CONTRA KEYNES AND CAMBRIDGE

F. A. HAYEK

THE COLLECTED WORKS OF

F. A. Hayek

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Essays, Correspondence

F. A. HAYEK

Edited by Bruce Caldwell

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EDITORIAL FOREWORD

I

The task which W. W. Bartley III, the founding editor of the Collected Works of F. A. Hayek, set for the editors of each volume was not only to assemble the writings of Hayek in a comprehensive and readable order, but to provide a theoretical, critical, and historical context in which the full significance of Hayek's work could be understood. *Contra Keynes and Cambridge,* volume 9 of the collected works and the fourth volume in order of publication, recreates the original debate between Hayek and John Maynard Keynes, which began on the pages of *Economica* in 1931 and which, in its implications for both economic theory and policy, has yet to be resolved.

The inclusion in this volume of the replies of Keynes and Piero Sraffa to Hayek's provocative review of Keynes's *A Treatise on Money* provides a new opportunity to examine the argument as it moved from similar premises to differing conclusions and on to altogether dissimilar premises and to conclusions that we ourselves must provide. The Hayek essays in this volume have not been previously collected, and his introductory essay, "The Economics of the 1930s as Seen from London", is published here for the first time.

II

Returning to the Hayek-Keynes debate after the events and controversies of over fifty years is not unlike stepping from the noise and bustle of the High Street into the measured precinct of a Cambridge or Oxford college court. And, like eager undergraduates, refusing to be intimidated by those august structures, we cannot help asking the question John Hicks asked: Which was right, Hayek or Keynes?

"Why was it right of Drake to play bowls when he heard the Armada was approaching, but wrong of Charles II to catch moths when he heard that the Dutch Fleet had entered the Medway? The answer is, 'Because Drake won'....We must take a larger view of the past than of the present, because when examining the present we can never be sure what is going to pay". So wrote E. M. Forster in 1920 from somewhere just off the High Street before his return to rooms just off the central court at Kings College.

Was Keynes right because he captured the professional economists and policymakers? Was Hayek wrong because it took much longer than he, or anyone, could have expected for certain of his predictions to be fulfilled? And could either eventuality have occurred in the same con- ceptual and political world in which it was initiated?

Neither Hayek nor Keynes was unmindful of the cultural and political consequences of their economic theories. They shared similar objectives: To preserve where possible and defend where necessary the values of prewar European liberal civilization. This was a world in which national identities mattered less than standards of conduct, which were not yet presumed to be amenable to government control; a world in which, for example, Ludwig Wittgenstein (Hayek's cousin), although fighting on the opposite side in 1915, could write to Keynes, in a letter posted from the K.u.K. Feldpost 186, "I am very interested to hear that Russell has published a book lately. Could you possibly send it to me and let me pay you after the war?...You're quite wrong if you think that being a soldier prevents me from thinking about propositions. As a matter of fact, I've done a good deal of logical work lately....The war hasn't altered my private feelings in the least (thank God!!)...." Civilization, for Keynes, was Cambridge and Bloomsbury, and he found himself pulled and prodded into increasingly nationalist positions (on tariff policy, for example, and the gold standard) and would not live long enough to reverse the severe nationalist measures that 'Keynesian' economics led to.

Hayek remained an internationalist to the end, more faithful to the values of the Cambridge halls than the ardent native. Hayek may have lost every battle except the last, but he kept alive for a new generation the possibility of discovering for themselves an answer to the persistent question, Which was right?

III

I would like to express my appreciation to Bruce Caldwell for accepting the perilous task of editing this volume and for remaining undaunted to its completion and to Gene Opton for preparing the text. We are grateful to Penelope Kaiserlian of the University of Chicago Press and Alan Jarvis of Routledge for their patient care in seeing this volume into print. Blackwell Publishers, *The Economist*, *The Journal of Modern History*, the Macmillan Press,

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I would like to thank the sponsors of the Collected Works of F. A. Hayek for their support of the project, and I am most grateful to Mr. Walter Morris of the Morris Foundation, without whose help and counsel the editorial labour of the project would have neither commenced nor continued. He, above all, can share no blame for our mistakes.

Stephen Kresge
Oakland, California

INTRODUCTION

In early 1927, Friedrich A. Hayek, a young Austrian economist who had not yet even begun his university teaching, sent a request to the most famous living British economist. John Maynard Keynes answered the query with a postcard dated February 24. It contained the single sentence, "I am sorry to say that my stock of *Mathematical Psychics* is exhausted".[1]

In early 1946, Hayek saw Keynes for the last time; their conversation would haunt him for years. Hayek asked Keynes whether he was concerned about what certain of his followers were making of his theories. The ever-confident Keynes replied that one must not worry about such things, that should those who called themselves 'Keynesians' ever become dangerous, he could turn public opinion against them in an instant. In the closing sentences of his review of Roy Harrod's *The Life of Keynes,* Hayek remembered the moment: "[H]e indicated by a quick movement of his hand how rapidly that would be done. But three months later, he was dead".[2]

In the nineteen years between the postcard and the conversation, twentieth-century economics was transformed, and the battle between Hayek and Keynes was central to the transformation. Sir John Hicks put it this way:

> When the definitive history of economic analysis during the 1930s comes to be written, a leading character in the drama (it was quite a drama) will be Professor Hayek. Hayek's economic writings—I am not concerned here with his later work in political theory and in sociology—are almost unknown to the modern student; it is hardly remembered that there was a time when the new theories of Hayek were the

[1]Postcard, Keynes to Hayek, February 24, 1927. In the Hayek collection, The Hoover Institution Archives, Stanford, Calif.

[2]F. A. Hayek, "Review of R. F. Harrod's *The Life of John Maynard Keynes*", *The Journal of Modern History,* vol. 24, June 1952, pp. 195–198, reprinted as chapter 10, this volume.

> principal rival of the new theories of Keynes. Which was right, Keynes or Hayek?[3]

Our goal in this volume is to recount the story, one that can be seen as part cautionary tale, part morality play, and (as it remains even now) part riddle. Though they first met in the late 1920s, the active exchange between Hayek and Keynes actually began in 1931. We will begin by tracing the sequence of events that brought each to his position in the ensuing debate.

Keynes

John Maynard Keynes was born in Cambridge on June 5, 1883, the first child of John Neville and Florence Keynes. Neville Keynes taught logic, but had been an early student of Alfred Marshall's and would become famous for publishing in 1891 an influential book on the methodology of economics. Maynard studied mathematics as an undergraduate. In 1905, he briefly took up economics to prepare for the Civil Service Examination. From 1906 to 1908 he worked in the India Office, then accepted a lectureship financed by A. C. Pigou in economics at Cambridge. Keynes was elected a Fellow of King's College in 1909 to continue his work on probability theory. He also continued to teach economics, and made his mark relatively quickly within the small circle of Cambridge economists. He took over editorship of the *Economic Journal* from F. Y. Edgeworth in 1911 at the age of twenty-eight and became secretary of the Royal Economic Society two years later. During the war he held a post in the British Treasury. His work there earned him a seat at the Paris Peace Conference as the chief Treasury representative. He was to resign in protest over the severity of the 'Carthaginian Peace' that, despite his best efforts, he saw emerging from the talks. Prior to his resignation, Keynes's successful efforts to ensure the avoidance of mass starvation in Austria had made him a hero among Central Europeans. But in the late summer, after leaving Paris, he penned the book that would bring him truly international fame, *The Economic Consequences of the Peace*.[4] Keynes became a hero to idealists and

[3]John Hicks, "The Hayek Story", in *Critical Essays in Monetary Theory* (Oxford: Clarendon Press, 1967), p. 203.

[4]J. M. Keynes, *The Economic Consequences of the Peace* [1919], reprinted as vol. 2 (1971) of *The Collected Writings of John Maynard Keynes*, Austin Robinson and Donald Moggridge, eds, 30 vols (London: Macmillan (for the Royal Economic Society), 1971–89). All further references to Keynes's writings will be to the relevant volume in *The Collected Writings of John*

internationalists around the world. His main thesis was not that the terms of the treaty were unjust, though he thought that they were. It was rather that the huge amounts of reparations demanded, intended to punish Germany and prevent her from ever becoming a power again, could potentially lead to the collapse of civilization in Europe. His prescience about the consequences of the peace increased Keynes's reputation as time passed.

Keynes and the Gold Standard

A central theme of *Economic Consequences* was that the war had transformed Europe, that relations among states were categorically different from those that had existed before, and that the new age demanded new policies. Keynes gave concrete form to his vision when he joined the debate over the return to the gold standard a few years later.

For two generations preceding the war, England had been the world center for trade and finance. The gold standard was widely credited at the time with keeping international financial markets orderly and thereby ensuring the steady growth of commerce and capital investment. It was thought to work this way: Whenever the British bought more goods from foreigners than they sold to them, gold would flow out to make up the difference. The gold outflow would, through various channels, cause the Bank of England to raise Bank Rate (the interest rate under its control) in response. As other interest rates were pushed upwards, economic activity would slow. The slowdown would bring about a general deflation, a forcing down of domestic prices and wages, which was usually accompanied by increased unemployment as well. The lowering of wages and prices was painful but restorative medicine. Lower British prices would reduce domestic demand for relatively higher-priced imports while stimulating foreign and domestic demand for British goods. This would lead to a restoration of balance of payments equilibrium.

Recent scholarship asserts that many of the beliefs prevalent in the interwar period about the workings of the gold standard were myths. The relative success of the standard in the late nineteenth century is now attributed less to the vigilance and power of the Bank of England, and more to the cooperation of a number of central banks and to the credibility of their joint responses to crises. World War I ended both the ability and willingness of the banks to act in concert. Indeed, the attempt to reestablish and maintain the standard in the new environ-

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Maynard Keynes.

ment was one reason that the 'Slump of 1930' turned into a worldwide Great Depression.[5] The central point for our purposes, however, is that at the end of the First World War many in government thought that a return to gold was a necessary condition for the reestablishment of stability in international commerce and finance.

In Britain, an embargo on gold exports imposed during the war became embodied in an Act in 1920, but was set to expire in 1925. If no further action were taken, on expiration the pound sterling would again be exchangeable against the dollar at the prewar exchange rate of £1 = $4.86. Though the pound was worth considerably less than $4.86 following the war, the embargo provided some breathing room during which, it was hoped, its value might rise towards prewar parity. A recession in Britain in 1920–21 helped move sterling in the right direction against the dollar. But the unemployment rate also soared, reaching a high of 22.4 per cent in July, 1920, and remaining in the 10 per cent range for the next three years.

It was in his 1923 book, *A Tract on Monetary Reform*, that Keynes began to speak out against the "barbarous relic" of the gold standard.[6] He began the book by detailing the adverse effects of an "unstable value of money" on both distribution and production. He analyzed both inflation and deflation, and summarized their effects as follows: "Thus inflation is unjust and deflation is expedient. Of the two perhaps deflation is, if we rule out exaggerated inflations such as that of Germany, the worse; because it is worse, in an impoverished world, to provoke unemployment than to disappoint the rentier".[7]

If England were to decide to return to the gold standard, Keynes (at least in 1923) was willing to take a wait-and-see attitude about whether it should be at the prewar rate or at a lower one. More controversially for the times, Keynes argued that a return to gold at a fixed convertibility rate, no matter what the value, would be a mistake. It was here that his vision of a changed world came into play. The gold standard may have provided stability for international markets when England dominated world trade. But its time had passed. European markets were in shambles; socialist, reactionary, and nationalist movements competed for influence in both long-established and newly formed nations; most

[5]See Barry Eichengreen, *Golden Fetters: The Gold Standard and the Great Depression, 1919–1939* (New York and Oxford: Oxford University Press, 1992).

[6]J. M. Keynes, *A Tract on Monetary Reform* [1923], reprinted as vol. 4 (1971) of *The Collected Writings of John Maynard Keynes*, op. cit., p. 138.

[7]*Ibid.*, p. 36. *Rentiers* are owners of financial capital and other property. In Germany, hyperinflation had wiped out the savings of the middle- and upper-class *rentiers* who had bought bonds to support the war effort.

importantly, the United States had replaced Britain as the world centre of commerce and finance. A return to gold would require that the US Federal Reserve system, only a decade old and buffeted by domestic political influences, should avoid errors and coordinate its actions with the Bank of England. Keynes doubted that such coordination could be achieved on a sustained basis. His policy recommendation was that the monetary authorities of Britain and the United States should make the internal stability of the value of money their first priority. Rather than fixing the exchange rate, he recommended that a form of the "crawling peg" system be instituted in which the exchange rate would move to preserve internal price stability. If the central banks of the United States and Britain were able to coordinate their actions, exchange rate stability would also result. But internal stability should be the first priority of policy.

Again his advice went unheeded. On March 17, 1925, Chancellor of the Exchequer Winston Churchill held an unusual dinner party. Two months earlier, he had distributed a memorandum that made the case against a return to gold, to which he invited a response. (Given its similarity to a school examination, the memo became known as "Mr. Churchill's Exercise".) Over dinner, Keynes and former Chancellor Reginald McKenna debated the merits of the case with two top Treasury officials. Churchill listened, occasionally offering comments of his own. In the end, the Chancellor decided to return to the gold standard at a fixed prewar parity of £1 = $4.86.[8]

The Evolution of Keynes's Policy Views

Harry Johnson called the return to gold at $4.86 "an act of blind traditionalism", and Churchill's error was indeed a consequential one.[9] Increased foreign competition had begun to undermine England's industrial, manufacturing, and commercial sectors even before the war. The disruption of trade during the war years exacerbated longstanding problems. In the best of circumstances, the 1920s would have been a painful period of structural realignment for England. The upwards

[8]For accounts of the fateful dinner party, see D. E. Moggridge, *British Monetary Policy 1924–31: The Norman Conquest of $4.86* (Cambridge: Cambridge University Press, 1972); and P. J. Grigg, *Prejudice and Judgment* (London: Cape, 1948). The latter was written by Churchill's private secretary for matters of Finance and Administration, who had attended the dinner.

[9]Harry Johnson, "The Shadow of Keynes", in *The Shadow of Keynes: Understanding Keynes, Cambridge and Keynesian Economics*, Elizabeth Johnson and Harry Johnson, eds (Chicago: University of Chicago Press, 1978), p. 176.

movement of the value of sterling towards prewar parity prior to 1925, and efforts to sustain that exchange rate afterwards, kept interest rates high, battered export industries, and held the unemployment rate in the 10 per cent range for the rest of the decade.

Even more crucial for our story is Keynes's response to the stagnant economic conditions of the 1920s. Though he did not deny the effects of both structural changes and policy missteps, Keynes ultimately concluded that a more fundamental change had occurred, that the whole system of laissez faire capitalism required re-examination.[10]

In Keynes's colorful prose, the unemployment rate had become "stuck in a rut"[11] at an unusually high level: something had caused the equilibration mechanism to stall. As noted above, one of the consequences of the return to gold was high interest rates. Such rates attracted savings. Unfortunately, the level of savings became too high; there were insufficient profitable domestic investment opportunities available. As a result, British funds were drawn to finance investments overseas. Looked at another way, British industry was no longer competitive.

Normally such a situation should not persist. High unemployment should cause British prices and costs to drop, and this should eventually restore a competitive edge. But it was here that an additional problem surfaced. Due to the growing political strength of Labour, it was more difficult to force wages, and hence costs, downwards.[12] Nor was a cut in real wages via inflationary monetary policy an option, since inflation would only serve to exacerbate the exchange rate problem.

It was in considering this dismal situation that Keynes hit upon another solution, one that went beyond the nostrums of laissez faire, one that he himself thought constituted a "drastic" remedy.[13] The state should coordinate savings and investment, undertaking an extensive program of public works (such as the construction of roads, housing, and electrical plants) that would create jobs to make use of the unemployed labour. This would reverse the flow of savings out of the

[10]That Keynes's goal in the interwar period was "to save a capitalist system he did not admire" (p. xv) is a dominant theme in Robert Skidelsky, *John Maynard Keynes: Volume Two, The Economist as Saviour 1920–1937* (London: Macmillan, 1992).

[11]J. M. Keynes, "Does Unemployment Need a Drastic Remedy?" [1924], reprinted in *Activities 1922–1929: The Return to Gold and Industrial Policy*, ed. Donald Moggridge, vol. 19, part 1 (1981), of *The Collected Writings of John Maynard Keynes*, op. cit., p. 220.

[12]Though it was to last only ten months, the first Labour government was formed in 1923 with Ramsay MacDonald at its head. Keynes's prognostications received further confirmation when a bitter dispute between workers and owners in the coal industry led to a General Strike in 1926.

[13]J. M. Keynes, "Does Unemployment Need a Drastic Remedy?", op. cit., pp. 219–223.

country, would add to the domestic capital stock, and best of all, once such projects were under way, it would be discovered that "*prosperity is cumulative*".[14] The happy effects on labour are described by Keynes as follows:

> [W]e must seek to submerge the rocks in a rising sea,—not forcing labour out of what is depressed, but attracting it into what is prosperous; not crushing the blind strength of organized labour, but relieving its fears; not abating wages where they are high, but raising them where they are low.[15]

Over the next few years, Keynes developed and promoted these ideas, both in his popular writings and in a series of Liberal Summer Schools, open to the public, held in alternate years in Oxford and Cambridge. In 1928, his ideas formed the basis for a number of themes in the Liberal Party publication *Britain's Industrial Future,* dubbed the 'Yellow Book'. Lloyd George, the Liberal Party leader, embraced the proposals in his manifesto, *We Can Conquer Unemployment,* published prior to the 1929 General Election.

The most outspoken opponent of Keynes's new views was neither another political party nor a body of academic economists, but the Treasury. In his budget speech in April, Churchill stated a position that soon became known as the 'Treasury View': "It is the orthodox Treasury dogma, steadfastly held, that whatever might be the political and social advantages, very little additional employment and no permanent additional employment can in fact, and as a general rule, be created by State borrowing and State expenditure."[16] This was followed by an official Treasury White Paper defending from Liberal criticisms various actions that the Treasury had taken. The Liberals placed third in the election. Ironically, neither Labour (which won) nor the Conservatives had any truck with the new ideas. Keynes's impression of the matter is recalled by Elizabeth Johnson:

[14] *Ibid.*, italics in original, p. 221. Note the suggestion of the notion of the multiplier in this phrase. Keynes's biographer Roy Harrod observed that this article contains "the outline of the public policy which has since been specifically associated with his name". See his book *The Life of John Maynard Keynes* (New York: Harcourt Brace, 1951; New York: Norton, 1982), p. 350.

[15] *Ibid.*, p. 220.

[16] The evolution of the Treasury View from a theoretical to a pragmatic argument against public works as a policy to fight unemployment is carefully documented in Peter Clarke, *The Keynesian Revolution in the Making, 1924–1936* (Oxford: Clarendon Press [1988], 1990), chapters 3 and 7. Churchill's quote may be found on p. 67.

> Both Conservative and Labour governments—in the "fatalistic belief that there can never be any more employment than there is", as Keynes had expressed it in 1929—sat tight during the 1920s and 1930s, instructed by the civil servants of the Treasury school whom he later characterized as "trained by tradition and experience and native skill to every form of intelligent obstruction".[17]

As usual, Keynes did not give up. Debate over the issue would continue in deliberations of the Macmillan Committee on Finance and Industry, a group set up to investigate the effects of the financial and monetary systems on the state of industry, which met from November 1929 through May 1931. Keynes both offered his own evidence and, as a member of the committee, played the role of interrogator when Treasury and Bank of England officials appeared.

The evolution of Keynes's thought on policy during the 1920s has necessarily been simplified in this account, but in broad outline it was as follows: The return to gold at a fixed and overvalued rate kept interest rates high, and it also effectively eliminated monetary policy as a stabilization tool. The emerging strength of the Labour party meant that cuts in nominal wages could be resisted. As such, the deflation necessary to bring the system back into equilibrium would take a very long time to work and would be accompanied by unacceptably high levels of unemployment. Increased spending on public works held out the promise of at least putting some people back to work. If prosperity indeed turned out to be "cumulative", it might be able to do much more. All of this was contained in Keynes's popular writings and governmental papers; it had yet to work its way convincingly into his theoretical tracts in economics.

A final episode provides additional insights into Keynes's views on policy, and into his personality as well. When Keynes was writing in the 1920s, the unemployment rate in Britain was 10 per cent. By 1931, it was in the 20 per cent range. As early as the summer before, Keynes began reluctantly to advocate that protectionist measures be undertaken to help fight unemployment and stem the flight of gold. He did this privately, in deliberations of government committees and in letters to government officials. But finally on March 7, 1931, he publicly endorsed a revenue tariff in an article printed in the weekly *The New Statesman and Nation*. This was followed by a more popular version the following week in *The Daily Mail*.[18]

[17]Johnson and Johnson, op. cit., p. 19.

[18]See his "Proposals for a Revenue Tariff", reprinted in *Essays in Persuasion*, vol. 9 (1972) of *The Collected Writings of John Maynard Keynes*, op. cit., pp. 231–238; also see the