The Eternal Struggle

T Y L E R C O W E N

‘K eynes vs. Hayek” has turned out to be a more durable theme than could have been expected in the 1930s. As recently as the 1990s, big-time macroeconomic debates seemed to be over forever; the nineties seem now like a very long time ago.

On the side of Hayek, Glenn Beck propelled *The Road to Serfdom* to no. 1 on Amazon with his repeated warnings that President Obama was bringing socialism to the United states. The man overseeing the Federal Reserve in the House of Representatives, Ron Paul (R., Texas), is an avowed fan of Hayek’s 1970s “denationalization of money” idea.

On the other side, Paul Krugman, through his *New York Times* column and blog, has revived the fortunes of Keynesian economics by insisting that we are suffering from a shortfall of spending or “aggregate demand.” A big swath of the economics profession has become more Keynesian in the last five years.

Krugman, Brad DeLong, and other writers devote a lot of energy to attacking the Hayekian vision of macroeconomics, which by now is over 80 years old; Krugman coined the now-current term “Austerian” to describe those who believe in both Hayek’s “Austrian” economics and a policy of fiscal austerity.

Most notoriously, Hayek and Keynes square off in two rap videos, produced by economist Russ Roberts and filmmaker John Papola. The first video has received over two and a half million views and the second, released this year, is already over 1 million views. The auteurs present both sides of the debate, but a careful viewing of the second video shows that while Hayek wins the fight, analogized in terms of a boxing match, the referee calls it for Keynes. In July, the London school of economics staged an actual Hayek vs. Keynes debate, with contemporary scholars filling the roles.

So what’s all the fuss about? Nicholas Wapshott’s new book, *Keynes Hayek*, does an excellent job of setting out the broader history behind this revival of the old debates. Wapshott brings the personalities to life, provides more useful information on the debates than any other source, and miraculously manages to write for both the lay reader and the expert at the same time. Virtually every page is gripping, and yet even the professional economist will glean some insight (e.g., in Wapshott’s discussion of Hayek’s now-obscure essay “The ‘Paradox’ of saving”).

The tale starts with Hayek in Vienna and Keynes in Cambridge. Hayek is impelled by fascism to leave the Continent and ends up teaching at the London School of Economics. Keynes spreads his influence to both Washington and London, often through a growing number of loyal disciples. Keynes dies in 1946, but Wapshott takes us through Hayek’s nobel Prize and intellectual comeback in the 1970s, including his influence on Margaret Thatcher and the post-Communist reformers. By the 1980s, Keynesian remedies are somewhat out of fashion, Communism is about to fall, and Hayek seems to have lapped his old rival, at least until the financial crisis of recent years. Unstable financial markets and lasting unemployment often seem more susceptible to Keynesian explanations, and so now the Hayekians are the counterpunchers rather than the ones taking the intellectual offensive.

As the story progresses, the reader is treated to a remarkable amount of research, but almost always with a light hand. We learn of Hayek’s first letter to Keynes (asking for a book copy),

Hayek’s original history as a socialist and his plan to run the Austrian central bank, how tensions rose between Hayek and Keynes after the Depression, how Hayek’s thick Viennese accent held him back as a lecturer and pundit, how the other British economists started to mock and disrespect Hayek, and how Ayn Rand later dismissed

Hayek as a “compromiser” and—in the margins of *The Road to Serfdom*—scribbled that he was a “total, complete, vicious bastard.”

It remains hard to judge the Hayek-Keynes debate, in part because there were several Hayeks from the time of the Great Depression. In the late 1920s, Hayek recommended a policy of monetary stabilization, rather than deflation, in response to a depression. In the early 1930s, Hayek came out for tight money and letting bad investments liquidate themselves, rather than propping them up with state subsidies and cartelization, popular ideas at the time. Much later in his career, Hayek admitted that his proposed “do nothing” policies were inappropriate for the early 1930s. Unfortunately, it was this deflation-tolerant Hayek of the early 1930s who ended up crystallized in the debate with Keynes.

On this point, decades of research, including classic papers by Milton Friedman and Anna schwartz, have shown that Hayek was wrong: sharp deflationary shocks have never been friendly to free markets or classical-liberal ideas, and Hayek—at least for a while—did not grasp this truth as clearly as he needed to.

There is one part of the longer story that Wapshott leaves out, and it is a quite recent development. Circa 2009, enter Scott Sumner, professor of economcs at Bentley University and author of the blog TheMoneyIllusion. Sumner has almost singlehandedly resurrected the tradition of Milton Friedman and, more broadly, the philosophy of neo-monetarism.

Although Sumner is a brilliant thinker, and extremely well read, he admits he hasn’t given Hayek’s Prices and Production a thorough tussle; he seems to find the ideas too difficult and too obscure, as indeed do most other professional economists. Sumner’s diagnosis is simple: The American economy has collapsed because the Fed did not stabilize the flow of purchasing power in the economy, or what Sumner calls “nominal GDP.” Circa 2008, the Fed let purchasing power decline when it should have supported it with an aggressive commitment to reflate the economy. This may sound too interventionist to many free-market supporters, and the parts of the argument that emphasize “aggregate demand” seem suspiciously Keynesian. Nonetheless, Sumner persuasively couches the entire argument in terms of constraining the Fed with rules, in this case a “nominal-GDP rule” that would stabilize the flow of purchasing power and create a predictable macroeconomic environment for businessmen and consumers.

The bottom line is this: Whether we like it or not, the Fed has to do something, and letting the money supply continue to fall, in down times, is one of the worst options. It will give the economy a sharp negative shock in the short run and sweep interventionists and their cure-all policies into power, while creating a public hungry for quick-fix recipes. That is indeed what has happened in the United States.

Over the last two years, I’ve been amazed, and pleased, to see how many market-oriented economists have come around to Sumner’s point of view. (These days I cannot go anywhere in the world of economics, or blog readers, without hearing his name.) What that means is not a victory for either Hayek or Keynes, but rather a comeback for Milton Friedman, Irving Fisher, and the good old-fashioned “quantity theory of money.” Stabilizing the flow of purchasing power is indeed what the central bank should be trying to do, even if it achieves this end only imperfectly.

For all his brilliance, Hayek didn’t—at the critical time—have a good enough understanding of the dangers of deflation. He didn’t fully realize the extent of sticky wages and prices and, more deeply, he didn’t see that ongoing deflation would render the “calculation problem” of a market economy more difficult. Hayek stressed that a market calculates value in a way that a central planner cannot—but lying behind this

ability to calculate is some basic macroeconomic stability. At the key moments, Hayek did not offer the proper recipe for that stability.
Hayek’s biggest intellectual victory probably has come in the aftermath of the Obama fiscal stimulus. A lot of the modern-day Hayekians, most notably Mario Rizzo of New York University, predicted that the stimulus would not provide lasting aid to the economy but rather would impose an artificial boombust structure on the economy. The early spending of money would boost measured national income, but eventually those jobs would prove unsustainable:
The stimulus funding would run out, the jobs would disappear, and the economy would slow down once again. That is exactly what we saw in the spring and summer of 2011. In essence, the American government spent almost a trillion dollars to postpone our economic pain by the grand span of two years.
Keynes, like Hayek, was brilliant, but he, too, missed some crucial points.
Most notably, virtually all of his policy recommendations were written for philosopher-kings. You won’t find too many of those in the current U.S. Congress. Keynes, after finishing Hayek’s Road to Serfdom, recommended more and better planning, rather than a greater reliance on decentralized institutions with healthy trial-and-error checks, as Hayek had recommended. In other words, Hayek made some big errors in the debate with Keynes, but he had a sound overall framework in a way in which Keynes did not, and in fact was at war with.
The deepest question raised by this book is why we look back to old economists to the degree we do. Is it that contemporary economists are, for the most part, so hyperspecialized that they no longer become iconic? Or does studying and discussing old economists give us a comforting impression that “our side” has a continuity of thought and values in a way that anchors world history in an easy-to-grasp “us vs. them” narrative?
Maybe it’s a bit of both. In any case, Hayek and Keynes remain the touchstones for current economic debates, and if you wish to learn about them, this book is a very good place to begin.