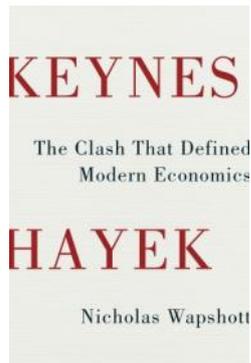


# [Review: Keynes Hayek, The clash that defined modern economics](#) [1]

Type: [Think Pieces](#)<sup>[2]</sup> Written by **Mikko I Arevuo** | Tuesday 3 April 2012



The confrontation between John Maynard Keynes, and his Austrian born free market adversary and friend, Friedrich August von Hayek, is one of the most famous in the history of contemporary economic thought. The debate took place during the Great Depression of the 1930s about the causes and remedies of business cycle downturns in market economies.

The origins of this debate can be traced back to the book 'Treatise on Money' (1930) written by Keynes, a rather obscure book, that was superseded by his masterpiece 'The General Theory of Employment, Interest, and Money' (1936). 'Treatise on Money' was a difficult book to read, and this probably caused Hayek and Keynes to misunderstand each other. As Keynes and Hayek were building their economic models at the same time, their debate was very much dominated by terminological definitions. One of the main topics that Keynes and Hayek corresponded about was the definition of savings and investment, and Hayek wrote three extensive systematic reviews of 'Treatise of Money?'. (1 - footnotes below) In turn, Keynes wrote only one article in response accusing Hayek of misrepresentation. (2)

The debate on 'Treatise of Money' was rather one sided, and in 1932 Keynes withdrew from the debate to reshape and improve his central argument, which was to become 'The General Theory?'. This work became probably one of the most influential economic treatises immortalizing Keynes as one of the greatest 20th century economists. His lasting legacy, that was to become known as Keynesianism, is an economic perspective that argues that private sector decisions sometimes lead to inefficient macroeconomic outcomes. The theory, therefore, advocates active policy responses by the public sector, including monetary policy actions by the central bank, and fiscal policy interventions by the government, to stabilize economic output over a business cycle.

Many Keynesian economists have not regarded Hayek as their man's equal. However, there is an increasing agreement today that Hayek, although controversial, was one of the most influential 20th century economists. He made fundamental contributions to economics in the theory of business cycles, capital theory, and monetary theory. He was also awarded the Nobel Prize for economics in 1974, jointly with Gunnar Myrdal, 'for their pioneering work in the theory of money and economic fluctuations?.'

Most of Hayek's work in the 1930s and the 1940s focused on the Austrian theory of business cycles. He believed that the price system of a free market was an efficient mechanism to coordinate people's actions, and that markets were a result of spontaneous order that had evolved slowly over a long period of time, as a result of economic exchanges between people. Contrary to the statement in Wapshott's book, that the Austrian School economists were more theoretical and mechanistic in their approach to economics, Hayek believed that markets were highly organic, and any interference with the spontaneous order of free markets would distort their efficient operation. In fact, it can be argued that Keynes' economic theory was more mechanistic, as economies could be manipulated in a machine-like fashion to behave according to the wishes of economic planners.

A true Renaissance man, Hayek also made intellectual contributions in political theory, psychology, and methodology. It is perhaps because of his work in political theory that some economists, especially those with a Keynesian orientation, have wrongly dismissed his core economic research as ideologically motivated. This is the trap that Wapshott seems to walk in, either intentionally, or because of Hayek's criticism of the Keynesian model, that had become de facto orthodoxy for the most part of the 20th century, extends many decades, and to some extent, has remained unnoticed, or ignored, by many economists and policy-makers.

Wapshott's book [Keynes Hayek: The clash that defined modern economics](#) <sup>[3]</sup> is a commendable effort to bring economic thought to the attention of the general reading public. It is written in an engaging 'human interest' style, and I am certain it will sell well. Its publication is also well timed, because there has been a marked increase in public interest about economics and economic policy, as a consequence of the 'Great Recession', and sovereign debt crisis that currently grips the world. And this is where the book fails to deliver. A reader should not expect any great insight into how Keynesian or Hayekian economics could be applied in today's economic situation beyond 'truly Keynesian', e.g. political, government policy interventions, as outlined in Wapshott's book.

Nevertheless, the book provides a delightful insight into the personalities of Keynes and Hayek. Keynes is portrayed as a privileged and bright economist at the top of his game effortlessly moving between academia, political elites, and his bohemian 'Bloomsbury group' of friends. Hayek, however, is painted as a stiff, humorless, theoretical, and linguistically challenged, central European scholar, brought to London School of Economics (LSE) by Lionel Robbins to provide an alternative to the theories of Keynes and his 'Cambridge circus' of almost evangelical followers. (3) Robbins, and the dons of the LSE, considered Keynes' view that when free markets were left to their own devices, this sometimes caused economic slumps, and that decisive government action was needed to pull the economy back to an equilibrium state of full employment, as heresy. In contrast to Keynes, the Austrian economists thought that free markets, driven by people's choices tended to adjust to equilibrium if left alone, and free from government intervention. Concerned with the increasing intellectual and policy influence by the new generation of Keynesian economists at Cambridge, Hayek was appointed to LSE to counterbalance Keynesian interventionist doctrine.

Much of Wapshott's book is about the political philosophy that divided Keynes and Hayek in terms of the role of the government in the running of an economy. Much less is spent on understanding the economics upon which the big-picture conflict was based. Indeed, Wapshott overemphasizes Hayek's 1944 book 'The Road to Serfdom', on the dangers of socialism. This book was written after Hayek moved to Britain where he observed that many British socialists were advocating some of the same policies of government control that had been advocated in Germany in the 1920s. His basic argument was that government control of people's economic lives was a form of totalitarianism: 'Economic control is not merely control of a sector of human life which can be separated from the rest'. it is the control of the means for all our

ends? (1944). The book became a best seller in the USA and it established Hayek as a leading classical liberal, or 'libertarian', as he would be called today. However, the success of the book, which was serialized in 'Reader's Digest', typecast Hayek as a free market ideologue, detracting attention away from his scientific contribution in economics.

Wapshott provides a 'workmanlike' description of Keynes' theory, but his treatment of Hayek's economics and the critique of 'The General Theory', is woefully inadequate. The fundamental tenet of 'The General Theory' is that there is a direct and positive relationship between employment and the aggregate expenditure in an economy. Therefore, according to Keynes, total demand determines the employment level in the economy, and the existence of unemployment indicates that aggregate demand is insufficient to employ all factors of production. Keynes considered that the capitalist system was volatile, and there were times when the level of demand would be insufficient to maintain full employment. Therefore, Keynes recommended that the public sector should address this by controlling the level of aggregate spending in the economy. His recommendations to reduce unemployment can be categorized as follows:

' Interest rates should be reduced as far as possible to encourage private investment;

' A progressive tax system should be used to divert income from the wealthy to the lower paid, as their propensity to consume is higher; (4)

' The government should actively participate in public investment activity to supplement private investment, should this prove insufficient to maintain a level of aggregate expenditure that corresponds with full employment.

After the publication of 'The General Theory', Hayek did not critique Keynes' work as was expected; this he regretted ever after (Hayek in Sanz-Bas, 2011). However, Hayek's critique of Keynes is incorporated into many of his works including 'Monetary Nationalism and International Stability' (1937), 'Profit, Interest, and Investment' (1939), 'The Pure Theory of Capital' (1941), 'The Campaign Against Keynesian Inflation' (1974), 'The Fatal Conceit' (1988). (5) It is perhaps because of the extended period of Hayek's writing that Wapshott fails to provide a full account of Hayek's economic thinking in general, and the critique of Keynesian theory in particular.

It is beyond the scope of this review to discuss Hayek's critique in detail. However, one of Hayek's main criticisms of 'The General Theory' was about Keynes' assumption that unemployment could be solved through increases in aggregate spending. Keynes linked aggregate spending with employment; if spending in the economy was increased sufficiently, this would result in workers getting their old jobs back, and the economic crisis would be averted. In contrast to Keynes, Hayek argued that the crisis was a direct result of the misallocation of resources during the previous economic booms. Hence, Keynes' solution to reestablish the same distribution of resources would not provide a sustainable solution to unemployment. The only solution to systemic unemployment, according to Hayek, required a liquidation of wrong investments and reallocation of productive resources. To quote Hayek:

*'If the real cause of unemployment is that the distribution of labour does not correspond with the distribution of demand, the only way to create stable conditions of high employment which is not dependent on continued inflation (or physical controls) is to bring about a distribution of labour which matches the manner in which in which a stable money income will be spent?' (1950).*

What we can infer is that Keynes' solution to economic crises was a short-term panacea, while Hayek advocated a market driven solution that would result in a more sustainable productive economic structure.

Such a structure would be consistent with consumer preferences. Trade cycles, according to Hayek, were a result of the government interference with the spontaneous order of the markets. Hence, the only way to avoid booms and busts, trade cycles, is to prevent them from occurring in the first place.

Wapshott concludes his book by crediting Keynes for 'saving capitalism a second time'. He makes a reference to Keynesian doctrine for solving the Great Depression, and the applicability of the same dogmatic panacea for the Great Recession from the 2008 onwards. He conjures the ghost of the Keynesian high priest, John Kenneth Galbraith, who scolds conservatives in the English-speaking countries for embracing Hayekian economics: 'better to accept the unemployment, idled plants, and mass despair of the Great Depression, with all the resulting damage to the reputation of the capitalist system, than to retreat on true principle'. What Wapshott misses in his argument is Hayek's central proposition: booms and busts are a result of malinvestment created by the government interference in the operation of free market, a result of the very policies advocated by the dogmatic Keynesians of today.

In contrast to Wapshott's conclusion, I leave the reader with Hayek's comment, that is particularly appropriate to this review:

*'I find myself in an unpleasant situation. I had preached for forty years that the time to prevent the coming of a depression is during the boom. During the boom nobody listened to me. Now people again turn to me and ask how we can avoid the consequences of a policy about which I had constantly warned. I must witness the heads of governments of all Western industrial countries promising their people that they will stop the inflation and preserve full employment. But I know that they cannot do this. I even fear that attempts to postpone the inevitable crises by new inflationary path may temporarily succeed and make the eventual breakdown even worse' (1979).*

Footnotes:

1. Hayek, *Economica*, August 1931; *Economica*, February, 1932; *Prices and Production*, 1931
2. Keynes, *Economica*, November 1931. *Keynes on Prices and Production: 'The book as it stands, seems to me 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.'*
3. *A critical reader of the book can't help notice the leading language used by Wapshott from the start. Keynes is described to have a 'commonsense understanding', while Hayek is described as 'intellectual', rather than practical. Keynes is motivated by understanding 'real life dilemmas' and 'improving the lives of others', whereas Hayek is boxed in as a 'theoretician'.*
4. *Keynes assumed that as incomes rise, people tend to save more. Therefore, the society's propensity to consume reduces as more of the income is saved. As a result, the society's investment multiplier will be lower. According to Keynes, the market mechanism is incapable to connect savings with investment. Instead, investment is dependent on business expectations and the creditors' liquidity preferences that determine interest rates. As a result, the capitalist system is prone to suffer from a systemic lack of demand and, as a consequence, a chronic level of unemployment.*
5. *For further discussion: Cochran, J. P. (2011) 21st century boom-bust and recession-recovery; Sanz Bas, D. (2011) Hayek's critique of Keynes; Caldwell, B. (1998) the reasons why Hayek did not critique 'The General Theory'.*

References:

Caldwell, B. (1998) *Why didn't Hayek review Keynes's General Theory*, *History of Political Economy*, 30:4.

Cochran, J. P. (2011) *Hayek and the 21st century boom-bust and recession-recovery*, *The Quarterly Journal of Austrian Economics*, Vol. 14: 3.

Hayek, F. A. (1944) *The road to serfdom*, Routledge, New York (2007)

\_\_\_\_\_. (1950) *Full employment, planning, and inflation*. In *Studies in Philosophy, Politics, and Economics*, University of Chicago Press, Chicago.

\_\_\_\_\_. (1979) *Unemployment and monetary policy: government as generator of the business cycle*, Cato Institute, San Francisco.

Sanz-Bas, D. (2011) *Hayek's critique of the general theory: a new view of the debate between Hayek and Keynes*, *The Quarterly Journal of Austrian Economics*, Vol. 14: 3.

---

**Source URL:** <http://www.adamsmith.org/research/articles/review-keynes-hayek-the-clash-that-defined-modern-economics>

**Links:**

[1] <http://www.adamsmith.org/research/articles/review-keynes-hayek-the-clash-that-defined-modern-economics>

[2] <http://www.adamsmith.org/research-type/think-pieces>

[3] <http://www.amazon.co.uk/Keynes-Hayek-Defined-Modern-Economics/dp/0393077489>