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Keynes vs. Hayek, oversimplified: missing the point on the economic battle of the century; Keynes Hayek: The Clash That Defined Modern Economics; Book review

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Keynes Hayek: The Clash That Defined Modern Economics, by NicholasWapshott, W.W. Norton & Co., 382 pages, $28.95

BRITISH JOURNALIST Nicholas Wapshott's new book, Keynes Hayek: TheClash That Defined Modern Economics is about a heated debate, eight decades past, between two of the most influential economists in modern history. That debate, which took place in the midst of the Great Depression, concerned the causes and cures of business cycle downturns.

The book comes out at a propitious time. The ongoing economic crisis raises many of the same questions that fueled the intellectual duel between the British-born liberal lion John Maynard Keynes and F.A. Hayek, his free market Austrian friend and opponent. The confluence between subject matter and current events surely helped Wapshott sell his book to a publisher and likely will sell many copies to readers. But potential buyers should be aware that the book says nothing abouthow the economic dispute between Keynes and Hayek might apply to today's economic situation. This omission proves fatal.

Wapshott does not ignore the present in favor of the distant past,although the bulk of the book's narrative is set in the 1930s. But he seems to think his subjects' contemporary relevance is best reducedto the big-picture conflict between government intervention (Keynes)and free markets (Hayek). Wapshott focuses on the disagreements the two had over political philosophy and practice rather than the technical specifics of their economics. Those political disagreements are important, but they arose from crucial differences in economic theory.

For example, Keynes believed that intelligent, well-meaning planners manipulating economic aggregates such as demand and employment canbring about a happy end to business cycles. Hayek, by contrast, insisted that individual decisions and imbalances between specific pricesand demand, or interest rates and specific plans for long-term productive projects, are where the economic action is.

Modern Keynesians tend to sniff at the notion that their man and Hayek were equal participants in the "clash that defined modern economics." They note that Hayek did not wield a similarly huge influence on modern macroeconomics, and they are fight in the sense that the Austrian questioned the value of macroeconomics as an intellectual project in the first place.

At its root the Keynes/Hayek clash concerned alternate theories about how business cycles work. Wapshott does a workmanlike job walkingreaders through the lectures, books, articles, reviews, rebuttals, and counter-rebuttals that made up the bulk of their dispute. That is the book's greatest value, and it's the most thorough and lengthy such discussion available in the lay literature.

Before the two men began feuding, Keynes was already a hero to therising generation of economists at Cambridge, but his ideas were considered somewhat heretical by the dons of the London School of Economics. The LSE's Lionel Robbins imported Hayek, a monetary/ business cycle theorist and disciple of Ludwig von Mises, to represent a counter-Keynesian perspective. (Robbins and Keynes had feuded as members of a government commission, where Robbins refused to sign on to Keynes' prescriptions for public works spending and tariffs as a solution to the Depression.) The Austrians thought free markets tended toward a workable equilibrium that reflected people's desires and choices; the new Keynesian ideas posited that free markets sometimes guided economies into ditches from which only concerted government action could pull them out.

This book is about nothing if not economic theory and history; thepersonalities simply aren't that gripping, despite slightly interesting scattered details about Hayek's marital troubles and the torrid affairs between Keynes' disciples. Yet Wapshott somehow never spends more than a sentence or two at a time on complicated economic ideas. He devotes far more space to discussing the feuding economists' intemperate tone than he does to explaining what they meant. Readers who don't already have a basic understanding of Hayekian and Keynesian economics will get little help here.

The book is riddled with errors of judgment, especially about Hayek's position. Wapshott thinks that Austrian theory is "mechanistic" and based on a belief that the "free market was virtuous." In fact, Hayek's notion was that markets were highly organic, especially compared to Keynes' vision of manipulating economies like machinery, and Hayek's Austrian perspective was studiedly and deliberately value-free in its economic analysis. While Austrians tend to think free markets redound to the greatest benefit of the greatest number, that conclusion arose from their scientific understanding of how the world worked, not a moral judgment about how it should be.

Wapshott thinks the Misesian critique of socialism was that prices"were made redundant" when what Mises actually said about socialism is that it made prices, and the information we get from prices, impossible. Wapshott thinks Hayek's understanding of the function served by prices was not about the spread and coordination of decentralized information and knowledge (which it was) but rather about freedom. At the end of the book, where you'd expect Hayek's economic views about business cycles to be central to the discussion, Wapshott forgets them entirely in favor of his politics.

But the Keynes/Hayek argument was more complex than just the political question

of government vs. markets. It was about complicated notions of price adjustment, especially the vital question of price adjustments for labor. In a 1930s context of very powerful unions, Keynesthought it was politically impossible to achieve the nominal wage reductions necessary to clear the market for labor--that is, to let wages fall so that hiring would be cheaper and unemployment thereby reduced. He instead promoted inflation as a means to trick labor into taking lower real wages.

Wapshott seems to want us to take Keynes' side on this. He writes sentences like, "Keynes believed that the chronic unemployment endured by Britain and America in the 1920s and 1930s was evidence that thefull employment equilibrium was a fallacy," without mentioning prices or wages. The point from Hayek's side is that no equilibrium is possible when prices don't or can't adjust. In neither country did wages--the price of labor--adjust downward in order to increase the demandfor labor--that is, employment.

Unemployment was understandably one of the great battlegrounds of the Keynes/Hayek feud. In a business cycle bust, did unemployment have to be cured by government manipulation of aggregate demand-by spending any way, any how, as Keynes advocated? Keynes thought that if youhave idle people and capital goods, you should get them working again by any means available, even if the projects prove inflationary or produce nothing that anyone wants (such as holes by the side of the road).

[ILLUSTRATION OMITTED]

From Hayek's perspective, booms and busts were caused by unnaturalcredit creation, setting in motion productive processes (say, home building) that end up not paying off in the end, given people's real desire for future goods vs. present ones. Under normal circumstances, those desires would tend toward equilibrium via adjustments in interest rates. But interest rates are skewed by artificial credit creation. While the additional credit has short-term stimulative effects (booms), in the long run a structure of production that does not match actual saved capital will collapse, leading to damaging busts.

Keynes' most famous quip (although he said it before his Hayek fight and in a different context) applied to Hayek's worries about the long-run effects of inflationary attempts to put the consumption cart before the production horse. "In the long run," Keynes said, "we are all dead."

Hayek thought the long run might come quicker than Keynesians believed. In his 1941 book Pure Theory of Capital, the Austrian quoted Keynes' famous line, adding, "I fear that these believers in [that principle] may get what they have bargained for sooner than they wish." Hayekians would argue that our current economic crisis is an example of living in Keynes' "long run"--that inflationary credit expansion and high levels of government spending have led to a bust and a debt crisis that we can't handle. While Keynes himself thought government should spend borrowed money only during recessions, his disciples in government observe no such restriction.

Partly because he shifted from economics to political philosophy in the second half of his career, Hayek is often treated merely as a small-government polemicist. (Wapshott, trying to complicate this view, erroneously reports that Hayek believed in universal government-provided health care.) It's a shame that a book centered on the years ofHayek's greatest and most influential work as an economist only cements

this incomplete reputation.

When the Royal Swedish Academy of Sciences awarded Hayek the 1974 Nobel Memorial Prize in Economic Sciences, it described his contributions this way: "His theory of business cycles and his conception of the effects of monetary and credit policies attracted attention and evoked animated discussion. He tried to penetrate more deeply into the business cycle mechanism than was usual at that time. Perhaps, partlydue to this more profound analysis, he was one of the few economistswho gave warning of the possibility of a major economic crisis before the great crash came in the autumn of 1929. Von Hayek showed how monetary expansion, accompanied by lending which exceeded the rate of voluntary saving, could lead to a misallocation of resources, particularly affecting the structure of capital."

These are precisely the aspects of Hayek's thought that make him relevant to the current crisis, and these are precisely the aspects that Wapshott avoids when discussing it. That lacuna makes his book a maddening missed opportunity for readers trying to understand how the hoary economic-journal arguments of the 1930s might shed light on today's problems.

The years leading up to our current crisis saw exactly the sort ofartificially low interest rates and monetary expansion that Hayek warned would cause unsustainable booms and busts, in this case manifestin the housing market. In reaction to the 2001 recession, Federal Reserve policy became highly expansionist. M2, a major monetary aggregate measure, stayed above 8 percent through 2003. The Fed also strove to keep interest rates low to stimulate growth. The "federal funds" interest rate plunged from 6.75 percent to 1.75 percent in 2001, reached a record low of 1 percent in mid-2003, and stayed at that level for a year.

"The real Fed funds rate was negative ... for two and a half years," economist Lawrence White wrote in a 2008 **Cato Institute** essay. "The Fed from early 2001 until late 2006 pushed the actual federal fundsrate well below the estimated rate that would have been consistent with targeting a 2 percent inflation rate.... The excess credit thus created went heavily into real estate. From mid-2003 to mid-2007, while the dollar volume of final sales of goods and services was growing at a compounded rate of 5.9 percent per annum, real-estate loans at commercial banks were ... growing at 12.26 percent."

That growth was artificial, and for various reasons having to do with federal housing policy and the practices of the financial industry it led to an economy unhealthily dependent on continually rising housing prices. As Hayek would have predicted, the bust was inevitable.And here we are.

This view is by no means the consensus among economists. Still, many economists outside Hayek's Austrian tradition--including monetarist Anna Schwartz, Keynesian Brad DeLong, and Treasury Secretary Tim Geithner--have at least partially blamed the boom and bust on the Federal Reserve's reckless credit expansion. But Wapshott doesn't even allude to the possible relevance of Hayek's business cycle theory to ourpresent mess, whether to support it or debunk it. It's as if he doesnot understand the actual significance of his project.

Wapshott's book comes on the heels of two glossy video parodies that became Internet sensations by portraying the Keynes/Hayek conflictas a hip-hop battle. The makers of those videos, George Mason University economist Russ Roberts and online

content developer John Papola,understood that the dispute was about something more specific than government vs. markets. It was about the boom and the bust, what causes business cycles and what might ameliorate them. In less than 20 minutes combined, those videos explain the contemporary significance of the Keynes/Hayek debate better than Wapshott's book. And they're a lot more fun as well.

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