Were Hayek's Monetary Policy Recommendations Inconsistent?*

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Abstract: Contrary to the claims that Hayek's views on monetary policy were inconsistent, we show that Hayek was never an advocate of any particular monetary policy. In particular, we reject the view that early Hayek was a money stream stabilizer, while late Hayek was a price level stabilizer. We argue that Hayek was always aware that each practical monetary policy involves difficult trade-offs and was thus reluctant to impose his own value judgment about what people should strive for.

Key words: F. A. Hayek; monetary policy; Austrian business cycle theory; price level stabilization; money stream stabilization

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It is often believed that Hayek's views on monetary policy underwent during his lifetime a substantial change. A prominent advocate of this belief is Professor White, who claims that, in his *Denationalization of Money* (Hayek 2009[1978]), 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, 118).[1] While the second part of White's claim has been effectively 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 an 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.

The paper is divided into three sections as follows. Section 1 presents White's claims about Hayek's views on monetary policy; these claims are rejected in Section 2 by referring to Hayek's works; Section 3 concludes the paper.

[1] A similar claim, although without closer explanation, is made by Haberler (1896, 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, 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, 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 cannot be directly applied to the conditions of the 1970s. This is in line even with Steele's own argument (Steele 2005, 11).

1 Hayek according to White

According to White (1999, 116), Hayek "abandoned constancy of money stream as a norm, and embraced consumer price-level stabilization as the most desirable monetary norm." (See also White (1999, 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:

(i) According to Hayek I the money stream should be kept constant.[5]
(ii) According to Hayek I price level stabilization is not desirable.[6]
(iii) 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] claims (i)-(iii) do not imply repudiation of *ABCT*. The reason is that the validity of *ABCT* is a theoretical issue, whereas (i)-(iii) concern issues partly or completely outside the scope of positive inquiry: they are either value judgments or value-judgment-based policy recommendations. Even if claims (i)-(iii) 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 change his recommendations while remaining faithful to *ABCT*. In the next section we argue that claims (i) and (iii) are in fact false, while (ii) is at least questionable, since Hayek largely refrained from imposing his value judgments about what goals monetary policy should strive for.

2 What Hayek actually wrote

In discussing claims (i)-(iii), we first focus on Hayek's views on the neutrality of money and then on price level stabilization.

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[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, 118).

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], 1984b[1933]).[9] However, Hayek I does not make the normative claim that the money stream *should* be kept stable.

First, Hayek I makes 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 as a norm for monetary policy, at least in the first instance" (Hayek 1984[1933], 159). See also Hayek (1934, 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[1978], 87–88).

One of the reasons for his attitude was the practical difficulties of keeping money neutral. 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).

Second, although Hayek I claimed that the approximation of money neutrality was "probably the most important [...] criterion for assessing maxims of monetary policy" (Hayek 1984b[1933], 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 1984b[1933], 161). According to Hayek I, we would have to look for a compromise not only in the presence of long term contracts and rigid prices as suggested above but possibly also in the absence of these factors; for, as he pointed out, trade cycles "are, in a sense, the price we pay for a speed of development exceeding that

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[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 1984b[1933], 161).

which people would voluntarily make possible through their savings, and which therefore has to be extorted from them" (Hayek 1933, 189–190).[10] Apart from the trade-off between neutral money and enhanced economic progress, there is also a trade-off between more stable or more neutral money, given that the stability of money is one of the desirable goals of monetary policy.[11] This second trade-off is emphasized by Hayek II:

> [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], 243). See also Hayek (1999[1981], 241ff).

It 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:

> 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, 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

[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, 85). See Hayek (1934).

[11] The stability of money as a goal of monetary policy (as opposed to it being an alleged means of avoiding the business cycle) is further discussed in Section 2.2.

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, 125).

2.2 Price level stabilization

We now turn to claims (ii) and (iii). 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 eliminating the 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, 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], 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[1978], 74, 1999[1981], 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], 74). Quite in line with Hayek I, Hayek II then warns that a “stable national price level could disrupt economic activity” (Hayek 2009[1978], 115). Although he indirectly discusses the possibility of stabilizing consumer price levels (Hayek 2009[1978], 75) he was never its critic or advocate; therefore, he could not switch from one to the other as White (1999, 118) claims (cf. Steele 2005, 12).

The main problem that Hayek II attempts 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 the majority of Hayek's *Denationalisation of money* is devoted to the analysis of this possible new arrangement or to a comparison 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 be like:

> 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 2009[1978], 20). See also Hayek (1999, 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 the free 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 the proposal for a new, non-inflationary monetary regime.[12] On this basis, we reject claim (iii). As for claim (ii), 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 of the complicated trade-offs which any policy norm necessarily involves and was thus reluctant to 'dictate' to people what they should strive for.

[12] Haberler (1896) 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).

3 Conclusion

We have attempted to refute the notion according to which Hayek was inconsistent in his monetary policy recommendations. 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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