THE AUSTRIAN ECONOMICS NEWSLETTER

Volume 3/No. 3 Summer 1982

Hutt's Critique of Keynes

Two Reviews of *The Keynesian Episode*

by William H. Hutt, Indianapolis: Liberty Press, 1979, 449 pp., pb. $4.50, hd. $10.00.

W.H. Hutt

Reviewed by John B. Egger

The Keynesian Episode is Professor Hutt's second edition of *Keynesianism—Retrospect and Prospect* (1963). He cautions us in his preface, however, that the changes are enough to make *Episode* "a new book," and this is substantially accurate. While pages 3 through 291 of *Keynesianism* appear as pages 87 through 401 of *Episode*, about 120 pages of the earlier work are omitted and 85 pages of new material added. Even in those pages which reproduce *Keynesianism* in substance, Professor Hutt has rewritten many of its most confusing parts, adding and omitting words, phrases, sentences, and even paragraphs here and there, revising their orders, and employing a more modern style. Paragraphs are no longer numbered, terms like "whilst" have disappeared, and most of his long lists of cases have been curtailed and incorporated into ordinary paragraphs. In short, *Episode* is much more pleasant to read than its ancester, and it's different enough that bibliophiles cannot give up their used-bookstore searches for *Keynesianism*.

The first six chapters of *Episode* deal explicitly with Keynes and "Keynesianism." The next seven, while frequently mentioning the ideas and policies of Keynes and his followers, are focused on the functioning of the market economy. The final five chapters zero in on popular macro concepts—the multiplier and accelerator, for examples—and discuss "the retreat" from Keynesianism by both Keynes and later economists. (Hutt is both modest and realistic enough to observe that, despite his 1963-stated hopes, *Keynesianism* has apparently had no impact whatsoever in accelerating this process.)

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Reviewed by Leland B. Yeager

Professor Hutt's new book began as an intended second edition of his *Keynesianism—Retrospect and Prospect*, 1963 (which, Hutt says, he had originally thought of entitling *The Curse of Keynes*). Not surprisingly, then, the book echoes familiar themes. I shall try to summarize them, not necessarily in Hutt's own terminology.

Fundamentally, behind the veil of money, people specialize in producing particular goods and services to exchange them for the specialized outputs of other people. Any particular output thus constitutes demand for other (noncompeting) outputs. Since supply constitutes demand, there can be no fundamental problem of deficiency of aggregate demand. Any apparent problem of that sort traces to impediments to exchange of goods and services for each other—to failures of markets to clear because of wrong prices. Impediments to exchange discourage production of goods and services destined for exchange. Say's Law, as Hutt further interprets and extends it, points out why cutbacks in production in some sectors of the economy, meaning as they do cutbacks in the real demands for the outputs of other sectors, cause cutbacks of production in those other sectors also. With demands curtailed, what might otherwise have been equilibrium prices for the outputs of those other sectors are now too high; and unless these prices are adjusted downwards, they impede exchanges and production. In this way, wrong prices and production cutbacks in some sectors make existing prices wrong and cause production cutbacks in other sectors also; the rot is cumulative. In the opposite and more cheerful direction, anything that promotes market-clearing prices and the recovery of production in some sectors promotes cumulative recovery

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The A.E.A. Session

Reviewed by Mark Manasco

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The *Austrian Economics Newsletter* is designed as a research and communications device for work in Austrian economics. As such, it is essential that we have the active support and cooperation of our readers. We need any information which would be of value to other Austrians and we welcome any suggestions for improving the *Newsletter.* The success of the *Newsletter* fundamentally depends on our ability to encourage the participation and involvement of our readers.

The *Austrian Economics Newsletter* is an independent project funded by the Center for Libertarian Studies and is published three times a year. Annual subscriptions are $7.50.
Back issues are available for $3.50 apiece.

Austrian Economics Newsletter
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Lately considerable interest has been aroused within the economics profession by the emergence of a revived Austrian tradition. This was never more in evidence than by a standing-room-only session at the annual meeting of the American Economics Association devoted to "Recent Developments in Economic Theory:Austrian Economics".

With the recent attempts to reconcile and incorporate Austrian insights into mainstream analysis it is particularly interesting that the session included a joint paper entitled "What is Austrian Economics?" written by two of the school's more able practitioners, Professors Mario Rizzo (NYU) and Gerald O'Driscoll (NYU) (soon to be expanded into a book to be released by Blackwell). The joint essay was one of three papers which included discussions on "Intertemporal Coordination in Macro-economic Theory" by Roger W. Garrison (Auburn) and "The Micro-foundations of the Moderate Quantity Theory" by J. Huston McCulloch (Ohio State).

In their provocative paper, O'Driscoll and Rizzo convincingly show that Austrian economics can no longer be considered a minor footnote in the history of thought, an old school whose revolutionary insights into the economic problem were long ago fused with neoclassical theory. Rather, they contend, it is a well integrated, vibrant body of thought that has much to offer contemporary economists in explanation of how markets work. In this clearly written, lucid overview of the Austrian "research program," the authors have not only argued for this favorable assessment of the modern Austrian school, they have supplied superb evidence in the form of this paper itself. This thoroughly researched, footnote-laden manuscript reveals that its authors possess a remarkably wide grasp of contemporary economics and that their school has a number of interesting things to say, both favorable and unfavorable, about recent developments in such areas as Rational Expectations theory and the Economic Analysis of Law.

The central task of the research program as seen by the authors is its attempt to "render social phenomena intelligible in terms of individual purposes and plans". As such the study of economics begins with tracing out the (often unintended) implications of human action. From the inception of the Austrian school the concept of purposeful behavior has been placed at the core of scientific inquiry. It is the origin of investigation for it is through the interaction of planned individual actions that social institutions such as language, law, or money and the price system evolve. The object of investigation is to "recompose or reproduce the social institution under study by tracing its logical origins to the interaction of individual plans". Pursuing this logic, Rizzo and O'Driscoll contend that we merely beg the question when, as in much of modern economics, we ignore the decentralization of knowledge. Explanations that treat the relevant data as somehow given in general to society, thereby abstract from an essential element of the socio-economic problem: the fact that no single mind is in possession of all the requisite information. Analysis that proceeds in this direction tends to lose sight of the crucial process and role that knowledge and information play in decision making.

The notion of subjectivism which the school has at times been characterized as having an unabiding obsession with is rigorously derived from the concept of purposeful behavior. Subjectivism is but the logical extension of placing economic ends and means—strictly as perceived by the actors themselves—at the heart of economic analysis. O'Driscoll and Rizzo have skillfully woven the basic themes of purposiveness and subjectivism into the fabric of a variety of issues in economics, showing the analytical usefulness of the Austrian concepts of time, uncertainty, profits, disequilibrium, and the market process. What emerges is a wholly consistent and open-ended research program that provides an alternative to those dissatisfied with "textbook economics".

Professor Garrison in his paper on "intertemporal coordination" presents a more specific case for the usefulness of the Austrian research program as an alternative to textbook macro-economics, and in particular draws attention to the hazzards of excessive aggregation. Theoretical models that obscure the heterogeneity of capital in general, and the diversity of capital goods with respect to the time structure of production in particular, conceal a key aspect of the market's coordination process. Garrison argues that in contemporary macro models the adequacy of the market process to allocate resources over time "is problematic to non-existent". The use of economy-wide aggregates is at the expense of a deeper analysis of

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"Muster-Voraussagen" und "Erklarungen des Prinzips" bei F.A. von Hayek: Eine Methodologische Analyse

by Hans-Georg Graf, Tubingen: J.C.B. Mohr, 1978, 108 pp., DM 19.80.

Reviewed by Stephan B. Bohm

Professor Hayek's keen interest in problems of the philosophy of science in general and the methodology of the social sciences in particular accounts for a considerable portion of his impressive *oeuvre* and can be traced to his celebrated 1937 paper "Economics and Knowledge", which with its far-reaching methodological implications can justly be regarded as a turning point in his illustrious career.

Hayek's insistence on and defense of the subjective and individualist approach of the social sciences was the central theme of "Scientism and the Study of Society" (reprinted in his *The Counter-Revolution of Science,* 1952) and sparked off one of the liveliest debates to have graced the philosophy of social science, the now-classic controversy of the 1950s over the issue of methodological individualism versus holism (collectivism). It is hardly surprising that Hayek's plea for a methodological dualism went unnoticed by economists at a time when Milton Friedman's most influential 1953 essay imported allegedly Popperian "positivist" philosophy of science into economics.

Hayek has subsequently elaborated his ideas on the methodology of the social sciences in a number of significant papers, "Degrees of Explanation" (1955) and "The Theory of Complex Phenomena" (1964) being perhaps the most important among them. Although interest in Hayek's social and political philosophy seems to be a growth industry (e.g. Norman Barry, *Hayek's Social and Economic Philosophy,* London: Macmillan 1979), his more recent contributions to the methodology of social science, beautifully summarized in his Nobel Memorial Lecture "The Pretense of Knowledge", have hardly received any serious attention from philosophers, let alone economists. Austrians cannot be completely absolved from this charge.

In view of these circumstances, Hans-Georg Graf's methodological study of Hayek's "pattern predictions" and "explanations of the principle" is a most welcome and long overdue addition to the literature. The introductory chapter, "The Principle of the Unity of Method and the Peculiarities of the Subject-Matter of Economics" briefly discusses some of the recurrent themes sounded by Hayek ever since the publication of "Scientism and the Study of Society": his vigorous attack on *"scientism",* "the slavish imitation of the method and language" of the natural sciences by the social sciences. In contrast Hayek conceives of the social sciences as sharply distinguished by (1) their essentially *subjective* character, not only in the sense that opinions, beliefs, and attitudes constitute their object, but also in that the method of obtaining knowledge of these "facts" is subjective, (2) their "compositive" or "synthetic" method (*methodological individualism),* and (3) the enormous *complexity* of their subject-matter.

Chapter two, "A Closer Look at the Methodological Problem of Complexity," provides a perceptive account of the Austrian notion of the market process, drawing heavily upon arguments Hayek employs in "Competition as a Discovery Procedure" (1968), and the Kirznerian treatment of the market process in *Competition and Entrepreneurship.*

In the third and final chapter, "The Methodology of Explanation and Prediction in Dealing with Complex Subject-Matters", covering half of the book, the author seeks to shed light on the logical structure and epistemological status of Hayek's "pattern predictions" and "explanations of the principle", relating them to the familiar Hempel/Oppenheim covering-law model of scientific explanation.

Many reasons have been offered, not least by Hayek himself, for supposing that the social sciences require different kinds of method and justification from the natural sciences, and conversely for supposing that these methods and justifications are or ought to be the same. In Hayek's case, it is by no means always so clear that the sharp distinction he claims to obtain between the natural and social sciences is a distinction in *methodology,* i.e. the logic of justification, as opposed to methods, i.e. techniques of investigation.

As the author points out on p. 8, he appreciates Hayek's theory of complex phenomena as a modification of rather than as a radical departure from the methodology of the natural sciences. For Graf, the emphasis on the aspect of complexity of social phenomena in Hayek's more recent writings does not replace the subjective and compositive method stressed in his earlier work; it rather supplements it. The doctrine of methodological individualism, i.e. the explanation of social processes in

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Briefs

The Winter 1980 issue of *History of Political Economy* (Vol. 12, #4) contains an article by Professor Gerald P. O'Driscoll entitled "Frank A. Fetter and 'Austrian' Business Cycle Theory." The article shows how Fetter's theory of capital and interest led him to develop a theory of business cycles which was quite similar to the theory that was later expounded by Mises and Hayek.

R.R. Nelson's "Assessing Private Enterprise: An Exegesis of Tangled Doctrine," which appeared in the *Bell Journal of Economics* (Spring 1981) is an important attempt to reexamine the question of market performance in light of many of the contributions of Mises and Hayek. Nelson contrasts the standard neo-classical idea of efficiency with Hayek's perspective which emphasizes the ability of institutions to disseminate knowledge.

Sudha Shenoy has edited a recent monograph put out by The Society for Austrian Economics in conjunction with the David Hume Society entitled *Order Without Design: Three Conference Papers on Economic Models and Social Formations.* Contained within are three essays: Antony Flew's "Intended Action and Unintended Consequences", Naomi Maldofsky's "Market Theory: Which One?", and Sudha Shenoy's "From Walras to Menger: General Equilibrium and its Microfoundations — An Austrian Commentary."

Norman P. Barry's "Austrian Economists on Money and Society" (*National Westminster Bank Quarterly Review,* May 1981) provides a helpful explanation of Austrian monetary theory which shows that it is fundamentally different from and at least in some respects superior to both the Chicago and Keynesian approaches to macroeconomics.

A Conference on "The Contributions of Ludwig von Mises to Economics" was held in New York from September 20-22 in honor of the 100th Anniversary of Mises' birth. Sponsored by New York University and Liberty Fund, the conference included papers by James Buchanan, Israel Kirzner, Steve Littlechild, Brian Loasby, Mario Rizzo, Leland Yeager, and Gerald O'Driscoll.

The A.E.A. Session
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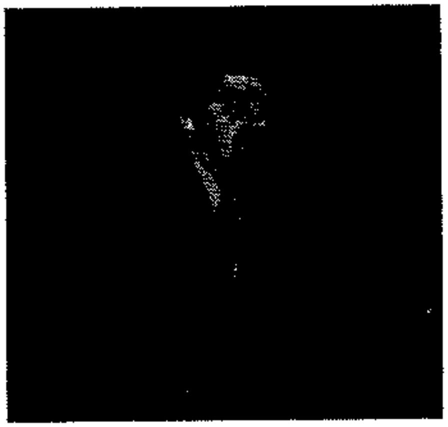

Roger Garrison

certain critical market processes involving the intertemporal coordination of economic activity. The development and evolution of the crucial concept of time and its role in the structure of capital is traced from Bohm-Bawerk through Wicksell and others to the dominant macro models of today. The Austrians, Garrison contends, are in a unique position to grapple with the problem of intertemporal coordination precisely because of the tradition's fundamental emphasis on the market process conceived as a decentralized procedure for coordinating the heterogeneous components of the capital structure into a coherent network of production. Treating capital as a simple quantity, K, does not take us very far in explaining the complex coordination through time that continually takes place within the capital structure.

In the third paper Professor McCulloch, drawing on Ludwig von Mises' discussion of how monetary disturbances affect the price level, constructs a mathematical model of the inflationary process under the guise of a moderate quantity theory. The attempt is to develop "a new and somewhat different partial adjustment equation" using microeconomic considerations, although members of the audience may have wondered whether some of Garrison's warnings about the pitfalls of overly simplified macro models could be directed at McCulloch's model as well.

The commentators' remarks and the brief discussion that followed the three papers were both interesting and quite revealing. The chair, breaking from standard practice, acknowledged the presence of the distinguished scholar, Lord Lionel Robbins, for comment. Professor Robbins, somewhat startled from the attention, was sympathetic with the main theme of the O'Driscoll/Rizzo paper and reiterated that Austrians should not be "too exclusive". He was concerned that the Austrial school "tends to disassociate" itself from the rest of the profession even though "there is a lot going on in modern theory today and a lot that deserves to be taken notice of."

But the exclusion that has kept Austrians and other modern economists from fruitful interaction has not been *entirely* the fault of the former disassociating themselves from the latter. In any case, as this session of the A.E.A. eloquently testifies, the modern Austrian school does not see itself as a wholesale rejection of contemporary economics but rather a positive program for its further development.

"Muster-Voraussagen" und "Erklarungen des Prinzips"
(continued)

terms of individual actions, attitudes, and beliefs remains the basis of the theory of complex phenomena. This point deserves special attention because a careless reading of Hayek's "explanatory patterns" might lend itself to a holistic interpretation. Moreover, pattern models of explanation of the holistic type, as expounded in the writings of A. Kaplan and P. Diesing, form the methodological basis of institutional economics. In this connection, it is worth mentioning that the late Jacob Viner, among others, has raised the charge of "historicism" and "social Darwinism" against Hayek in his review of *The Constitution of Liberty (Southern Economic Journal,* 1961).

Figuring prominently on the list of criticisms leveled at the possibility of a social science, the notion of "complexity" has troubled social scientists, and especially economists, for some time. However vague and ambiguous the term may be, it is fairly safe to argue that, in a very broad meaning, it encapsulates all those problems which are held to face the establishment and development of a theoretical social science. More specifically, ever since J.S. Mill's discussion of the moral sciences in *A System of Logic* it has been maintained that the relevant factors in social scientific studies are far too numerous ("plurality of causes") to be ascertained and too rapidly in flux to provide the necessary stable conditions for the separation of causes from contingently accompanying factors. A radical conclusion from these points, which has frequently been drawn, would be the assertion that all phenomena of the social world must be considered unique, thus precluding any satisfactory empirical generalisations.

In "Degrees of Explanation" Hayek argues that in the construction and application of explanatory patterns for typical complex situations we are essentially performing a deductive task, which does not provide us with new knowledge. "What will be new about such a 'new' explanation of some phenomena will be the particular combination of theoretical statements with statements about facts regarded as significant for the particular situation (the "initial" and "marginal conditions"), not any one of the theoretical statements from which it starts. And the problem will not be whether the model as such is true, but whether it is applicable to (or true *of*) the phenomena it is meant to explain." (Hayek, *Studies*, p. 7)

The assertion that a certain explanatory pattern (or model) is applicable is an empirical, and hence falsifiable statement; in this case, "applicability" refers to the phenomenon to be explained rather than to a subsumption of concrete initial conditions to the abstract conditions contained in the if-component of a nomological statement.

On the other hand, Hayek has forcefully insisted on the possibility and indispensability of "abstract" social theory. As Graf notes on p. 46, Hayek sets out to find a solution to the following problem: Given the social scientist's ignorance of the circumstances determining specific outcomes, how is it possible in the disciplines dealing with structures of essential complexity to establish empirical theories which do take the causality of the individually known facts somehow into account instead of assuming them away and relegating them to unspecified *ceteris paribus* conditions? Hayek proposes that instead of aiming at explanations and predictions of individual events, which would require unattainable knowledge of singular circumstances, we should content ourselves with less specific *explananda,* thereby reducing the information required in the *explanans.* "Explanations of the principle" and pattern predictions do not refer to particular events but always to *some* properties of a particular phenomenon.

The far-reaching implications of this position for interventionist policies are obvious. Under the formidable aegis of Erich Hoppmann of the University of Freiberg, the translator of *Competition and Entrepreneurship,* these Hayekian arguments have had a great impact on discussions of antitrust policy in the West German literature.

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"Muster-Voraussagen" und "Erklarungen des Prinzips" (continued)

In "The Theory of Complex Phenomena" Hayek takes pains to point out that "predictions of a pattern are nevertheless both testable and valuable. Since the theory tells us under which general conditions a pattern of this sort will form itself, it will enable us to create such conditions and to observe whether a pattern of the kind predicted will appear." (F.A. Hayek, *Studies in Philosophy, Politics and Economics*, p. 36)

This quotation seems to suggest very clearly that Hayek's "pattern predictions" are statements in the logical form of a universal conditional, or in other words, the general "if-then" statement is subject to falsification, and not only the singular statement that a particular pattern will occur. According to this interpretation, "pattern predictions" and "explanations of the principle" are based on a system of nomological hypotheses about the occurrence of abstract patterns.

Graf argues (p. 84) that the examples which Hayek offers as candidates for potential falsifications of his pattern predictions are misconceived because they merely negate the if-component of the universal conditional, which simply means that the statement is not applicable to this specific example. The author proceeds to demonstrate that Hayek himself has come up with a rather different interpretation of the logical structure of his "explanations of the principle".

To be sure, many questions will still trouble students of Hayek's theory of complex phenomena after having read Graf's essay. Nevertheless, the author is to be congratulated on his admirable job of clarification of a somewhat mysterious, hitherto sadly neglected aspect of Professor Hayek's work. He credits Hayek with having designed a systematic methodology which enables us to do theoretical work in the face of the seemingly insurmountable problems posed by the complexity of social phenomena, contrary to those critics of "scientism" who simply argue that "social science is not 'really' possible." Moreover, Graf succeeds in demonstrating that Hayek's notion of complexity is intimately linked to his familiar notion of competition as a discovery procedure. Substantive and methodological issues cannot be separated in Hayek's theory of complex phenomena. And that is precisely why, in the reviewer's opinion, Hayek's theory is so much superior to the shallow trivialities that many economists—with the notable exceptions of Brian Loasby and Herbert Simon—have written on the subject of complexity.

A Tiger by the Tail: The Keynesian Legacy of Inflation

by F.A. Hayek, compiled and introduced by Sudha R. Shenoy;
San Francisco: Cato Institute, 1979, 176 pp. $4.00.
Reviewed by Robert L. Bradley, Jr.

Over the past five decades, F. A. Hayek has been a notable yet relatively neglected participant in the debates of greatest concern to professional economists and laypersons alike—unemployment, inflation, and the trade cycle. In an expanded reprint recently published, pertinent excerpts from Professor Hayek's writings over this period are collected that in sum constitute a systematic critique of what is called "the Keynesian Legacy of Inflation." Entitled *A Tiger By the Tail*, Hayek focuses on the theoretical case for and consequences of expansionary monetary policy, a policy popularized by J.M. Keynes' *General Theory of Employment, Interest, and Money* of 1936.

Historians of thought will remember that in the early thirties, Hayek and Keynes - and their respective students - carried on theoretical debates in the journals of economics. (An account of this rivalry is provided in J.R. Hicks' "The Hayek Story" in *Essays in Monetary Theory*.) The debate, however, was prematurely ended when Keynes' above work became so methodologically and politically in favor that a nontheoretical victory was achieved over Hayek. The "Revolution" was so complete, in fact, that a discouraged Hayek left economics for social and political philosophy. But with the recent reconsideration of Keynesian theory, in light of the problems Hayek had originally warned against, the once closed debate is reopened with Hayek's contributions as pertinent as ever.

The book under review is distinguished in two different but highly related senses — one methodological and one analytical. After first examining Hayek's methodological positions, we will apply these to his specific criticisms of Keynes' case for expansionary monetary policy.

I. Hayek on Methodology

Throughout all of Professor Hayek's writings - including the rich sampling contained in the present volume - four methodological parameters, explicity or implicity, are to be found.

1) Statistical averages and aggregates are inappropriate in economic reasoning since only within their micro components is causality present. As he states (p. 14): "...none of these [macro] magnitudes as such ever exerts an influence on the decisions of individuals; yet it is on the assumption of a knowledge of the decisions of individuals that... economic theory [is] based."

2) Statistical modeling and testing likewise cannot decide between competing theories since the macro correlations are more coincidental than causal. Hayek speaks (p. 104) of the "complex order of economic life" that for testing makes the necessary *ceteris paribus* postulate impossible to assume, unlike in the laboratory sciences.

3) Economic analysis must study an hypothesized economic situation in its entirety rather than emphasize short run developments only. Hayek recognizes (pp. 33-34) that "what is best in the short run may be extremely detrimental in the long run," and thus to leave the public uninformed regarding the latter would be a "dangerous intellectual error" and "betrayal of the main duty of the economist."

4) Economic analysis must methodologically (not empirically!) assume full employment to understand situations of less than full employment rather than beg the disequilibrium question. Keynes, contrarily, postulated, in Hayek's estimation (p. 101) "full unemployment: the assumption that there normally exist unused reserves of all factors and commodities" and is criticized since "this assumption—makes the whole price system redundant, undetermined, and unintelligible."

The above methodological statements are all antithetical to the Keynesian paradigm. The "model-test" method, suggested more than utilized by Keynes in *The General Theory*, has become the litmus test of theoretical inquiry for this school. Averages and aggregates, handmaidens to the "positivist" method, are assumed to be independent of the microeconomic interrelationships within them.

Further, Keynes' preoccupation was with the short run, indicated by his most famous quotation ("In the long run we are all dead") while his most remembered theoretical novelty was the alleged "escape" from the neo-classical full employment assumption. So all in all, we can appreciate the sharp divergences between Keynes and Hayek regarding method that brought forth the specific arguments we will review below.

II. Hayek on Keynes

Keynes' holistic thinking simplified an economy to the point that his "demand management" idea assumed plausibility. To him, the twin (and supposed-

(continued on page 7)

Unemployment and Monetary Policy: Government as Generator of the "Business Cycle"

by F.A. Hayek, San Francisco: Cato Institute, 1979, 80 pp., $2.00. Reviewed by J.A. Dorn

This reprint is an updated version of the IEA's *Full Employment at Any Price* revised for the American audience, including in this edition a new Preface by Hayek, a concise introductory note on Austrian Capital Theory by Sudha R. Shenoy and an excellent Forward by Gerald P. O'Driscoll, Jr. It is divided into three parts. Part I, "Inflation, Misdirection of Labor, and Unemployment," is a revision of a lecture Hayek delivered in Rome in February, 1975. Part II, "The Pretense of Knowledge," is a reprint of Hayek's 1974 Nobel Address, and Part III, "Unemployment: Inevitable Consequence of Inflation," is a revision of his Rome lecture delivered in the United States in April, 1975. The purpose of these lectures is to make us rethink the fallacies of the now-crumbling Keynesian orthodoxy in order to avoid repeating the same policy errors that have produced the current "stagflation."

In Part I Hayek presents his main policy message of the last 40 years—the impossibility of curing inflation without unemployment. By this Hayek does not mean we should use unemployment to fight inflation; he means that unemployment necessarily follows from inflation's effect on relative prices. The inflationary "full employment" policies followed since the end of World War II present us with three policy alternatives: Allow inflation to accelerate and ultimately destroy the market economy; impose wage-price controls and sabotage the indispensable guiding role of relative prices; or stop expansionist monetary policy altogether and accept the *temporary* increase in unemployment. Hayek, of course, favors the third alternative. His experience with the "Great Inflation" taught him that "the employment created by inflation diminished as soon as the inflation slowed down, and that the termination of the inflation always produced . . . a 'stabilization crisis,' with substantial unemployment" (p. 4). Consequently, Hayek has never been convinced by the Keynesian thesis that employment is determined by total spending.

Hayek offers two reasons why the Keynesian paradigm gained attention vis-a-vis his own theory, which stipulates a direct relationship between above-equilibrium wage rates and unemployment. First, Keynes' theory was statistically tested and found apparently consistent with the facts, while his own theory was "untestable" because equilibrium states are unknown *ex ante.* Hayek therefore contends that "scientistic prejudice" led to the rejection of his "true" theory and the adoption of a "fatal idea": that the cause of unemployment is insufficient aggregate demand rather than a disequilibrium pattern of relative wages. The second reason Hayek gives is that since Keynes' policy prescriptions generate instant benefits, they offer broad political appeal compared to Hayek's call for immediate sacrifice. In Hayek's opinion this is a much stronger reason for the success of the "Keynesian Revolution" that its "scientific" appeal.

Not only does Hayek reject the notion of a permanent trade-off between inflation and unemployment, he sees inflation as ultimately increasing unemployment. In other words, he sees the possibility of an upward sloping Phillips curve in the absence of stabilizing expectations. His explanation is that as inflation accelerates it will introduce more and more distortions into the relative price structure. This "noise" renders the market communications system less useful as a means of efficiently allocating resources. Consequently, more labor and capital will be misdirected and unemployment rates will increase along with inflation. Indeed, empirical evidence has been consistent with this thesis: the inflation rate and unemployment have ratcheted upward in the U.S. over the last 30 years.

In Hayek's view, the most serious consequence of inflation is not the arbitrary redistribution of income, but the misallocation of resources. Indexing would not cure inflation nor would it alleviate its effect on the pattern of relative prices and production. Hayek therefore proposes two policy measures that he believes will generate prosperity without inflation. First, in a departure from his earlier work (e.g. *Prices and Production)* and one that would perplex many "Austrians," Hayek recommends the adoption of a monetary rule in order to stabilize the value of money. He desires a rapid stabilization, but recognizes that for technical reasons the deceleration in monetary growth will probably have to be gradual. Hayek's monetary rule (like Friedman's!) would limit the growth of money to the growth rate of real output. According to Hayek, this policy should be clearly announced in order to dampen inflationary expectations; however, he says, the rule should not be legally binding. We should emphasize that Hayek has not abandoned his affection for the gold standard, but thinks it is impractical in today's atmosphere.

Hayek's second proposal is to re-establish competitive markets through long-run institutional reform. He emphasizes that unless we can reduce union monopoly power and other barriers to entry, unemployment will persist. In modern jargon, he wants to shift the long-run Phillips curve leftward, and reduce the "natural rate" of unemployment by making markets more efficient.

Part II is devoted to an attack on "scientism"—the application of the

Friedrich A. Hayek

methods of the physical sciences to the social sciences—and its contribution to the adoption of Keynesianism. Hayek seems to believe that economic theories are testable in Popper's sense of being refutable, but that they cannot be used to make the same type of predictions as most physical sciences. The best we can hope for is "pattern prediction," rather than prediction of specific numerical results. Nevertheless, many economists have been swayed by the "scientistic attitude" to search for theories that produce numerical predictions.

A Tiger by the Tail
(continued)

Keynesian theory filled this mold and gave rise to numerous forecasting models, while Hayek's did not.

Hayek is not opposed to the use of mathematics in economics. Pareto's equations, he points out, are very useful to illustrate general equilibrium and economic interdependence, but to think that they can actually be solved by plugging numbers into some computer model is absurd. Central planners simply do not have the relevant information that would be necessary to predict exact outcomes in a complex system like the market. This has been one of Hayek's main points during his long career (see "Economics and Knowledge" in *Individualism and Economic Order*). Hayek therefore warns us to be "humble" in our expectations concerning the usefulness of mathematics in economics. We should not be embarrassed by our inability to predict specific outcomes: pattern predictions are useful and can help us avoid costly policy errors.

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Note To The Reader:

We, the editors and staff of AEN, sincerely apologize for the fact that the printing of this issue has been delayed for so long. Due to circumstances beyond anyone's control, however, this delay was unavoidable.

It is our intention to once again get each issue to you on schedule and, of course, to continue in our efforts to provide a useful forum for the communication of Austrian ideas.

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ly opposite) evils of inflation and resource idleness were, in final analysis, an aggregate demand problem that monetary policy could control. (Hayek's interpretation of Keynes, one notices, downplays the other two levers of demand manipulation – government spending and taxing.) In the context of Keynes' 1936 work, despite the adjective *General*, expansionary monetary policy to combat economic depression was the focal point.

Against this, Hayek's view of "easy money," before and after Keynes restated the inflation argument "in an original and apparently much improved form (p. 127)," is that such policies would both create tendencies for unwanted upward price movements and distort the production structure away from underlying consumer preferences. Thus to Hayek, far from being a cure for unemployment, monetary expansion is the root cause of the problem.

Keynes' fundamental error, Hayek argues, was his belief that (p. 101) "the creation of additional money (would) lead to the creation of a corresponding amount of goods." Such an error logically followed the equally specious assumptions it was based upon—the full *un*employment postulate as well as the non-microeconomic view of price changes and the capital structure. But once we admit to the (p. 27) "varying degrees of scarcity", as Hayek postulates, "bottlenecks" and the like allow inflationary pressures to develop within a situation of idle factor capacity. Thus, a rudimentary explanation of "stagflation" is provided. Further, the inherent shifts of relative prices due to the monetary increases employ and reemploy resources that create tensions of reversibility once the impermanent money creation is *anticipated* and/or *slowed*. (See pp. 60-61, 88-89 on this point.) Hayek's cycle theory, stemming from Wicksell and Mises, is elaborated in his other writings, notably *Prices and Production*.

Thus Hayek's analysis of Keynes' program for achieving and maintaining full employment emphasizes the microeconomics of prices and production that the macro method must preclude. But of equal importance is the understanding —also made possible from the microtheoretic point of view—of the existence of "non-fictional" unemployment. To Hayek (p. 123), "the problem of unemployment is in the last resort a wage (read price) problem," *not* an inadequacy of aggregate demand. The cure, then, is to have wages and prices, sectorally, be at market clearing levels. This would translate into lowering wages and prices in surplus situations and *not* as Keynes recommended, depreciating real wages via monetary creation. In this regard, a free market in labor—a "true freedom of association" (p. 78)—is the recommended institutional framework.

III. Hayek on the Future of the Debate

The close interrelationship between the methodological and analytical in his censure of Keynes is fully recognized by Hayek. His dissatisfaction with Keynes' *General Theory* stemmed from (p. 98) "the general (macro) approach followed in the whole work" and not "so much to any detail of analysis." And he believes that his fellow economists will also choose sides on the "Hayek-Keynes" debate because of method rather than detail. As Hayek concludes (pp. 103-104):

> I believe (my debate with Keynes) will be decided not by any future discussions of his special theorems but rather by the future development of views on the appropriate method of the social sciences...I venture to predict that once this problem of method is settled, the "Keynesian Revolution" will appear as an episode during which erroneous concepts of the appropriate scientific method led to the temporary obliteration of many important (read microeconomic) insights which we had already achieved and which we shall then have painfully to regain.

In all, *A Tiger By the Tail* offers the reader a wide ranging review of Keynes' ideas by his then and now principal rival, F.A. Hayek. And since Hicks and others steeped in the Keynesian tradition have tried to emphasize to the profession this rivalry and the need to understand Keynes through understanding Hayek, the book under review should be of great service.

In conclusion, this pamphlet is a useful introduction to Hayek's methodology and his theory of unemployment and the business cycle. The serious reader, however, will want to pursue these ideas further. A good place to start is the recommended reading list at the end of the pamphlet.

with the Austrians, including an appreciation of general economic interdependence, of the problem of coordination, and of the significance of complementarities among capital goods; a concern with actual processes and with the decisions and actions of individual persons; an understanding of why effective use of dispersed knowledge requires

prompts me to make some observations on his writing style. (I regret seeming to criticize Hutt. His message is important and largely correct—far more so than the Keynesianism that until recently was so dominant in scholarship and policy. His article "The Yield from

(continued on next page)