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REVIEW ESSAY

HAYEK: GOOD MONEY

BY

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F. A. Hayek, *The Collected Works of F. A. Hayek*, *Volume* 5—*Good Money Part I*: *The New World*, edited with an introduction by Stephen Kresge (Chicago: University of Chicago Press, 1999) pp. xi, 259, $45.00. ISBN 0 226 32095 2.
F. A. Hayek, *The Collected Works of F. A. Hayek*, *Volume* 6—*Good Money Part II*: *The Standard*, edited with an introduction by Stephen Kresge (Chicago: University of Chicago Press, 1999) pp. x, 259, $45.00. ISBN 0 226 32097 9.

These two volumes represent the latest available in the University of Chicago Press's *Collected Works of F. A. Hayek*, and they constitute an overview of Hayek's writings on monetary policy, broadly construed, from some previously untranslated work of the early 1920s, up to some of his last work on money, including *The Denationalization of Money* and related articles from the late 70s. These two volumes focus on monetary policy fairly narrowly, avoiding Hayek's work on the trade cycle, which will appear in subsequent volumes, and the debate with Keynes, which has already appeared as Volume 9. Much of the material here has been available in one form or another for awhile now, but these two volumes, done in the high-quality manner of the previous volumes in the series, nicely collect some more difficult to find articles and books in an easily accessible way. Both volumes include excellent introductory essays by the editor Stephen Kresge, each of which nicely sets the historical stage and places Hayek's work in the context of the economics of the time. It is also worthwhile to read back through Hayek's work on money in the order in which things were written, particularly with the hindsight of history.

What is most striking is the way in which the events of twentieth century monetary history affected both the issues Hayek chose to address and the particular perspectives that he took on them. His early work on the Federal Reserve System in the 1920s grew out of then-contemporary concerns with currency elasticity, price stability, money management, and the return to gold. With the advent of the Great Depression and World War II, his well-known work on the business cycle came to the forefront, but so did his concern with issues of the international monetary order—the relationship between monetary

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policy and nationalism in particular. When Hayek returned to monetary issues in the 1970s, it was now an age of inflation, not depression. But more important it was also a time in which the broad faith in the possibility of effective political management of the economy had begun to be undermined, both in theory and in practice. As a result, Hayek's most famous later work on money, *The Denationalization of Money*, offers market competition rather than political management as a solution to the ongoing problem of inflation. A closer look at these two volumes enables us to explore some of these themes.

As recent articles by White (1999) and Selgin (1999) have both noted, one of the more curious aspects of Hayek's writings on money is the traverse he made from being a skeptic about price-level stabilization in the 1920s and 30s, to a proponent of it in his final works in the 1970s. His early opposition to price-level stabilization is clear in the articles collected in Volume 5. The 1924 paper "A Survey of Recent American Writing: Stabilization Problems in Gold Exchange Standard Countries," which was written for a German audience for the purpose of introducing them to the then-current debates in the U.S., is focused on Fisher's *Stabilizing the Dollar* (1920) as well as the work of Foster and Catchings, and several other lesser-known American monetary theorists. Much of Hayek's energy is devoted to a discussion of the problems of index numbers and whether price-level stabilization is desirable in the face of downward pressure on employment and output. Of particular interest is his relatively favorable treatment of Foster and Catchings, which contrasts with the later stinging critique he would offer in "The Paradox of Saving" (1931). Included as an addendum to this article, is a paper previously unpublished and dated from February of 1924 entitled "Exchange Rate Stabilization or Price Stabilization?" Hayek points out there that one cannot stabilize exchange rates and the price level at the same time, an issue that continues to have significant relevance for the more globalized economy of our own day.

Another highlight of Volume 5 is the first complete translation of Hayek's "Monetary Policy in the United States After the Recovery from the Crisis of 1920." This was part of an intended longer project on the history of the U.S. banking system since 1900. As it stands, the paper is a lengthy and detailed overview of U.S. monetary policy in the early 1920s (the paper was published in German in 1925), and is of interest to both monetary theorists and historians of monetary policy. Reflecting the themes he was then developing, Hayek focuses on the accumulation of gold by the U.S. and the effects that might have on monetary policy there and elsewhere. His concern is that the U.S. gold holdings have ended the international competition for gold, which would end the "automatic regulation" process of the gold standard. The implication is that "new scientific methods would have to be devised ... for assuring the stability of the value of money, if it is not to be exposed to the sway of political factors" (p. 91). He then goes on to explore the ways in which American monetary policymakers were trying to make use of such new methods. He points out that the adjustment processes of "self-regulating currencies secured by their convertibility into a precious metal" often work too slowly to prevent problems and are subject to influences from the market conditions of the underlying metal (p. 139). One can already see the familiar Hayekian themes of contrasting the self-organizing

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processes of the market with the intentional policy-making of the political process. His desire for "scientific" methods to escape both the inadequate adjustment of the gold standard and the complete politicization of the money supply is notable given his later work that is so critical of our ability to "scientifically manage" market processes.

This period reflected some of the first attempts to manage the money supply for the purposes of price-level stabilization, and Hayek's discussion of these issues is fascinating history. It also reveals, in an embryonic form, ideas that would later become central to his work on the trade-cycle: a concern with forced savings and the relationship between capital goods and consumer goods. He contrasts the European roots of those ideas (in Mises, Wicksell, and Hawtrey) to the American work he is discussing. The differing focuses on each side of the Atlantic are of note, as the capital-theoretic foundations of the work inspired by Wicksell seem not to have penetrated American thinking at the time, which was heavily influenced by Mitchell's empirical work. The American focus on price-level stabilization to the neglect of Wicksellian concerns about investment, savings, and intertemporal coordination is quite clear in Hayek's overview of 1920s monetary policy.

Volume 5 concludes with a new translation of Hayek's 1928 paper on intertemporal equilibrium. This translation is not substantially different from the one published in 1984, but it does read a bit more clearly. The paper is correctly placed at the end of the first of the two volumes, as it represents the transition from Hayek's early work to his mature work on the cycle and later work on monetary policy. One can reconstruct a probable line of thought leading to the issues the paper addresses. The key is to remember that Hayek's second doctoral thesis was on imputation theory (a fact of some relevance to the role that capital theory would play in both his monetary theory and his contributions to the economics of socialism). Hayek clearly approached the American work he read in the 1920s with the German language capital theory he learned in Vienna and a clear sense of the importance of intertemporal price relationships. One can see through these essays of the 1920s a progressive sharpening of the kinds of criticisms he was raising about attempts to use central bank policy to stabilize the price level. That sharpening centers around the role of relative prices and the possibility that aggregative stabilization policies might discoordinate the underlying relative prices, especially those between consumer goods and capital goods—a natural concern to a man who had written a doctoral thesis on imputation, and a point he would later make in his review of Keynes' *Treatise*.

Although there are some problems with the 1928 essay (as White (1999) discusses), the essential argument that our understanding of the structure of prices had to be infused with the element of time, and that changes in productivity might necessitate downward movements in prices through time, is crucial to understanding Hayek's later work on the trade cycle. The problem for price stabilization policies is that attempting to increase the nominal money supply in order to drive up a price level falling due to real productivity gains will cause distortions in the intertemporal price structure. Those real productivity gains should be allowed to play themselves out through microeconomic adjustment processes, and trying to offset them with increases in the money supply will only

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undermine the ability of entrepreneurs to use monetary calculation to plan out their production processes. This set of ideas was also the source for Hayek's famed prediction of the collapse of the late 1920s. He argued that the relatively stable U.S. price level was masking underlying intertemporal discoordination caused by the expansionary monetary policy necessary for stabilizing the price level. The accuracy of that prediction provided some credibility for his cycle theory work that would follow.

Volume 6, subtitled "The Standard," includes Hayek's various books and essays on the most desirable monetary standard. The two key pieces here are reprints of his 1937 monograph *Monetary Nationalism and International Stability* and the 1978 edition of *The Denationalization of Money*. The 1937 book is one of Hayek's lesser known works and is often overlooked in discussions of his monetary and cycle theory in the 1930s. Hayek argues that a system of independent national banks, each trying to manipulate the domestic money supply for their own purposes, is bound to lead to international instability. With all of its faults, the gold standard was, for Hayek, superior to the national central bank model. He is clear to argue that any proper monetary system should be truly international, rather than a loose amalgamation of "competing" territorial monopolies. The preferred system, in Hayek's view, is either an international system of "free banking," where no single bank could have a territorial monopoly and all could control their own reserves, or an international central bank. However, "both of these ideals seem utterly impracticable in the world as we know it. But I am not sure that the compromise we have chosen ... is not one of the most unstable arrangements imaginable" (p. 88).

Much of the analysis in the monograph parallels Hayek's cycle theory work of that era and remains relevant for current events. It is worth asking how much of Hayek's critique of monetary nationalism still holds in a world where the transaction costs of exchanging currencies are near zero thanks to the communications revolution. With so much talk of the decline of the State, and the way in which international markets discipline central banks, it is not clear how many of the problems of monetary nationalism are still with us. That point notwithstanding, the reprinting of *Monetary Nationalism and International Stability* will bring its underappreciated analysis to a new audience.

One focus of Hayek's work on money in the 1930s was the concept of neutral money. The question was whether or not one could have a money that would have no effect on the determination of prices. That is, could changes in the money supply leave the structure of relative prices undisturbed from their equilibrium values? It was this concern that motivated Hayek's early view that a constant money supply was the desirable policy, as he thought that any change in the money supply would necessarily cause prices to deviate from their appropriate values. He modified this view over the course of his contributions by recognizing (in the second edition of *Prices and Production*) that it was appropriate to offset changes in income velocity with an inverse change in the nominal money supply. This view implied, as his earlier criticisms of price level stabilization suggest, that he thought it appropriate to allow the price level to rise or fall with productivity changes as long as monetary equilibrium was maintained. This reflects the Wicksell influence, where ensuring the investment-

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savings equilibrium was the key to monetary policy. The Wicksellian natural rate-market rate distinction was also the centerpiece to the Mises-Hayek theory of the trade cycle.

It is on these issues that *The Denationalization of Money* becomes somewhat anomalous in Hayek's monetary theory. At one level, the book represents the culmination of much of Hayek's lifework: he is bringing together his detailed technical work on monetary theory with his political economy of spontaneous order. In arguing that the proper solution to the problems of the monetary order is to take the money production process out of the hands of the State, Hayek was making almost the same argument he said was "utterly impracticable" forty years earlier. The fact that Hayek now thought it practical enough to devote a whole volume to is reflective of changes in the ideological and political landscape in the intervening years, not to mention the reality of the inflationary environment of the 1970s. Hayek was able to take his broad work in social theory and apply it to the more narrow economic problem that had vexed him for fifty years.

However, rereading *Denationalization* raises the anomaly that Hayek argues for denationalizing money on the grounds that it will bring price level stability! Hayek's traverse from critic to defender of price-level stabilization appears to be complete. Of course, the inflation of the times is the likely explanation for Hayek's change of position, a change he even acknowledges (p. 189):

> It is now generally recognized that even those additions to the quantity of money that in a growing economy are necessary to secure a *stable* price level may cause an excess of investment over saving. But though I was among those who early pointed out this difficulty, I am inclined to believe that it is a problem of minor practical significance. If ... average prices [are kept] approximately constant, we would come as close to a condition in which investment approximately corresponded to savings as we are likely to do by any conceivable method. Compared, anyhow, with the divergences between investment and saving which necessarily accompany the major swings in price level, those which would occur under a stable price level would probably be of an order of magnitude about which we need not worry.

So, due to the issue of practicality and a question of magnitude, Hayek ends his work on monetary policy by defending price level stability and apparently rejecting, again at least at the level of practical implementation, the "productivity norm" position he seemed to have held earlier (Selgin 1995). For Hayek, the reason to favor the competing fiat currency proposal he put forth in *Denationalization* is that it would do the best job possible in securing price level stability.

Hayek's perception that there was no "conceivable method" to do better than price stability has been challenged in succeeding years by the literature on "free banking" (Selgin 1988, White 1996), which argues that a system of competing *redeemable* currencies would do better yet in ensuring macroeconomic order. Precisely because it was inspired by Hayek's work on competing currencies, it is of interest that the justification for free banking is not that it would provide price-level stability, but that it is one "conceivable method" of maintaining the investment-savings equality that Hayek believed was beyond our power to achieve. In some sense, this Hayekian work completes a Hayekian circle: it links

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Hayek's later work in political economy with his earliest work in monetary theory and policy by envisioning a spontaneously ordered, competitive monetary system as being the best way to prevent inflation, deflation, and the trade cycle. Those with an interest in free banking and monetary equilibrium theory will find much of value in the more obscure articles collected here.

As is often the case with scholars of the first-order, they do not see all that is implicit in their own works. This is quite clear in reading through the almost sixty years of Hayek's monetary thought collected in these two volumes. Hayek's attempts to grapple with the fundamentals of monetary theory and policy, and to respond to the intellectual and economic events of his time, offer fascinating and fruitful reading for anyone interested the history of monetary thought and policy, Hayek's political economy, or contemporary concerns about monetary policy and international monetary affairs. The work collected here has already provided fertile ground for new ideas and the refashioning of old ones. The two volumes of *Good Money* contain an excellent selection of materials that reflect ideas that are still very much alive, and these volumes will serve both theorists and historians well in the years to come.

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