Book Review: Friedrich A. Hayek's A Free Market Monetary System And The Pretense Of Knowledge

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Summary

- Soros glosses over and misinterprets Hayek as can clearly be seen by anybody who has made an attempt to study the latter's work.
- Hayek on a free market currency system.
- Hayek on preserving the distinction between human and physical sciences, and the fundamental problem of socialist/command economies.

Recently Seeking Alpha published an excerpt from a speech given at the Cato Institute by George Soros who espoused a rather critical analysis of Friedrich Hayek's economics couched in the guise of an empathetic and respectful "agreement" with "some" of that thinkers' ideas. Of course, those of you who have read this piece will notice that this respect is secondary to the more critical aspects. Furthermore, those of you who are familiar with Hayek will realize that Soros unjustly pigeon holes Hayek as a "market fundamentalist" and juxtaposes him to Karl Popper while ascribing to him an "agenda" (as if Soros himself didn't have one) that led him to sacrifice reason for the sake of "fighting communism."

I found this to be intellectually dishonest, and having taken a week-long vacation, I decided to re-read some Hayek while reading a couple of other pieces for the first time, and decided that I would discuss one of his works in my next book review. Seeing that Soros saw fit to juxtapose Popper with Hayek, and seeing that he fails to do justice to Hayek's brilliant Nobel Prize acceptance speech, I decided to go with this, even though it isn't technically a book (it is only about 30 pages long).

The volume I am reviewing also has another essay - written a couple years later - entitled "A Free Market Monetary System" - in which Hayek describes how a free market monetary system would work should the government get out of the way. While we, of course, are seeing nothing like this today, I think there is a compelling analogy to be made with some of the ideas in this essay and the decline of the U.S. Dollar as the global reserve currency. The rise of the Yuan and other foreign currencies, of gold as a central bank reserve, and even of Bitcoin are all signs that we are heading in a direction that Hayek envisions, and it is worth discussing.

So this is really half book review and half critique and analysis. Before moving on, I should point out that despite the fact that Hayek is not really a proper Austrian economist (in the Misean sense, although he was born in Austria-Hungary) this volume, along with several other of Hayek's writings, have been made available for free by the Mises Institute.

A Free Market Monetary System

The first essay discusses the idea of a free market monetary system. We have been conditioned to believe that money must be issued by the government. The justification for such an assumption is pretty straightforward: it means that we have one common unit which we all use in the settlement of contracts, and even in a relatively Laissez Faire system of government, libertarians will admit that a fundamental role of government is to see to it that contracts are upheld. This is far more convenient if we are all using the same monetary unit.

Now, as history has shown, this can be highly problematic as the government is in a position to abuse this power. Over long periods of time government-run currencies lose a substantial amount of value as increasing the amount of currency in order to fund government activity is politically simpler than raising taxes on the people. This, however, is not set in stone, as the people can check the government's currency creating power by limiting the amount of currency it creates to the amount of gold it holds in its vaults. This is the justification of the gold standard (not "gold-as-money," which is a different issue). When governments are forced to limit their currency creation based on the amount of gold they hold in their vaults, the currency remains stable (e.g. the U.S. Dollar throughout most of the 19th century). When we switch to a gold exchange standard (e.g. Bretton Woods) or no gold backing such as we have now, the government is free to create currency as it wants, and we have seen the consequences over the past 45 years or so. We have seen the prices of goods and services rise faster than wages and as a result the American standard of living has fallen dramatically.

Hayek's proposal isn't a gold standard, as this is not a free market solution and it can always be corrupted through subtle distinctions such as that between a gold standard and a gold exchange standard. Rather, Hayek wants a system in which institutions are allowed to freely create their own monetary units. He is relatively agnostic when describing this system because, as previously mentioned, we are so conditioned in the current system that the idea is counterintuitive. He thinks that we should let institutions experiment with various methods which may or may not include some sort of gold or commodity backing.

The one thing that must hold is that the currency's value needs to be stable. If it loses value then nobody will want to hold it, and if it gains value then nobody will want to borrow in terms of it. Of course, this is an ideal and not an achievable reality. Despite gold's relatively stable supply, its price is up nearly 5-fold over the past 14 years while it is down 40% in the past 3 years. Bitcoin has been even more volatile.

While this may be unsettling for some, keep in mind that the government has done a miserable job managing the value of its own currency for the benefit of the people (it has managed this brilliantly as a highly indebted institution looking to inflate away the value of its debt).

As a final note, I just want to briefly revisit my initial point regarding the decline of the USD and the rise of competing currencies, as I see this phenomenon as something akin to what Hayek discusses in this essay. The parallel has the Dollar as the national currency with the Yuan, the Aussie Dollar, the Brazilian Real, gold, silver (especially in Mexico), and Bitcoin and other crypto-currencies. The Dollar is still dominant, although longer-term trends clearly point to its decline. While many have proposed that we will end up with a system once again dominated by one currency, it seems that we are actually heading towards a multi-currency system that would please Hayek to a certain extent. All of these "currencies" can be winners at the expense of the Dollar, and while we as citizens of a particular nation will be legally limited to certain choices, there will certainly be greater diversity and investment opportunities in the currency market arising from this phenomenon.

The Pretense of Knowledge (aka Hayek's Nobel Acceptance Speech)

Returning briefly back to the Soros piece, I want to start my discussion of this essay by quoting a paragraph from the Soros piece:

But Hayek subordinated his methodological arguments to his political bias. That is the source of his inconsistency. In the Economica, he attacked scientism. But after World War II, when the communist threat became more acute, he overcame his methodological qualms and became the apostle of market fundamentalism - with only a mild rebuke for the excessive use of quantitative methods in his Nobel Prize acceptance speech.

Ignoring the fact that Soros equates quantitative methodology with market fundamentalism, this "mild rebuke" is not only repeated in several other Hayek pieces but it is, in fact, the entire topic of the Nobel Prize speech.

In it Hayek expresses concern that we cannot apply quantitative methods to economics - or the social sciences more generally - with the certitude with which we can apply them to the physical sciences. We are deluded into thinking we can because economic models resemble physical models. The key difference, however, is in the fact that an economic model makes assumptions about the decisions of individuals in a market economy. For instance, we can come up with an economic model that says that if we tax cigarettes that people will buy less of them. And while this is intuitive and difficult to rebuke, we don't know what is in the mind of every single smoker and go on faith that some will continue to smoke, some will smoke less, and some will quit smoking in response to the tax. But this kind of knowledge doesn't parallel my knowledge that if I throw a ball into the air it will fall to the ground. It also ignores other possibilities such as the few entrepreneurial smokers who are willing to take the risk of smuggling and selling cigarettes on the black market.

We ultimately do not have the data necessary to clearly delineate the causal link between the tax and its impact on the economy, but our reductive thought processes and our desire to have simple solutions to our problems lead us to this conclusion.

This is clearly laid out by Hayek:

Into the determination of these prices and wages there will enter the effects of particular information processed by every one of the participants in the market process - a sum of facts which in their totality cannot be known to the scientific observer, or to any other single brain. (p, 39) (I encourage readers to look at this entire paragraph carefully)

A command economy is one in which a single brain or a group of single brains attempt to come to these conclusions, and it is for this reason that Hayek continues to argue that the inherent fallacy of the scientific approach is precisely the reason why a market-based economic system is superior. Ironically Soros believes something of the opposite of Hayek, that he uses quantitative and scientific methods in order to arrive at his "market fundamentalism" when in fact quite the opposite is the case.

Ultimately Hayek's so-called "market fundamentalism" comes down to this: the unfettered trial and error that the free market produces is superior in its heterogeneity than the dictates of a single governing body, which in its own arrogance is prone to the aforementioned error of believing that etiological connections in the behavior of individuals can be "reduced" to equations and quantitative relationships.

And if that is market fundamentalism then count me in!