

Macro Economics II Assignment

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Present a report which outlines and evaluates the main contributions Friedrich Von Hayek (1889-1992) made to our understanding of macro economics.

The Austrian born economist Friedrich Von Hayek presented some of the most influential theories on markets in the 20th century. As a defender of the free market and of classical liberal principles he believed that we must move away from a state-controlled or “planned” economy and towards a society based upon freedom of association and exchange according to the rule of law. He is credited as being the “most prodigious classical liberal scholar of this century” and has been described as the central pioneering figure in changing the course of economic thought in the twentieth century.” (Thomas Sowell, 1995).

Hayek was born in 1899 in Vienna into a family of intellectuals. After serving in the army of World War I, he studied and received doctorates in law, psychology and economics from the University of Vienna (1921-1923). It was at this time that the theories of the Austrian School of Economics were being formulated and refined by Eugen Boehm, Friedrich Wieser and Ludwig von Mises, all of whom were second generation Austrian Economists. The Austrian economists believed that their view could be distinguished to that of the neo-classicalists by 5 major points; radical subjectivism, methodological individualism, purposiveness in human action, casual-geneticism and methodological essentialism. While studying in Vienna, Hayek view on socialism changed radically as a result of his exposure to the works of Ludwig von Mises. Initially sympathetic to socialism, his economic thinking was transformed during his student years. Mises was to become not only an intellectual companion to Hayek but also a

major influence in his work. Some say that Hayek's work can be thought of as "an attempt to make explicit what Mises left implicit, to refine what Mises had outlined, and to answer questions Mises had left unanswered." Hayek himself stated of Mises that; "there is no single man to whom I owe more intellectually." From 1922 to 1927 Hayek worked under Mises in a government office. In 1927 he became the Director of the Institute for Business Cycle research which he and Mises had set up together. It was during this time that Hayek made some of his first important contributions to our understanding of macroeconomics.

Hayek started his work in refining the technical understanding of capital coordination and the institutional details of credit policy which Mises had begun in his book "The Theory of Money and Credit". Hayek's first book "Monetary Theory and the Trade Cycle" (1920) analysed the effects of credit expansion on the capital structure of an economy. The Mises-Hayek theory of the trade cycle explained the "clusters of errors" that characterises the cycles. "Credit expansion, made possible by the artificial lowering of interest rates, misleads businessmen; they are led to engage in ventures that would not otherwise have appeared profitable. The false signal generated by the credit expansion leads to mal-coordination of the production and consumption plans of economic actors. This mal-coordination first manifests itself in a 'boom' and then, later, in the 'bust' as the time pattern of production adjusts to the real pattern of savings and consumption in the economy." Soon after publication of the book Hayek was called to give lectures in the London school of Economics. His lectures there were published in a second book "Prices and Production" (1931) which was cited by the Nobel Prize Committee in 1974. His lectures in the London School of economics were received with such acclaim that he was

called back to the prestigious University and appointed Tooke Professor of Economic Sciences and Statistics. He was to serve as that institutions answer to Cambridge's John Maynard Keynes. Hayek was only 32 at the time and had already reached what many believed to be the pinnacle of the economic profession.

At the time in England, Keynes was credited by the academic community as the author of many serious books on economics. His essay "the end of Laissez-Faire", (1926), presented his argument for active government intervention in economic affairs. Keynes was heralded as the "saviour of capitalism" amongst his colleagues rather than being recognised as the advocate of inflation that he was. Hayek disagreed immensely with the theories that Keynes held and the Hayek-Keynes debate became the most fundamental debate in monetary economics in the 20th century. Hayek felt that the problem with Keynes economics was his failure to understand the role that interest rates and capital structure play in a market economy. Hayek felt that Keynes had failed to address these issues adequately in his book "A Treatise on Money", (1930). Hayek pointed out that "Keynes's aggregation tended to redirect the analytical focus of the economist away from examining how the industrial structure of the economy emerged from the economic choices of individuals." Keynes did not take kindly to Hayek's criticism. He and Sraffa joined forces and attacked Hayek's "Price and Production", in an attempt to bury both Hayek and his cycle theory. Keynes then claimed he no longer believed what he had written in "A Treatise on Money", and turned his attention to writing another book, "The General Theory of Employment, Interest and Money", (1936), which in time became the most influential book on economic policy in the 20th century. The publication of this book totally altered the terms of the debate. Hayek then turned his attention to refining

capital theory rather than criticising what Keynes had presented in his general theory. “Hayek was convinced that the essential point to convey to Keynes and the rest of the economic profession concerning monetary policy lay in capital theory. Thus Hayek proceeded to set forth his thesis in *The Pure Theory of Capital* (1941).” In this publication he further explained the origin of the business cycle in terms of central bank credit expansion and its transmission over time in terms of capital misallocation caused by artificially low interest rates. The book also attempted to develop a joint theory of investment and capital. However correct his assessment may have been, this book, Hayek’s most technical, was his least influential. The book inexplicably failed to sell. At this time Keynes’s brand on economics was on the rise. It appeared that in the eyes of the public Keynes had defeated Hayek and Hayek lost his standing in the profession. The “*Pure Theory of Capital*” proved to be Hayek’s last substantial effort in the area of theoretical neoclassical economics.

During this time Hayek was also involved in another grand debate sparked from Mises’ denial that “a socialist economy could price its goods and services in accordance with the principles of relative scarcity.” (Blaug, 1988, p88). This debate was known as the socialist calculation debate. Mises wrote, in his famous article “*Economic Calculation in the socialist Commonwealth*” (1920), that “pricing systems in socialist economies were necessarily deficient because if government owned the means of production, then no prices could be obtained for capital goods as they were merely internal transfers of goods in a socialist system and not objects of exchange, unlike final goods and thus they were unpriced and hence the system would be necessarily inefficient.” Mises refined his argument in his 1922 publication “*Socialism: An Economic and Sociological Analysis*”.

Hayek was profoundly impressed by Mises work in this area and set about developing Mises argument further in several essays in the 1930's. In these essays Hayek claimed that "prices are not merely rates of exchange between goods but rather a mechanism for communicating information." (Hayek, 1945). He argued that people have little knowledge of the world beyond their immediate surroundings and this is what forces them to be price takers, this is the crucial ingredient that makes the price system work. Again the economic profession did not appreciate Hayek's criticisms. The planned society envisioned under socialism was not only supposed to be as efficient as capitalism but it promised to be fairer. Socialism was considered the wave of the future and Hayek's apparent lose in the Keynes debate had lost him the credibility he needed to be recognised as the correct party on the Socialist calculation debate. Fortunately Hayek could not be discouraged and he continued to refine his argument for the liberal society. The problems of socialism that he had observed in Nazi Germany led him to write "The Road to Serfdom" in 1944. This publication won Hayek "monetary notoriety as a political thinker and marked the beginning of his later rise to leadership in the world wide libertarian movement." (Blaug, 1988, p89).

"The Road to Serfdom" was a polemical defence of laissez-faire. In the book he argued that those who would rise to the top in a socialistic regime would be those who had a comparative advantage in exercising discretionary power and were willing to make unpleasant decisions. He claimed that socialism had a strong probability of leading towards totalitarianism because central planning could not be restricted to the economic sector and would eventually affect social life as well. Hayek wrote that "totalitarianism is not an historical accident that emerges solely because of poor choice of leaders under a

socialist regime.” He showed that it is a logical outcome of the institutional order of socialist planning. He pointed out the need for market prices as conveyors of dispersed economic information. He also showed that attempts to replace or control the market lead to a knowledge problem.

In 1950 Hayek moved to the University of Chicago where he taught until 1962. While there he wrote “The Constitution of Liberty” in 1960. This work was “a major statement of modern liberalism, which shocked many readers by its effective criticism of inheritance taxation and high marginal rates of income taxation.” (Blaug, 1988, p89). In 1962 Hayek moved to Germany where he had obtained a position at the University of Freiburg. It was at this time that Hayek centred his efforts on examining the “spontaneous” ordering of economics and social activity. This idea encompassed the “belief that a harmonious, evolving order arises from the interaction of a decentralised, heterogeneous group of self seeking agents with limited knowledge.” This order, he claimed, “was not designed nor could be designed by a social planner, but merely emerged or evolved spontaneously from a seemingly complex network of interaction among agents with knowledge.” That is to say that the market is a spontaneous order, the result of human action, but not of human design. From this theory of spontaneous ordering Hayek had set about to reconstruct liberal social theory and to provide a vision of social cooperation among free individuals. Hayek continued his work on evolving order and linked it with political and legal theory. As a result of this work Hayek is commonly referred to as the founder of evolutionary economics.

Hayek spent the remainder of his years in Germany. In 1974 he received a Nobel Prize with Gunnar Myrdal. Interest in Hayek and his work increased after the 1974 award and has kept on that track right up to the present day. Hayek lived long enough to see his rivals; socialists and Keynesians eventually defeated, and the re instatement of Classical Liberalism as a vibrant body of thought. The collapse of communism in Eastern Europe furthered the much deserved credibility of Friedrich von Hayek's theories.

Hayek has been one of the most influential economists of the 20th century and is often referred to as the Adam Smith of the 20th century. While speaking about Hayek, Milton Friedman the Noble Prize winner wrote; "I think the Adam Smith role was played in this circle (the late 20th century collapse of socialism in which the idea of free-markets succeeded first, and then special events catalysed a complete change of socio-political policy in countries around the world) by Friedrich von Hayek's *The Road to Serfdom*." Hayek can be credited with many distinguished accomplishments. He can be regarded as the key figure in the 20th century revival of liberalism. He played the lead role in the current tide change away from statism and back to liberalism which is regarded by many as a defining event of the 20th century.

Hayek contributed greatly to our present day understanding of macroeconomics. He emphasised the importance of prices. He explained that the price system reflects the imbalance of demand and supply, and it automatically steers resources to where they are most needed without the need for planners to discover, understand, and correct the imbalance. He showed that competition was a dynamic process in which people are constantly searching to discover the cheapest mix of resources to produce the most

desired output. Hayek highlighted the advantages of markets over planning. He demonstrated that the planned economy rests on the unlikely assumption that everyone can agree what to produce unlike the market exchange which works because people value things differently. It is around these basic principles that Hayek based his theories which have earned him the renowned respect as one of the most masterful economists of his time.

Hayek's reputation has gone through a remarkable cycle as has the popularity of his work. He has provided the present day world with many foundations on which to build our understanding of economics, he truly was the political economist that economics had not seen since Adam Smith.

References

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