

Business Cycle, Capital Theory and Extended Order in Hayek's Economic Thought

Sergio Noto – Dipartimento di Economie, Società e
Istituzioni – Università di Verona

Hayek's business cycle theory: a survey

- Business cycle is now very popular
 - Crisis make cycle interesting
- BCT in Hayek's thought is fundamental
 - Connected with CT
 - **1929:** *Geldtheorie und Konjunkturtheorie*, Wien und Leipzig, Hoelder-Pichler-Tempsky
 - **1928:** *Das intertemporale Gleichgewichtssystem der Preise und die Bewegungen des "Geldwertes"*, «Weltwirtschaftliches Archiv», XX-VIII, n. 2, pp. 33-76. in English as: *Intertemporal Price Equilibrium and Movements in the Value of Money*
 - *Einige Bemerkungen über das Geldtheorie zur Konjunkturtheorie*, «Schriften des Vereins für Sozialpolitik», CLXXIII, n. 2, pp. 247-294.
 - *Gibt es einen "Widersinn des Sparens"?* Eine Kritik der Krisentheorie von W.T. Foster und W. Catchings mit einigen Bemerkungen zur Lehre von dem Beziehungen zwischen Geld und Kapital, «Zeitschrift für Nationaloekonomie», I, n. 3, pp. 387-429 [1931. «Economica»]

Survey: part II

- **1929:** Review: WILHELM ROEPKE, *Die Theorie der Kapitalbildung*, «Zeitschrift für Nationalökonomie», I, n. 3, pp. 474-475
- **1931:** *Prices and Production*, London, Routledge & Sons.
- *Reflections on the Pure Theory of Money of Mr. J.M. Keynes*, «Economica», XI, n. 33, pp. 270-295.
- *The Pure Theory of Money: A Rejoinder to Mr. Keynes*, «Economica», XI, n. 34, pp. 398-403
- **1932:** *Reflections on the Pure Theory of Money of Mr. J.M. Keynes (continued)*, «Economica», XII, n. 35, pp. 22-44
- *Das Schicksal der Goldwährung*, «Deutsche Volkswirt», VI, n. 20, pp. 642-645 e n. 21, pp. 677-681. *The Fate of the Gold Standard*
- *Money and Capital: A Reply*, «Economic Journal», XLII, pp. 237-249
- *Kapitalaufzehrung*, «Weltwirtschaftliches Archiv», XXXVI, pp. 86-108. *Capital Consumption*
- *A Note on the Development of the Doctrine of “Forced Saving”*, «Quarterly Journal of Economics», XLVII, pp. 123-133.

Capital and cycle

- **1933:** *Monetary Theory and the Trade Cycle*, London, Jonathan Cape, English modified edition of GK
- *Der Stand und die nächste Zukunft der Konjunkturforschung. Festschrift für Arthur Spiethoff*, hrsg. GUSTAV CLAUSING, München, Duncker & Humblot
- *Über "Neutrales Geld"*, «Zeitschrift für Nationalökonomie», IV, n. 5, pp. 655-661. Traduzione inglese: *On «Neutral Money»*, in MCF. English modified version: *Some Supplementary Remarks on «Neutral Money»*, in PP, 2° ed., Appendix to Lecture IV.
- **1934:** *Capital and Industrial Fluctuations*, «Econometrica», II, n. 2, pp. 152-167
- **1939:** *Profits, Interest and Investment, and Other Essays on the Theory of Industrial Fluctuations*, London, Routledge & Kegan Paul.
- **1941:** *The Pure Theory of Capital*, London, Routledge and Kegan Paul.

Germans and Austrians

- Not a pure Austrian BCT (Böhm- Bawerk and Mises)
- BB 1884: Capital and Interest: History and critique of interest theories
- Mises 1912: Theory of Money and Credit
 - Much more a monetary theory
- Mises key figure: theoretically influential and professional supporter of H.
 - Austrian Institute for Business Cycle Research (1927)
 - Germany 1925: Wagemann in Berlin Institute for Business Cycle Research
- German and other influences on Hayek (Spiethoff and Schumpeter)
- Second great influence: 1931 Lionel Robbins and LSE
 - Hayek's lecture in London 1931 (cit. Ebenstein p. 53)
 - A triumph
 - But the beginning of a new era

A peculiar (happy ending) story

- An Austrian gentleman in England
 - Involved in quarrels between LSE and Cambridge, Robbins and Keynes
 - Hayek supported new LSE leading (too much!)
 - Unpolite with Keynes
 - Hayek accepted to be a mean in the battle between LSE and Cambridge and never changed his mind; Robbins and LSE on the contrary changed their minds, left Hayek alone.
 - The Road to Serfdom (1944), Hayek abandoned technical economics, focus on the theoretical and epistemological basis of economics
- Nobel Memorial Prize:
 - «Professor Hayek's contribution in the field of economic theory are both profound and original ... he tried to penetrate more deeply into the business cycle mechanism than was usual at that time. Perhaps partly due to this more profound analysis, he was one of the few economists who warned about the possibility of the major economic crisis before the great crash came in the autumn of 1929

Vertical maladjustments

- USA and Europe, great economic boom 1922-1929
 - After boom, deficit spending. USA protectionism (Smooth-Hawley Tariff) no Gold Standard
 - High inflation Germany, Austria. Germany: chancellor Brüning deflated economy to get rid of reparations
- Key concept Hayek's BCT: *vertical maladjustments of production structure*
 - *Inflation depresses the rate of interest below its equilibrium level. This leads to overinvestment in the earlier stages of production (in an Austrian perspective «to a lengthening of period of production») and involves an unsustainable use of forced savings.*
 - The boom can be prolonged by ever-larger inflationary injections, but the longer it lasts, the more severe and painful the unavoidable crisis.
- INFLATION doesn't mean RISING PRICES
- INFLATION mean RISING QUANTITY OF MONEY

Secondary deflation and unemployment

- During Seventies (1974: “Full Employment at any price?”) clarified that he rejects employment as a direct and simple function of what is called aggregate demand, and that could be sufficient to keep a high level of aggregate demand to secure lastingly full employment
- Structural unemployment(<4%) due to maladjustments and unemployment caused by secondary deflation
- Capital theory: low (artificial) interest rates → unproductive investments → permanent change capital structure → unemployment
- Deliberate attempts to maintain money stream are not appropriate ... we shall not get a functioning economy until wages are flexible
- Secondary deflation in the medium long period determines depression and unemployment becomes general
- We have insufficient data (still today) in several economic demonstrations, but we still prefer to believe that our theoretical assertions are true, even if they are not seriously statistically tested (Hayek’s epistemology, e.g. “The Pretense of knowledge” 1974)

Hayek-Ricardo effect

- “Profits, Interest and Investment” H. discusses Ricardo effect, later called Hayek-Ricardo effect or concertina effect:
 - «machinery and labour are in constant competition, machinery can frequently not be employed until labour rises = in conditions of full employment an increase in the demand for consumer goods will produce a decrease in investment and vice versa»
- H. explains the upper turning point of the cycle:
 - 1. prices rise faster than money wages = decline
 - 2. shift in the method of production = maladjustment in the structure of production, drop investments, reallocation of labor, downswing
 - 3. wage rigidity is the main problem, overgenerous unemployment benefits keep wages too high, human capital most important development factor
- An Austrian explanation:
 - + wages = + machinery = - protection = lengthening period of production
 - - wages = - machinery = + protection = shortening period of production

Neutral money

- Inflation/deflation:
 - Inflation is first of all a disequilibrating factor
 - Depresses the rate of interest below the equilibrium level
 - Investment exceeds voluntary savings, imposes «forced savings»
 - NB: we must allow price level should decline so as to reflect the secular growth of output and employment
- Central Banks' role:
 - Growing economy: C.B. follow monetarist policy of increasing money supply to keep price level stable, imposes also unsustainable forced saving = inflation
- Hayek's proposal:
 - Neutral money = neutral to real economy, which plays no role at all.
- Case:
 - economy grows 5% per annum. CB pursues monetarist policy, interests lower, stimulate investments = forced saving
 - Neutral money (no monetarist policy): price level decline -1% a year; some troubles. Hayek's ideal policy would be suspended to avoid a depression

Business cycle and extended order

- Impressive structure Hayek' BCT
 - TBC (any) can hardly be applied to the historical recorded cycles, influenced by all sorts of forces
- Comparison with Schumpeter:
 - Both pessimistic about the actual survival of capitalism, both strong faith in the productive power of capitalism
 - S. = driving force the innovating entrepreneur, creative destruction. Innovation may involve either "lengthening" or "shortening" of the period of production. S. is aware that cyclical mechanism is subject to adventitious (historical) circumstances (errors).
- Hayek's BCT is only a small part of his enormous contribution to economics
 - BCT belongs to a Weltbild/Weltanschauung
 - Not only economics as a process of information and prices as the most effective information
 - Economic freedom as a moral basis of the society
 - Rules and laws as fundamental stones of economic development
 - Extended order mainframe for society and economics
 - Only individuals can decide at the best what is more convenient to them and what is in the most efficient for the society (unintended consequences)