

Notes

1. Patrick J. Buchanan, *A Republic, Not an Empire* (Washington, D.C.: Regnery, 1999).
2. Vreeland Hamilton, *Hugo Grotius: The Father of the Modern Science of International Law* (New York: Rothman, 1986).
3. Sally might have taken more notice of Röpke's advocacy of the gold standard, which may have helped explain why he was opposed to flexible exchange rates. For under the gold standard, there is a single monetary standard to use in world trade, even though it differs in name and unit of measurement.
4. Philip Cortney, *The Economic Munich: The I.T.O. Charter, Inflation or Liberty, the 1929 Lesson* (New York: Philosophical Library, 1949).

The Hayek-Keynes Debate Lessons for Current Business Cycle Research

John P. Cochran and Fred R. Glahe
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Professors John P. Cochran and Fred R. Glahe undertake the formidable task of comparing and contrasting Hayek's and Keynes's approach to trade-cycle theory. In addition, they include a thorough discussion of the relative differences between the classical and the neoclassical approaches to the business cycle.

There is a general introduction followed by a brief exposition of the "Wicksell connection" and of objections by Hayek and Keynes to classical monetary theory and quantity equation, chiefly over the methodology of separating monetary and value theory. The subsequent chapters provide a Hayekian interpretation of the methodology and foundations of trade-cycle theory; the role of capital theory in trade-cycle theory; the self-reversing nature of a monetary change; crisis, unemployment, and policy implications; use of equilibrium in trade-cycle theory; and lessons for contemporary theorists from the Hayek-Keynes debate. One advantage of this organization is that the authors were able to present Hayek's theory in detail. However, the principal disadvantage of this format is that a fair

amount of repetition occurs. The concluding chapter attempts to synthesize the material in the preceding chapters.

According to the authors, Keynes and Hayek rejected the early classical model as an essentially tautological quantity equation that dealt mostly with changes in price level. The classical model, they believed, ignored the Wicksellian transmission mechanism and lacked a theory of capital. The classical resurgence yielded the natural unemployment rate hypothesis, rational expectations, real business cycle models, and supply-side economics. These theories predicted that any fully anticipated monetary policy would be ineffective. Changes in the rate of monetary growth would not cause the rate of unemployment to diverge from its "natural rate" without a continuously accelerating rate of inflation or deflation. The natural-rate hypothesis further implies that the effects of a non-accelerating monetary disturbance will be self-reversing. Expansion of the money supply at a constant rate will cause the economy first to expand and then to contract without further exogenous changes; and vice versa for a monetary contraction. This theory, like Hayek's, explains a trade cycle in terms of a response to a single shock. In the long run, policy is ineffective because real phenomena dominate the purely monetary ones. The savings-investment-interest rate mechanism deals with the allocation of output, is not a determinate of aggregate output or the price level, and is not needed to explain macro disturbances. The interest rate mechanism can be relied upon to coordinate inter-temporal decisions of households and firms. Macro adjustment processes remain in the form of causal relationships among broad aggregates. As in Keynesian models, questions regarding capital problems and the time structure of production are essentially ignored.

The alternative models of Hayek and Keynes used the Wicksellian savings-investment-interest rate mechanism as a basic tool of analysis; but their explanations of the economic process and policy prescriptions were diametrically opposed. Hicks observed, "Wicksell plus Keynes said one thing, Wicksell plus Hayek said quite another" (9). At one key juncture Hicks proposed a rhetorical question, "Which was right, Keynes or Hayek?" (v)

In the Cochrane and Glahe interpretation, Keynes's analysis turned to the financial markets, following his use of the Wicksellian transmission mechanism. It does not appear that Keynes had a theory of capital. He felt that the money rate of interest was the determining factor in the business cycle, as the real variables were forced to adjust to the money rate. Keynes believed that, "The available money capital is influenced by the public's demand for liquidity," which would "... create a general tendency for the rate of interest to exceed the natural rate" (186). Thus, he predicted, "... banks and credit institutions

can maintain the rate of interest at a level not consistent with the natural rate, and as a rule the rate will tend to be above the natural rate" (187). If either the money rate is above the natural rate or entrepreneurs underestimate future returns, the level of investment will be less than that required for full employment. There will be underinvestment and involuntary unemployment. Some monetary disturbances will not be corrected because consumption and investment will change in the same direction. Since Keynes thought such monetary influences would persist, policy intervention would be needed and may be effective.

Given that central banks over the last fifty years have been mostly engines of inflation, the Keynesian bias toward underinvestment and unemployment may have led neoclassical economists to regard Keynes's *General Theory* as a special theory of depression. The authors observe that, "Leijonhufvud ... has argued that the correct Keynesian response to the challenge of the new classical approach is the re-introduction of the savings-investment mechanism to the policy effectiveness debate" (194).

Three features of Hayek's trade-cycle theory stand out. First, it can be considered a microeconomic theory because it employs the conceptual apparatus of "methodological individualism." Second, it includes a self-reversing process to a monetary change and so couples the short run with the long run. Third, it incorporates a theory of capital. Yet, the authors admit, "Hayek, himself, was not entirely successful" in "[d]elineating in a simple and understandable way a complete trade cycle which depends on the interaction of capital and monetary phenomena..." (106).

The regular wave like changes in economic activity are explained using ... the individualistic method.... Economic events can only be explainable in terms of 'individual human actions'. Economic analysis should lie 'bare the true causal relationships at work in the social world' and not be 'content to simply establish empirical regularities among dubious statistical aggregates'" (155).

According to Cochrane and Glahe, the role of money and time are two basic elements in Hayek's trade-cycle theory. Money injects indirect exchange and time involves uncertainty and expectations in a dynamic process. Hayek and Keynes believed that, "... the faith in, or justification for, self-adjusting markets in a monetary economy cannot be based on the existence of equilibrium in a perfect foresight, perfect competition, economic model (or its modern rational expectations equivalent)..." (178).

Hayek, like Keynes, followed the Wicksellian transmission mechanism regarding saving, investment, and interest rates. Whereas Keynes expected the public's liquidity demand and the banking system's practices to maintain the money rate of interest, noted above, Hayek proceeded from an expansion of money credit that would result in a money rate of interest below the equilibrium rate. The consequence would be an increase in investment as entrepreneurs first respond to misleading signals in the price system, which would likely move the economic system away from its long-run equilibrium. By injecting a theory of capital, which involves both the structure and the stages of production, Hayek expected this additional investment to change the quantity and the form of investment. Then, as spending in the economy proceeds to the several factors of production, consumer incomes would increase. As the next round of spending reflects consumer preferences, misallocation of resources will be exposed. The real factors overcome the monetary ones and thus a reversal occurs, coupling the short run with the long run. Because of the specific nature of capital in the investment industries, which cannot be reallocated promptly to the production of consumer goods, unemployment may occur. A crisis will develop if the boom is permitted too long, so the role of policy is to prevent that eventuality. Otherwise the self-reversing process will move the economy back toward equilibrium so that intervention would be unnecessary. In fact, ill-conceived intervention could intensify both the rate of unemployment and economic instability. One may wonder whether, according to Austrian trade-cycle theory, if there is conflict between the role of consumer sovereignty and the ease by which entrepreneurs are misled in their investment decisions by a lower money rate of interest.

The authors observe that Hayek's Nobel Prize was awarded in part for his work on the business cycle, but this may not have been the strongest aspect of his economic theory. But, then again, neither is business cycle theory one of the stronger branches of economics. It is also difficult to find in the last fifty years of economic history "regular wave like changes in economic activity."

In the last seventeen years the United States economy has experienced one mild, short recession (1990 through 1991), triggered by a congruence of events including an untimely tax increase. The recessions since World War II may be attributed to non-monetary disturbances (shocks, such as oil prices during the years 1973 to 1975) or to the central bank's first sudden increase in the money supply and subsequent restriction of monetary flow (evident during the years 1969 to 1970 and again from 1981 to 1982, which followed the 1980 credit crunch). The United States experience of these last seventeen years suggests that if the central bank maintains a stable price level, recessions can be minimized,

if not avoided, as the economy's markets closely approximate those of the competitive model. The flexibility (adjustability) of a decentralized competitive economy in which individual consumer and producer units respond to the information markets supply (as in Hayek's article on "The Use of Knowledge in Society")¹ may yield a workable substitute for the perfect foresight of pure theory.

Was Keynes's or Hayek's response to the Wicksellian mechanism correct? In Bruce Caldwell's judgment, neither was correct (v). Yet, according to Roger W. Garrison, Hayek's perspective superior because it allowed for "... a real coupling between the short run and the long run in Austrian theory" and "because of its ... identifying the relative-price effects ... of a monetary disturbance..." (vi). Even so, in the absence of regular cyclical behavior in recent economic history and in view of the shortcomings of seventy years of cycle research and theory, it may be better to follow the neoclassical approach, which argues that neither Keynes nor Hayek was right.

However, for those who wish to pursue further research on the trade cycle and to "... redevelop a capital-based macroeconomics" (196), a reexamination of the Austrian, Misesian, and especially Hayekian theories of capital and the trade cycle deserve careful review, as Cochrane and Glahe suggest. If so, Cochrane and Glahe's work on the Hayek-Keynes debate provides an excellent entry point for further reflection.

Note

1. F. A. Hayek, "The Use of Knowledge in Society," *American Economic Review* 35, 4 (September 1945).