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WERE HAYEK'S MONETARY POLICY RECOMMENDATIONS INCONSISTENT?*

Abstract:

Contrary to the received view, we maintain that Hayek's monetary policy recommendations were not inconsistent. The prevalent perception of early Hayek as the money stream stabilizer and late Hayek as the price level stabilizer is attributable to an unjustified normative interpretation of Hayek's positive analysis. We argue that in his contributions to monetary theory, Hayek took the goals of monetary policy as exogenously given and analysed the efficiency of different means to achieve these goals. Hayek's allegedly inconsistent switch from being a critic to an advocate of price level stabilization is explained by a change in the issues on which he focused, rather than by a change in his theoretical views. We also claim that Hayek was always aware that every practical monetary policy involves difficult trade-offs and was thus reluctant to impose his own value judgments about what people should strive for.

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It is oftenbelieved that Hayek's views on monetary policy underwenta substantial changeduring his lifetime. A prominent advocate of this belief is Professor White, who claims that, in his *Denationalization of Money*(Hayek, 2009[1976]), Hayek switched from being a critic to an advocate of price level stabilization and thus "repudiated his earlier business cycle theory and all that rested on it"(White, 1999,pp. 118).[1] While the second part of White's claim has been partially rejected by Steele (2005) and Cochran (2011)[2], who convincingly show that late Hayek remained faithful to the principles of the Austrian business cycle theory (*ABCT*),[3] the first part of his claim seems to have raised virtually no objections in the literature. We therefore take up the challenge and attempt to show that Hayek was never really anunequivocal advocate of *any* norm of monetary policy: whether early or late in his career, he was rather reluctant to give clear-cut monetary policy recommendations, being aware of the fact that each such recommendation is a difficult compromise between various competing goals.

In our interpretation, Hayek was, in his works, concerned foremost with causal issues, and considering him as a proponent of a certain monetary rule amounts to reading value judgments into his positive claims. Statements which could be misinterpreted as policy norms are in fact instrumental *if-then* statements of the type "if *A* is to be achieved, then *B*should be done". Hayek took policy goal *A* (elimination of the business cycle in his early works and stabilization of price level in his later works) as given exogenously and analysed the tools that were instrumental in reaching this goal. When he did address the normative issue of which policy goals should be strived for (e.g. in Hayek, 1999[1981]; 2008[1979]), he argued that trade-offs faced by monetary authorities (especially the trade-off between more stable money and more neutral money) are best resolved by the market in the system of free-banking.

[1] A similar claim, although without closer explanation, is made by Haberler (1986,pp. 431): „...[proposal for denationalisation of money] is clearly inconsistent with Hayek's earlier proposal for constant money..."

[2] Cf. also Carilli et al. (2004)and Carilli and Dempster(2008,pp. 272) who „believe that White is reading more into Hayek's words than is justified".

[3] We are, however, puzzled by Steele's assertion that Hayek "retrospectively discounts 'practical significance' [of his diagnosis and prognosis] to the Great Depression"(Steele, 2005, pp. 8). We find only weak evidence for this statement both in Hayek's works and in Steele's paper. In our (and, as it seems, also in Carilli's et al.(2004) and Cochran's (2011))view, the correct statement is that Hayek realized that his business cycle theory of the 1930s could not be directly applied to the conditions of the 1970s. This is in line even with Steele's own argument (Steele, 2005,pp. 11).

The paper is divided into three sections. Section I presents the received viewof Hayek's monetary policy recommendations; thisviewisrejected in Section II by referring to Hayek's works; Section III concludes the paper.

1 The received view

The received view of Hayek's policy recommendations was established in an influential paper by White (1999). According to White (1999,pp. 116), Hayek "abandoned constancy of the money stream as a norm, and embraced consumer price-level stabilization as the most desirable monetary norm." (See also White,1999,pp. 118). Denoting early Hayek of the 1920s and 1930s as "Hayek I" and late Hayek of the 1970s as "Hayek II",[4] we split White's views into the following three claims:

(1a) According to Hayek I,the money stream should be kept constant.[5]
(2a) According to Hayek I, price level stabilization is not desirable.[6]
(3a) According to Hayek II,the price level should be kept stable.

First of all, observe that, contrary to what seems to be White's view,[7]none of the claims (1a)-(3a) implies repudiation of *ABCT*. The reason is that the validity of *ABCT* is a theoretical issue, whereas (1a)-(3a) concern issues partly or completely outside the scope of positive inquiry: they are either value judgments or instrumental statements. Even if claims (1a)-(3a) were true, it would be possible that Hayek II continued to stick to *ABCT* if he changed his views about what was desirable, or, alternatively, if he took policy goals as exogenous and only provided instruments for their achievement; as these goals changed, Hayek would have changed his recommendations while remaining faithful to *ABCT*. We argue that the latter is indeed the case. Our claims are as follows:

[4] This distinction is independent of those used by Hutchison (1981),Caldwell (1988), Foss (1995), Block and Garschina(1996), and Witt (1997) referring to an alleged methodological or paradigmatical shift in Hayek's work. Our paper has nothing to contribute to this issue.
[5] This claim is made also by White (2008), Gustavson(2010), and Cochran (2011).
[6] See also Cochran (2011).
[7] „As he was logically compelled to do if he were to embrace consumer price-level stabilization, Hayek here essentially repudiated his earlier business cycle theory..."(White, 1999, pp. 118).

(1b) According to Hayek I,elimination of the business cycle requires that the money stream be kept constant. He does not see the elimination of the business cycle as necessarily desirable because, as he acknowledges, it also involves costs.

(2b) According to Hayek I, price level stabilization does not lead to the elimination of the business cycle. It is not implied that price level stabilization is necessarily undesirable because, as he acknowledges, it also involves benefits.

(3b) According to Hayek II,a stable price level is a possible goal of monetary policy (even though it could cause the creation of a business cycle). Trade-offs faced by monetary authorities should be resolved by the market rather than by these authorities.

In the next section we provide some support for our claims and argue that Hayek largely refrained from imposing value judgments about what goals monetary policy should strive for.

2 What Hayek actually wrote

In an attempt to show that (1b) – (3b), rather than (1a) – (3a), are correct statements, we first focus on Hayek's views on the neutrality of money and then on price level stabilization.

2.1 The neutrality of money

According to Hayek, the business cycle is a monetary phenomenon[8] and as such could be eliminated if we were able to make money neutral. In his works, Hayek I looks for the conditions under which the neutrality of money would be achieved, one of them being stability of the money stream (Hayek, 1967[1931]; 1984[1933]).[9] However, Hayek I does not make the normative claim that the money stream *should* be kept stable.

First, Hayek I makes it clear that the "concept of neutral money was designed to serve as an instrument for theoretical analysis, and should not in any way be set up

[8] Although Schumpeter (1994[1954]) categorized Hayek's theory as non-monetary. On this issue see O'Driscoll and Rasmussen(2012).

[9]The other conditions are the perfect flexibility of prices and correct prediction of the future movement of prices (Hayek, 1984[1933],pp. 161).

as a norm for monetary policy, at least in the first instance"(Hayek, 1984[1933], pp. 159). See also Hayek (1934,pp. 166–167).This is confirmed also by Hayek II:

> "Although I have myself given currency to the expression 'neutral money'...it was intended to describe this almost universally made assumption of theoretical analysis and to raise the question whether any real money could ever possess this property, and not as a model to be aimed at by monetary policy."(Hayek,2009[1976], pp. 87–88)

Second, although Hayek I claimed that the approximation of money neutrality was "probably the most important [...] criterion for assessing maxims of monetary policy"(Hayek, 1984[1933], pp. 161), he was perfectly aware that the "realization of this ideal may compete with other important aims of monetary policy, and, consequently, that the only practical solution attainable is a compromise"(Hayek, 1984[1933], 161). In particular, according to Hayek I, in the presence of certain institutional factors, such as long term contracts in fixed sums of money and the rigidity of prices, neutral money policy «would set up frictions of a new kind»(Hayek, 1934;1967[1931]). Hayek I also writes that we would have to look for a compromise not only in the presence of long term contracts and rigid prices but possibly also in the absence of these factors; for, as he believed, trade cycles "are, in a sense, the price we pay for a speed of development exceeding that which people would voluntarily make possible through their savings, and which therefore has to be extorted from them"(Hayek, 1933, pp. 189–190).[10]

It thus turns out that Hayek I makes the following *if-then* statement (as it seems, never rejected by Hayek II): if the business cycle is to be eliminated (without saying whether this should be the primary goal of monetary policy), then money must be kept neutral by, among other things, keeping the money stream stable. To deduce from this statement the conclusion that Hayek I suggested stability of the money stream as a norm for monetary policy is unwarranted. After all, in his preface to *Monetary Theory and the Trade Cycle*, he is explicit about his inability to come up with a simple rule for monetary policy:

[10] This claim of Hayek's has been criticized by Block and Garschina(1996). However, they are incorrect in attributing to Hayek the normative statement that we „must continue to use fractional reserve banking in order to spread the development of technical and commercial knowledge"(Block and Garschina, 1996, pp. 85). See Hayek (1934).

> "The opponents of the stabilization programme still labour – and probably always will labour – under the disadvantage that they have no equally simple and clear-cut rule to propose; […] the one thing of which we must be painfully aware […] is how little we really know of the forces which we are trying to influence by deliberate management; so little indeed that it must remain an open question whether we would try if we knew more."(Hayek,1933, pp. 23)

In *Prices and Production* he attempts at least partly to overcome this disadvantage; nonetheless, rather than recommending the stable money stream rule, he suggests that"...the only practical maxim for monetary policy to be derived from our considerations is probably the negative one that the simple fact of an increase of production and trade forms no justification for an expansion of credit..."(Hayek, 1967 [1931],pp. 125).

2.2 Price level stabilization and Hayek's alleged U-turn

We now turn to claims (2a), (2b)and (3a), (3b). First, it is important to note that the role of the stable price level in monetary policy can be twofold: it can serve as either a means or an end of monetary policy. Hayek I rejects it as a means of eliminatingthe business cycle, while saying nothing about its desirability as an ultimate end. In his own words, he attempts "to refute certain theories which have led to the belief that, by stabilizing the general price level, all the disturbing monetary causes would be eliminated"(Hayek, 1933, pp. 16). Second, while criticizing the policy of price level stabilization as a means of avoiding cycles, he at the same time concedes that the stabilization of some price index is probably the 'most practicable' of feasible policy norms:

> "...the adoption of the stabilization of some particular price level as the criterion for that policy which represents a compromise between the competing aims is not thereby excluded. Rather, it seems to me that the stabilization of some average of the prices of the original factors of production would probably provide the most practicable norm for a conscious regulation of the quantity of money."(Hayek, 1984 [1933],pp. 161)

Without contradicting Hayek I, Hayek II adds that people may find the stable purchasing power of money desirable *per se* (i.e. not as a means of monetary policy but as one of its goals) and he explains at length the various reasons why this is the case (Hayek, 2009[1976], pp. 74; 1999[1981], pp. 242). He goes on to talk about the stabilization of particular price levels (raw material prices, wholesale commodity prices), pointing out that different people are interested in the prices of different commodities and it is not clear "which price level most people will want to see constant"(Hayek, 2009[1978],pp. 74). Quite in line with Hayek I, Hayek II then warns that a"stable national price level could disrupt economic activity"(Hayek, 2009[1978],pp. 115). Although he indirectly discusses the possibility of stabilizing consumer price levels(Hayek, 2009[1978],pp. 75) he was never its critic or advocate; therefore, he could not switch from one to the other as White (1999,pp. 118) claims (cf. Steele, 2005,pp. 12).

It should be emphasized that Hayek did not forget to point out the trade-off between more stable or more neutral money even in one of his last published pronouncements on the topic:

> "[In a growing economy] prices have a tendency to fall and they can only be kept constant by increasing the quantity of money [...] but only at the expense of distorting the structure of relative prices [...] This is a very serious dilemma. The price of money must either fall or rise with the decrease or increase in productivity, or it can be kept stable at the cost of displacing factors of production (Hayek,1999 [1981],pp. 243)." See also Hayek (1999[1981], pp. 241ff).

The only important change we observe in Hayek's writings is the change in focus, which is a mere response to the circumstances in which he wrote: rather than on the question of how to eliminate the business cycle, he focuses on the question of how to eliminate inflation.[11]Hence, the main problem that heattempts to solve is how to obtain a stable price level *given that it is desirable*. The question is thus how to achieve some given goal (price level stability), not which goal we should pursue. The solution is found in free banking, and themajority of Hayek's *Denationalisation of money* is devoted to the analysis of this possible new arrangement or to acomparison

[11] Haberler (1986) understands Hayek II's acute attempt to cut inflation as a response to periods of high inflation and the loss of trust in politically controlled central banks. This is confirmed by Hayek himself: „The pressure for more and cheaper money is an ever-present political force which monetary authorities have never been able to resist [,..] Our only hope for a stable money is indeed now to find a way to protect money from politics"(Hayek, 1976,15–16).

with the current state of affairs. Admittedly, the normative part of the problem, i.e. whether it is appropriate to maintain price level stability, is partly discussed, but Hayek II was convinced that such a decision should be made by people through their choices in the market, not by economists or politicians. Actually, he found it difficult to specify definitively what'good' money should belike:

> "We do not even quite know what exact qualities we want because in the two thousand years in which we have used coins and other money, we have never been allowed to experiment with it, we have never been given a chance to find out what the best kind of money would be (Hayek, 2008[1979], pp. 20)." See also Hayek (1999[1981],pp. 141ff).

To summarize Hayek's views, he merely acknowledges that the demand for stable purchasing power is persistent among people, and although it can have (and probably will have) some negative consequences, described by*ABCT*, it is considered to be the task of thefree market to choose the best features of every commodity, money not excluded. That is why Hayek II respected the prevailing call for a stable medium of exchange and devoted his efforts to theproposal for a new, non-inflationary monetary regime. On this basis, we reject claim (3a) in favour of (3b). As for claims (2a) and (2b), we conclude that both Hayek I and II were aware of the difficulties of the policy of price level stabilization; yet, at the same time, Hayek I as well as Hayek II recognized price level stabilization as a possible policy norm. In any case, Hayek was always cognizant ofthe complicated trade-offs which any policy norm necessarily involves and was thus reluctant tosuggest some unequivocal monetary policy norm.

3 Conclusion

We have attempted to refute the notion that Hayek was inconsistent in his monetary policy recommendations. His recommendations were always relative to some goal: early in his career Hayek asked how to eliminate the business cycle, while in later years he aimed at cutting inflation. These changes in focus were not due to changes in his theoretical views: in his published works he never repudiated *ABCT*. In our view, Hayek's position throughout his academic career reflects both his careful separation of positive and normative issues, as well as his understanding of the economy as an immensely complex system, intervention into which always involves difficult trade-offs.

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