we have been living, the shorter will be the period of suffering.

Nothing is easier than creating additional employment for a time by drawing workers into activities made temporarily attractive by the expenditure of additional money created for that purpose. Indeed, during the past twenty-five years we have deliberately and systematically resorted to the quick provision of employment precisely by increasing the supply of money, which during the preceding 200 years had been regularly increasing as a result of a defect in the credit system—thus becoming the cause of recurrent depressions.

We should not be surprised at this result, inasmuch as we have successively removed all the barriers erected in the past as defenses against the ever-present popular pressure for "cheap money." What happened at the beginning of the period of modern finance has happened again—we have been seduced by another silver-tongued persuader into trying another inflationary bubble. And that bubble has now burst. We shall soon discover that much of the artificially induced "growth" was a waste of resources and that the harsh truth is that the West is living beyond its means.

Urgent as is the need to reintegrate the jobless into the productive process, if we are to prevent similar calamities in the future, it is no less important that we avoid making matters worse by repeating the mistakes made in the recent past. It is to this most urgent task of rethinking the theoretical conceptions that have guided us that the lectures here printed are addressed.

The first two lectures were delivered to academic audiences in Italy[1] and Sweden,[2] and were destined for publication in the memoirs of the learned institutions to which they were presented. The third, added when the first two were already set in type, contains elaborations and elucidations I found necessary to add when I pursued the themes of the first during a lecture trip in the United States.[3]

I am very grateful to the Cato Institute for making these lectures available to readers in the United States by including them in the Institute's series of *Cato Papers.*

March 1979 F. A. Hayek

[1] "Inflation, Misdirection of Labor, and Unemployment" is a revised version of a lecture delivered on February 8, 1975, to the "Convegno Internazionale: Il Problema della Moneta Oggi," organized in commemoration of the 100th birthday of Luigi Einaudi by the Academia Nazionale dei Lincei at Rome and published in the proceedings of that congress.

[2] "The Pretense of Knowledge," an Alfred Nobel Memorial Lecture, was delivered on December 11, 1974, at the Stockholm School of Economics.

[3] "Unemployment: Inevitable Consequence of Inflation." Lecture delivered at various places in the United States during April 1975.

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The erosion of civil and economic liberties in the modern world has occurred in concert with a widening array of social problems. These disturbing developments have resulted from a major failure to examine social problems in terms of the fundamental principles of human dignity, economic welfare, and justice.

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