

## FRIEDRICH AUGUST VON HAYEK

prof. Ing. Ján Lisý, PhD.

Faculty of National Economy, University of Economics in Bratislava

*Friedrich August von Hayek, who was awarded the Nobel Prize for Economics in 1974, is known as the most important representative of the so-called Neo-Austrian School, and the broad expert public regards him as the most important representative of liberalism of the 20th century. He had a very wide range of academic interests. He is well-known for his view that nobody can be a good economist, if he is only an economist. Such an economist may do more harm or even be dangerous. Hayek also concerned himself with legal questions of the economic system, psychological – philosophical problems of the functioning of individual market entities and various socio-economic systems. His main ambition was to justify the advantages and viability of the*



*liberal, individualistically oriented socio-economic system. Hayek was convinced that important economic problems can be understood and explained only by application of an inter-disciplinary approach. The nomination for awarding the Nobel Prize mentions his pioneering contribution to the theory of money and the theory of economic cycles. However, the work which made Hayek the “breaker of the myths of the 20th century in the area of monetary theory” was published only in 1976 in the work “Denationalisation of Money”. (1) The views contained in this book show that Hayek inclined to the position of laissez faire in the area of the theory of money and the issuing of money, during the last third of his life.*

F.A. Hayek was born on 8th May 1899 in Vienna. The intellectual environment in which Hayek grew up significantly influenced his future academic orientation. His father was a doctor of medicine, who devoted himself to research and educational work at Vienna University. He completed the Secondary grammar school in Vienna. In 1917 – 1918, he fought in the Austro-Hungarian Army on the Italian Front. After the First World War, he studied at Vienna University, where he gained a doctorate of law in 1921 and a doctorate of political science in 1923. During his study at Vienna University, he already got to know the views of the representatives of the Austrian School of neo-classical economics K.Menger and E.Böhm-Bawerk. His views were significantly influenced by the lectures of Ludwig Mises, who worked at that time at Vienna University. From 1921 to 1926 he worked as an adviser to the government on questions connected with the peace treaty. In 1923-1924, he was also a postgraduate student at New York University. From 1927 to 1931 he directed the Austrian Institute for Research on the Economic Cycle and Economic Policy. He also lectured as a private lecturer on economics at Vienna University from 1929 to 1931. In 1931, Hayek was appointed professor of economics and statistics at London University, where he worked until 1950. In 1938, he was granted British citizenship and in 1944 he became a member of the British Academy. In 1950, he accepted the position of professor of social and moral sciences at Chicago University, where he worked until 1962. Chicago University had a very creative atmosphere, to which Hayek also contributed. He organized regular weekly scientific seminars in which the most important personalities from different departments of the university participated. They discussed topical problems from socio-economic life. In 1962 he accepted the position of professor of economic policy at Freiburg University. After retiring in 1967, he accepted the position of honorary professor at Salzburg University in his native

Austria. He also served as visiting professor at the universities of California, Virginia, Stanford and Cape Town.

He was granted honorary doctorates at the universities of Tokyo (1964), Vienna (1971) and Salzburg (1974). He was an honorary member of the Academic Senate of Vienna University from 1991 and an honorary member of London University from 1992. He was a correspondent member of the Austrian Academy of Sciences from 1970. Hayek spent the last years of his life at Freiburg, where he died in 1992.

Although Hayek is known as a great supporter of liberalism, he also maintained contacts with differently oriented economists. From 1928 he had private discussions with J.M. Keynes about the importance of money in the economy, especially about Keynes' work “Treatise on Money”. Keynes reacted to Hayek's critical comments on this work by stating that he had since completely changed his view on this problem. Fear of another change of view by Keynes led to Hayek not making a thorough study and critical analysis of Keynes' most important work, “The General Theory of Employment, Interest and Money”, which Hayek later regarded as a great mistake. It is noteworthy that these supporters of different views were willing to help each other as people. When the London economic school had to move to Cambridge for safety from the war in 1940, Keynes helped Hayek find space at the university.

Although Hayek is mainly famous as an enthusiastic supporter of liberalism and a firm opponent of socialism and central planning, his contribution to the field of economics is much more extensive, deeper and more original. His theory of the economic cycle, theory of prices and the price system, theory of money and interest policy are important.

<sup>1)</sup> Hayek, F.A., The Denationalisation of Money, London, The Institute of Economic Affairs, 1976



## The views of Hayek on money in the 1930s and 1940s

Hayek is the author who most comprehensively explained the monetary theory of the economic cycle.<sup>(2)</sup> He proved on the basis of scientific analysis, that money, specifically bank loans, causes economic imbalances. According to Hayek, if the central bank increases the amount of money in circulation, the commercial banks increase the availability of credit, which means lower interest rates on loans. Cheaper loans enable increased investment activity by businessmen. Voluntary or enforced savings can be a resource for the growth of investment activity by businesses. Voluntary savings mean that part of the money intended for consumption is diverted to investment. In this case economic imbalance does not arise, since the demand for investment and its supply increases in proportion to the decline in demand for consumer goods and their supply. In conditions of so-called forced saving, when the central bank rapidly increases the amount of money in circulation, the supply of loans increases, the production of capital goods grows, but not enough consumer goods are produced. The growth of investment accelerates the growth of incomes, which raises the demand for consumer goods, but the supply is not increased. The imbalance between the supply of consumer goods and the demand for them leads to rises in their price. Further growth in production requires further investment. However, in reality, it was only a matter of a one-time and time limited expansion of money. Businessmen learn that the supply of credit resources is exhausted, that the banks are charging higher interest rates for loans. Interest in loans declines, because the interest rate reaches a level at which businessmen cannot effectively gain credit, which slows down investment activity. The structure of capital also changes as a result of the general availability of cheap loans. Businessmen also invest in capital demanding production. In reality it is a matter of bad investment caused by forced savings with an advantageous interest rate. Therefore a recession (2) occurs, in the course of which the structure of capital can be improved. The bad structure of capital is improved during a recession, but, at the same time, much productive capacity disappears and many people lose their jobs.

Hayek later supplemented his monetary theory of the economic cycle with real factors. In his view interest in credit declines when modern facilities are unavailable to the majority of businessmen as a result of high prices, which result from high demand. At the same time, real wages fall because the prices of consumer goods rise. Therefore, businessmen prefer to pay for more labour rather than for modern production equipment, so investment gradually declines. A recession is manifested in inadequate investment and insufficient use of existing productive ca-

pacities. Hayek proposed to solve these problems with the help of so-called neutral money. This is money which does not influence relative prices or interest rates. It does not influence breakdowns in production or the level of profit. Neutral money should eliminate the disproportionate development of prices, and this should lead to the balanced development of the economic activities of businessmen. According to Hayek, this requires an unchanged quantity of money in circulation. Later Hayek corrected his view and admitted that it is possible to change the quantity of money in circulation, depending on the number of transactions, the speed of circulation of money and other factors. Hayek later came to the conclusion that it is actually very difficult to influence the course of the economic cycle with the help of neutral money. However, he still claimed that the less monetary circulation is controlled and influenced by the central bank, the better it will be for the economy.

F.A. Hayek explained the monetary theory of the economic cycle in the works: "Prices and Production", "Monetary Theory and the Trade Cycle", "Profits, Interest and Investment" and "The Pure Theory of Capital". The most important contribution of these works is Hayek's conclusion that a change in the quantity of money in circulation and changes in the volume of loans available in the economy cause a whole series of situations, which direct financial resources into areas they would not go in normal conditions. He considered that changes in the quantity of money in circulation was also harmful if the aim was to stabilize the price level. In these works from the 1930s, he does not mention the free market and competition in the issuing of money. Even in "The Road to Serfdom" published in 1944, he regards the issuing of money and banking as unavoidable exceptions in the functioning of free markets. At that time, he openly expressed the view that no reasonable person had ever denied the fact that a monetary system must be centrally directed. Thus, Hayek definitely rejected freely competing banking.

### Do we need a central bank?

Hayek's views on this problem developed and finally radically changed in the course of the 1970s. He became a great supporter of laissez faire in the issuing of money and claimed that this was the only way to secure a stable price level. Analysis of the causes of the high inflation in the 1970s motivated Hayek to a more detailed study of this problem. He came to the conclusion that abolition of the monopoly position of the state as the only issuer of money would help to reduce inflation and secure monetary stability. Hayek explained the essence and principles of free issuing of money by private banks in his work "The Denationalisation of Money", published in 1976.

In the introduction to this book, Hayek says that the basic problem of the market system, to which he most frequently points, is the tendency to the occurrence of regu-

<sup>2)</sup> Hayek, F.A., *Monetary Theory and the Trade Cycle*, London, Jonathan Cape, 1933

larly repeated periods of depression and unemployment. In his view, this is caused by the traditional state monopoly of the issuing of money. Hayek believed that private money would help to remove these problems. The basic idea of this book by Hayek is the statement that money is not different from other goods, and so supply of it can be secured best by private issuers, since private interest represents the most effective motivation to achieve the best results. Hayek thought that governments had failed in the supply of money, were still failing and would always fail. This inadequacy could be removed by competing private currencies and abolition of the government monopoly of issuing money.

He also supposed that the name and denomination of a bank's currency would be protected against unauthorized use like the protected trade mark or name of a company, and protected against falsification in the same way as other documents. Currencies issued by different banks would have different denominations and their value against other currencies could vary freely. If various competing currencies existed, people would be able to see whether their value was maintained on a stable level. They would naturally choose the currency which was most stable and least subject to inflation. Apart from the fact that the relative values of individual currencies could change, the currencies of different banks could distinguish themselves by their degree of acceptability to different groups of people, liquidity and so on. Thus, the desire of the public to have the currency of a certain bank would be an important factor on which its value would depend. The issuing bank would also have an interest in securing a stable price level in units of its currency in relation to a certain basket of commodities. To secure a stable value for its currency, the issuing bank should issue only the amount of money the public is willing to hold and accept. It cannot increase the quantity of a given currency, since this would cause growth in the price level of commodities in units of its currency. The bank would also avoid a decline in the quantity of its currency below the level the public wants to hold, so that it would not have to reduce issues, which would cause a decline in prices of commodities in the given currency. The exchange rate of the currency of the given bank against other currencies would be important information for the issuing bank. Banks would react to the need to reduce or raise the quantity of its money in circulation either by means of granting loans or selling its own currency. Rapid and immediate operations with direct effects would be carried out by purchase or sale of currencies in an exchange. Operations with long term effects would be performed by changes in credit policy. Hayek observed that a stable value of money can be secured only by appropriate regulation of the amount of money in circulation. The quantity of money in circulation would depend on the desire of the public to hold the money of a particular bank and not on demand for credit. Irresponsible raising of the amount of money in circulation would result in the return of mo-

ney to the bank becoming more rapid than the demand of the public to hold the money. Banks should issue money covered by assets defending its stability, and competition would prevent it being issued in excessive quantities.

In his analysis of the problem of how the public would choose a currency, Hayek started from the assumption that people choosing from several currencies issued by private banks would always choose a better currency than the state provides today.

### **Hayek's position on the quantitative theory of money**

Some authors identify the understandings of money of Hayek and Friedman. However, Hayek rejected this, saying that he differed from M. Friedman in the view that, even when there is only one currency in a country, he regards the quantitative theory of money as nothing more than a useful rough approximation to an adequate explanation. However, it is absolutely unusable if several competing currencies are used in the territory of a given country. Hayek regarded the unambiguous emphasis on the mutual relationship between the quantity of money in circulation and the overall price level as the main inadequacy of the monetarist theory of money. It does not respect the much more important and more dangerous results of changes in the quantity of money in circulation for the structure of relative prices and the resulting ineffective allocation of resources, especially the disadvantageous and ineffective allocation of investment.

Hayek also doubted the validity of the quantitative theory of money in conditions of the existence of one currency in a given country. He claimed that there is really no such thing as the quantity of money in circulation and that every attempt, which considers a certain group of means of exchange expressed in one denomination to be homogeneous and perfectly substitutable, is erroneous and misleading. A stable price level and high stable level of employment does not require or admit that the total quantity of money in circulation be constant or that it changes at a constant rate. According to Hayek, the aim of monetary regulation is not to determine the quantity of money in circulation either in the conditions of a monopoly or in conditions of competing issuers. Monetary policy has to secure by market principles a quantity of money adequate to maintain stable price levels in the long-term.

The main advantage of abolishing the government monopoly of the issuing of money lies in the fact that in conditions of competing issuers, responsibility for the quantity of money, its value and stability is given to entities, which have a direct economic interest in influencing the quantity of money in the most advantageous way for the users.

Hayek was aware that proposals for the free issuing of private competing currencies would encounter strong opposition from politicians, governments and the banking



establishment, but also from many economists, both theoretical and practical. Implementation of such a radical new monetary system would require far-reaching political and institutional changes. The reforms proposed by Hayek in this context are complementary. The monetary system he proposes – private competing currencies – could be implemented only in conditions of reduction of government intervention in the economy. At the same time, government intervention in the economy can be reduced by the abolition of the state monopoly of the issuing of money. Strong opposition to the abolition of the state monopoly of the issuing of money can also be expected from bankers, who are used to the routine mechanism of the functioning of banking, from central banks and from many important personalities in banking, who cannot imagine how a monetary system of competing private currencies could function, and so consider these ideas impossible and impractical. In spite of such strong opposition to private currencies, Hayek did not give up. He enthusiastically argued in favour of abolition of the state monopoly of the issuing of money and in favour of competing private currencies. He also proposed abolition of the state monopoly in this area because throughout history governments had misused their position and so seriously disturbed the automatic functioning of the market mechanism.

The introduction of competing currencies would give people an alternative, but would not mean change in their familiar use of money. Experience would show them how they could improve their position by changing to a different kind of money. According to Hayek, the introduction of competing currencies and abolition of the state monopoly needs to be done suddenly and not gradually. Successful implementation of this proposal requires the creation of free competition between the issuing banks and complete freedom of movement for all currencies and for capital, also across frontiers. People will trust the new currencies only if they are convinced that they are not subject to any state control. It is possible to assume that the private banks will maintain the stability of the value of their currencies only if the private banks are under strict control by competition. Only if people can choose which currency they use for a purpose will there be a ge-

neral spread of good and stable money. Banks will be cautious and able to adopt the necessary measures only if the exchanges function flexibly and well. Certainty that cartel agreements and collusion between local banks with the aim of misusing a particular currency will not occur is possible only if there is free movement of money and capital across frontiers. The process of adaptation of supply and demand will function only if there are free commodity markets, leading to stable average prices of commodities.

Hayek believed that competition would create new, previously unknown possibilities in the area of currency. If a new monetary system is created, competition will exclude unsuccessful companies, with only a few widely used currencies remaining in a free system. One or two currencies will have a dominant position in large areas of the world, although the frontiers of their use will not be precisely determined. Naturally, if the money issued by a state is recognized and stable, people will probably still give priority to it, but pressure from competing private currencies would contribute to stabilization of price levels and controlling inflationary pressures.

Hayek realized that his proposal to deprive the state of its ages old monopoly position in the area of issuing currency was so unusual and radical for many people, that there was no hope of implementing the proposal in the near future. However, Hayek believed that the public and the people responsible for the effective functioning of society could gradually change their view on this.

It is interesting that Hayek was against the creation of a single currency for the European Union. He thought that a single currency would not be better than the individual national currencies. He proposed that the individual national currencies could be used freely without any limitation in all the countries of the EU, and that banking should be deregulated in all the member states of the EU. This would create a level of discipline and responsibility in the existing currency and financial structures, which would ensure that only reliable and stable money was issued. Each country would issue only the amount of money for which it could ensure a stable value. Governments would not be allowed to misuse the issuing of money to cover deficits and “solve” other problems.

### The most important works of F.A. Hayek

- Prices and Production, 1931
- Monetary Theory and the Trade Cycle, 1933
- Profits, Interest and Investment, 1939
- The Pure Theory of Capital, 1941
- The Road to Serfdom, 1944
- Individualism and Economic Order, 1948
- The Sensory Order, 1952
- The Counter-Revolution of Science, 1952
- The Constitution of Liberty, 1960
- Studies in Philosophy, Politics and Economics, 1967
- Law, Legislation and Liberty, 1975, 1976, 1979
- Choice in Currency, 1976
- The Denationalisation of Money, 1976
- The Reactionary Character of the Socialist Conception, 1978
- Unemployment and Monetary Policy, 1979