

FRIEDRICH HAYEK: THE COMPLETE ECONOMIST

G. R. Steele

By the width of his perspective, Hayek presents a challenge. Those who face up to that challenge are changed by the experience. The inevitable conclusion is that mainstream economics is defective by both its self-indulgent over-quantification and its persistence in presuming to formulate meaningful relationships between aggregates and averages.

Few economists give much attention to the economics of Friedrich Hayek. The simple explanation is that the characteristics of mainstream economics are incompatible with Hayek's approach. In sketching salient features of the relevant issues, the limitations and failings of the mainstream are examined.

Microeconomics is where mathematicians play. There is no social context and no institutional context and its method may be described in two words: 'constrained optimisation'. Its objective is to answer the question, 'How is it possible to achieve the best possible outcome when there are limited resources?' In applying constrained optimisation (that is, using differential calculus) to answer the question, agencies (households or firms) are assumed to know all there is to know and to act rationally in deploying their revenues and expenditures in order to achieve their goal (maximum satisfaction or maximum profits). However, with everything known, entrepreneurial initiative and discovery are redundant. More generally, with perfect knowledge all activity grinds to a standstill.

Hayek uses the fictional account of Professor Moriarty's pursuit of Sherlock Holmes to illustrate this particular point. In taking the train from London to Dover, Holmes decides to alight at an intermediate station because he knows that Moriarty can take a special faster train that arrives at Dover earlier. Yet, in knowing Holmes's thoughts and actions, Moriarty also travels to the intermediate station, which means that Holmes should instead go directly to Dover; but, of course, Holmes knows that Moriarty is alert to that action so must react accordingly. Such interdependent thinking reduces Holmes and Moriarty to rational inaction.

Microeconomics is understandably lampooned for the simplifications that are necessary for its mathematical formulations. When canned provisions are washed up on a desert island, the castaway economist assumes the availability of a can opener (at a known price). Albert Einstein might be quoted to the mathematicians, to salutary effect: although 'things should be as simple as possible, they should be no simpler'; and whereas 'not everything that can be counted counts, not everything that counts can be counted'.

Macroeconomics is where policy-makers play. John Maynard Keynes provided politicians with a rationale to intervene to improve national economic performance. Of course, the politicians required very little persuasion. The political game is to convince an electorate that one (rather than another) set of economic policies is superior to those offered by their rivals: faster growth, fuller employment and lower inflation. It took a Labour Prime Minister – Jim Callaghan, in 1976 – to prick the bubble of vain aspiration:

'We used to think that you could spend your way out of recession. . . . I tell you in all candour that option no longer exists, and that in so far as it ever did exist, it only worked. . . . by injecting a bigger dose of inflation into the economy, followed by a higher level of unemployment. . . . That is the history of the last twenty years.'

The relevance of Hayek's IEA pamphlet – *Full Employment at Any Price?* – to Callaghan's conversion, makes for interesting speculation:

'The primary duty today of any economist who deserves the name seems to me to repeat on every occasion that the present unemployment is the

direct and inevitable consequence of the so-called full employment policy pursued for the last twenty-five years.'

(Hayek, 1975, p. 35)

The notion that public expenditure, fiscal aggregates and the rate of interest might be systematically adjusted to bring a prosperity that evades the market process has no empirical support. Nobel Laureate Lawrence Klein provides a detailed historical account of the development of macroeconomic forecasting models, over a period of almost 40 years (Klein, 1984); but while the detail of the technical advances is impressive, not a single comment is offered upon the accuracy of the forecasts produced by those models. The reason: there has been no improvement.

Friedrich Hayek

Hayek came to the London School of Economics in 1930, in a move that was regarded as a counter to the influence of Keynes. This is understandable, because Hayek dismisses the whole macroeconomic approach – 'the pseudo-scientific economics of averages' (Hayek, 1972, p. 20) – as simplistic and damaging to incentives and to the network of linkages within the extended economic order. When the state assumes a responsibility to maintain full employment, it is inevitable that business, organised labour and the public at large come to rely upon the guarantee of no failure, which is a sure path to mediocrity.

Hayek rejects the modern proliferation of narrow disciplines: 'if you know economics and nothing else, you will be a bane to mankind, good, perhaps, for writing articles for other economists to read, but for nothing else' (Hayek, 1944a; 1991b, p. 42). Economics is not a discipline that can be studied meaningfully in isolation. Yet the drive to specialism has produced a profession of highly qualified narrowly-educated tunnelled visionaries. Hayek's description of those who are 'a bane to mankind' fits most academic economists. To find an economics curriculum that includes Hayek is rare indeed.

In presenting economics as an integral part of a broad theory of human action founded upon social theory and psychology, Hayek shows the limitations of mathematics in economics. An insistence upon tractable solutions means that mathematics can be applied only when the complexities of social engagements are assumed away. Social enactments occur in a context where knowledge is imperfect, incomplete and dispersed. In making best use of the 'particular knowledge of time and place' (Hayek, 1952 [1964, p. 80]), the role of local entrepreneurship is vital to economic advance. If the outcome could be said to fall short of precise mathematical optimisation, it is an output achieved without benefit of perfect foresight. Although entrepreneurs necessarily conduct their business against a background of uncertainties, they draw upon their 'local' expertise; and free markets allow that expertise to be utilised to the full, in a manner that brings greater benefits than any other known system.

Learning and serendipity feature within the mechanisms of entrepreneurial successes and failures. In learning from error and in drawing insights from experience, a liberal ethos allows individuals ever to seek new opportunities and to make discoveries:

'[L]iberty is essential to leave room for the unforeseeable and unpredictable; we want it because we have learned to expect from it the opportunity of realizing many of our aims. It is because every individual knows so little that we trust the independent and competitive efforts of so many to induce the emergence of what we shall want when we see it.'

(Hayek, 1960, p. 29)

Entrepreneurial trading benefits sellers who divest themselves of things they do not want, and buyers who acquire things they desire. More generally, such entrepreneurial successes achieve an improved distribution of resources. At its simplest, the entrepreneur is the man in the middle, who sets out to buy cheaply, sell expensively and to profit thereby. If entrepreneurial trading is a success, the purchase price rises, the selling price falls and the 'gap' begins to close. Hence, the tendency that underpins the economic 'law of one price' (with the practical proviso that irreducible transactions costs may leave a residual gap).

Consumers also act entrepreneurially when they have in mind an upper limit (a reservation price) to how much they would be willing to pay for a product. The greater the gap between the offer and the (higher) reservation price, the more readily the consumer makes a purchase. In economics jargon, the gap between the two prices is the 'consumer surplus', which is widened by a consumer's successful entrepreneurial activity in seeking a better deal. The consumer buys where products are cheap (exerting upward pressure upon prices) and avoids suppliers whose prices are high (exerting downward pressure upon prices). Here, the consumer-entrepreneur is the obverse of the producer-entrepreneur. If an individual buys successfully, he gains a 'consumer surplus'; if an individual sells successfully, he gains a 'producer surplus' (with a price above his reservation price: the minimum at which he would have been prepared to sell).

An alternative to speculative entrepreneurial trading across diverse markets is provided by socialist central planning, which Hayek describes as a 'beautiful illusion' and a 'fatal conceit'. The key problem is that socialists lack 'an understanding of economic processes' (Hayek, 1992, p. 140). Central planning has no access to tacit skills and knowledge, whose absence compromises efficient outcomes. In coping with the vast array of intermediate products and alternative production opportunities, market-determined exchange-values are indispensable. So, for example, concerns about greenhouse emissions lack coherence where recommendations are not founded upon exchange values. Moreover, the dirigiste apparatus of a central plan is incompatible with liberal institutions and the rule of law, so that it is civilisation itself that is ultimately threatened. It is not that socialists are unintelligent. To Hayek, the very opposite is manifest: 'One's initial surprise at finding that intelligent people tend to be socialists diminishes when one realises that, of course, intelligent people will tend to overvalue intelligence' (Hayek, 1988, p. 53).

Hayek's economics

Hayek is a meticulous theorist. His technical economics relates to capitalistic production methods and to business cycle theory. It is technically difficult because it incorporates the

dynamics of the passage of time. It is offputting to mathematicians because it does not trade over-simplifications in return for mathematical tractability. The 1974 Nobel Prize for Economics citation recognises Hayek 'as one of the few economists who warned about the possibility of the major crisis before the great crash came in the autumn of 1929' (Royal Swedish Academy of Sciences, 1974). That warning derives from Hayek's early monetary theory.

Lax money had prolonged the boom of the US economy in the 1920s. With an onset of business recession, there is no panacea in the easing of bank credit. Once investments have become inappropriately structured (which was the effect of keeping interest rates artificially low in the 1920s), solutions rest with rebuilding capital in a coherent fashion, as directed by market signals. Easing money to lift an economy is likely to defer that recovery; and Keynes's recommendation for a 'somewhat comprehensive socialisation of investment' (Keynes, 1936, p. 378) was pernicious advice. *The Road to Serfdom* (Hayek, 1944b) warned of the consequences in taking that direction.

Even now, when the full paraphernalia of Keynesian monetary and fiscal instrumentation are no longer deployed, short-term interest rate adjustments remain at the centre of economic policy. The belief is strong that interest rates can be tailored to benefit an economy and this is central to the debate relating to the euro. Economy A is overheating and deflation is needed. Economy B is in decline and needs a boost. Interest rates should be raised in economy A and lowered in economy B. In short: 'one size cannot fit all', it is argued.

Hayek would see this as macroeconomic nonsense. Interest rates are intertemporal prices that are distorted by policy manipulation. When interest rates are manipulated, consumption and production patterns become misaligned. So, for example, an interest rate cut encourages consumers to increase current expenditures (saving falls), and it encourages producers to invest more for future consumption, even though that is not what consumers want. When interest rates are artificially lowered, saving (too little) becomes out of line with investment (too much), investments are deployed in the wrong places, the wrong goods are produced and sustainable growth is compromised. These are the forces that drive Hayek's theory of business fluctuations.

Hayek's socio-economic theory

Spontaneous market adjustments provide a surrogate for the perfect knowledge readily invoked by the mathematician economists. Socialism is unscientific because socio-economic systems are complex and the knowledge required to implement

the central plan is incomplete, tacit and dispersed. The spontaneous social order is superior by its adaptive capacity in the face of unintended consequences. In short summary, the economics of Friedrich Hayek is embedded within that broad context. By his intellectual contributions in economics, epistemology, ethics, law, philosophy, politics and psychology, Hayek came close to the status of complete economist:

'To be a complete economist, a man need only be a mathematician, a philosopher, a psychologist, an anthropologist, a historian, a geographer, and a student of politics; a master of prose exposition; a man of the world with the experience of practical business and finance, an understanding of the problems of administration, and a good knowledge of four or five languages. All this in addition, of course, to familiarity with the economics literature itself.'

(Shackle, 1953)

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G. R. Steele is Reader in Economics at the Lancaster University Management School. His book, *The Economics of Friedrich Hayek* (2nd edn., 2007) is published by Palgrave Macmillan (G.Steele@lancaster.ac.uk).