
GOOD MONEY, PART II



F. A. HAYEK

THE COLLECTED WORKS OF

F. A. Hayek

GOOD MONEY, PART II

The Standard

F. A. HAYEK

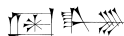
Edited by Stephen Kresge



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Good Money, Part II, is volume 6 of The Collected Works of F. A. Hayek, published by The University of Chicago Press.

First published by The Institute of Economic Affairs, London, 1976;
revised edition, 1978.

This Liberty Fund paperback edition of *Good Money, Part II*, is published by arrangement with The University of Chicago Press and Taylor & Francis Books, Ltd., a member of the Taylor & Francis Group.

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P 1 2 3 4 5 6 7 8 9 10

Library of Congress Cataloging-in-Publication Data

Hayek, Friedrich A. von (Friedrich August), 1899–1992.
Good money/F. A. Hayek; edited by Stephen Kresge.—Liberty Fund
paperback ed.

p. cm.—(The collected works of F. A. Hayek; v. 5–6)
“Good Money, Part [I and] II, is volume [5 and] 6 of The Collected Works of
F. A. Hayek, published by The University of Chicago Press.”

Includes bibliographical references and index.

ISBN 978-0-86597-746-4 (pbk.: alk. paper) 1. Money.
2. Monetary policy. 3. Gold standard. 4. Foreign exchange rates.
5. Prices. I. Kresge, Stephen. II. Title.

HG220.A2H39 2008
332.4—dc22 2008030052

Liberty Fund, Inc.
8335 Allison Pointe Trail, Suite 300
Indianapolis, Indiana 46250-1684

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the American National Standard for Permanence of Paper for Printed Library
Materials, Z39.48-1992.∞

Cover design by Erin Kirk New, Watkinsville, Georgia
Printed and bound by Thomson-Shore, Inc., Dexter, Michigan

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EDITORIAL FOREWORD

The title of this collection of F. A. Hayek's essays on monetary theory and policy is the title which Hayek had hoped to use for a conclusive summation of his ideas on the subject of money. "I still hope", he confided in an interview with Axel Leijonhufvud in 1978, "to do a systematic book which I shall call *Good Money*. Beginning really with what would be good money—what do we really want money to be—and then going on to the question of how far would the competitive issue of money provide good money in terms of that standard". This book remained unwritten, but the subject had occupied Hayek off and on throughout his career. The essays brought together in the two parts of *Good Money* exhibit the full range of Hayek's views on money—some consistently held, such as the Cantillon effect, and others, such as the apparition of a stable price level, modified or abandoned. Taken all together, the essays provide a solid introduction to aspects of monetary theory often neglected, with insights still applicable to the disordered and bewildering monetary events of the present.

Hayek was born on May 8, 1899, in Vienna. He died on March 23, 1992, in Freiburg im Breisgau in Germany, having lived long enough to see the fall of the Berlin Wall and the vindication of his long struggle against socialism. He had become a British subject in 1938 when he was Tooke Professor at the London School of Economics. After the Second World War, he came to the United States to teach at the University of Chicago from 1950 to 1962. As an economist, Hayek is among his peers perhaps the least confined to a view of the world which seeks to identify a model of an economy with a single nation. He was quick to learn languages—Swedish and Italian among them—and quick to spot the evils of coercion which lurk within nationalistic pretensions.

Hayek made his first visit to the United States in 1923, where he responded to the controversies of the day with an insight into monetary theory as to the crucial role of *time* in any concept of equilibrium. Once it is understood that prices change over time, the order in which prices change in response to changes in the supply of money cannot be ignored.

This insight was a new departure both for Hayek and for economics. The aftermath of the First World War brought to the forefront of the concerns of central bankers and economists the difficulty of stabilizing the value of currencies, both in terms of a domestic price level and in terms of other currencies. Hayek criticized the goal of an artificial stabilization of the value of money, resting his argument on a pioneering demonstration of the need for intertemporal equilibrium in the formation of which money must remain neutral.

By 1937, the views on monetary policy which Hayek criticized were largely discredited by events. In a lecture on “Monetary Nationalism and International Stability” he drew attention to what we now know to be the prime cause of the economic distress of the 1930s—the failure to maintain an international monetary standard. Yet all too quickly the scourge of belligerent nationalism had forged the calamity to come, and after the Second World War the US dollar, tied loosely to gold, became the accepted international standard. By 1973, the dollar was no longer tied to gold, and much of the world experienced levels of inflation not seen since the period following the First World War. Hayek concluded that national governments could not be relied upon to provide good money. He offered a bold proposal for the denationalization of money: People should be allowed to choose the money they prefer to hold; governments should compete with private issuers to supply money.

Between his 1937 argument for fixed exchange rates and his later proposal for competing currencies, Hayek put forward a proposal for a commodity reserve currency. Money would be backed by stored commodities in some fixed proportion, and money could be exchanged for a fixed unit of these commodities, or if it were found more profitable to do so, commodities could be offered for storage in exchange for money. Two advantages were claimed for this system: an automatic limit on the supply of money and a counter-cyclical mechanism for limiting the trade cycle.

At this writing, the world seems to be slipping back into the monetary expediency of nationalist controls; governments are again intervening in currency markets, stock markets, and banking. The value of money and the level of interest rates are subject to bouts of uncertainty not seen since the 1920s and 1930s. Good money is once again an elusive goal. In perhaps only one respect are monetary conditions greatly changed from those which formed the context in which Hayek wrote: Communications are swifter, to the degree that adjustment to unforeseen change may be instantaneous—for better or worse. The danger is that we will be overwhelmed by ‘information’ the significance of which we cannot know, since we have lost the standards by which we judge. Hayek’s essays are an in-

valuable contribution to a theoretical and historical perspective which we may call upon to sort out the good money from the bad.

The essay "A Commodity Reserve Currency" was, surprisingly, catalyst to the Collected Works of F. A. Hayek. Just how this came about is, in its own not insignificant way, an example of Hayek's concept of 'spontaneous order'. The initial impulse came from Walter Morris, who attended the keynote address given by Hayek at the convocation of the Open Society and Its Friends in New York in November 1982. Morris was an admirer of Benjamin Graham, whose book *Storage and Stability* was one of the sources of Hayek's essay. In what was to be only the first of many acts of generosity, Morris then brought together, at a dinner party in honor of Hayek, W. W. Bartley III; Irving Kahn, who has recently seen Graham's *Storage and Stability* back into print; and, among others, this editor. The talk at the dinner party was about Hayek's ideas, notably his proposal for the denationalization of money.

In the following year, Walter Morris supplied the enthusiasm, good will, and persistence that convinced Hayek and Bartley that a collected works must be produced to acquaint the present generation with Hayek's thinking and to preserve for future generations a legacy which we can now see is nothing less than an introduction to the development of the modern world. We owe to Walter Morris and to the Morris Foundation, for its continuing financial support of the project, an immense debt of gratitude. The editor wishes to express his personal appreciation to Walter for the untiring support he has provided in some difficult times.

In bringing order to the unwieldy bounty of words that somehow manage to become the manuscripts of the collected works, Gene Opton, who has been assistant editor from the start, has been indispensable. Routledge and the University of Chicago Press, Hayek's longtime publishers, are due our appreciation for their support, with particular thanks going to Alan Jarvis and Penelope Kaiserlian. For their help with Part Two of *Good Money*, the editor thanks his research assistant, Elisa Cooper; Bruce Caldwell, for spotting certain incautious conclusions and other possible muddles; and Denis O'Brien for his thorough and knowledgeable criticism of the Introduction. We would like to thank the Institute of Economic Affairs for permission to reprint "The Denationalization of Money", and to express our appreciation to Lord Harris, John Blundell, and the late John Wood for their support of the Collected Works. We would also like to thank Anthony S. Courakis and the estate of John Hicks for permission to print a letter from Hicks to Hayek. For permission to reprint "The Future Unit of Value", we would like to thank Kluwer Law

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International; and for permission to reprint “Toward a Free Market Monetary System”, we thank Burton S. Blumert and the Center for Libertarian Studies.

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INTRODUCTION

One of the more dramatic images that Hayek has left us from his long life—he was born in Vienna in 1899 and died in Freiburg, Germany in 1992—was the preparation he made in 1939 for a possible escape from Nazi-controlled Austria which he wanted to visit before the outbreak of war. Although by then he was a British subject and could travel with a British passport, “I didn’t want to be suspected of having any special privileges with the Germans”, he remembered. “I knew those mountains so well that I could just walk out. I knew [the mountains in Carinthia] well enough, even better than the Vorarlberg-Switzerland boundary”.¹ Those boundaries, indeed all of the boundaries of Eastern Europe which had to be established following the collapse of the Austro-Hungarian empire, lay at the core of much of the horror inflicted on the twentieth century.

Vienna had saved Europe from the invading Ottoman Turks in 1683; the First World War—in which Hayek fought for Austria—had its origins in the conflict of nationalist and imperial pretensions growing within the declining Ottoman empire. One of the more perceptive writers of the inter-war period prefaced a warning with a prophetic anecdote:

In 1886 a young Englishman, son of Joseph Chamberlain, was sent to Paris by his family to prepare for a career in public affairs. One day, at the Ecole des Sciences Politiques, he heard the lecturer on diplomatic history, Albert Sorel, make this pronouncement: ‘On the day when the Turkish question is settled Europe will be confronted with a new problem—that of the future of the Austro-Hungarian Empire’. But what perturbed young Austen Chamberlain was not the possibility that the Austro-Hungarian Monarchy might collapse and its dominions disintegrate. It was that Sorel went on to draw a conclusion most discomfiting to any thinking Englishman. The young man, destined to be Foreign Secretary of his country, heard the French professor describe the disintegration of

¹F. A. Hayek, *Hayek on Hayek*, Stephen Kresge and Leif Wenar, eds (Chicago: University of Chicago Press, and London: Routledge, 1994), p. 137.

Austria-Hungary as a possible preliminary to the break-up of the British Empire.

Sir Austen Chamberlain said that he never forgot Sorel's warning. The former Foreign Secretary of the United Kingdom was not happy about the disruption of the Austro-Hungarian political and economic unity, sanctioned by the victorious Allies in the Peace Treaties. He became towards the close of his life increasingly unhappy about the future of maimed and lamed Austria, threatened by Germany's Third Reich. But, perhaps fortunately, he did not live to see what happened to Europe in 1938. For then what his French professor had feared half a century earlier came to pass. The last vestiges of the Austro-Hungarian Empire, the small independent states reared on its ruins and in its place, collapsed before two short and sharp German diplomatic assaults.²

Suppose that one knew nothing of history and had before one only two maps of the world: one map drawn at the end of the nineteenth century and the other at the end of the twentieth. One fact would be clearly visible: The empires of the European powers which covered the world at the end of the nineteenth century had vanished by the end of the twentieth. Knowing nothing of history, one could not know how this happened, or even if it mattered. Without history, the present division of the world into numerous independent states becomes a political and economic fact, without causes and, one might suppose, without consequences. One consequence is that each of these now independent states had to develop means to maintain internal order and coherence; resolve conflicts that arose from past legal, religious, or ethnic differences; and establish new currencies for internal use. But with the establishment of new boundaries comes the challenge of communicating *across* borders, the difficulty of conducting trade when independent currencies may be linked by no common standard. With a little investigation of the monetary conditions that prevailed in the nineteenth century, the map reader would learn that the imperial currencies had possessed a common standard—the gold standard—which did not survive their collapse. What did these now-independent countries put in the place of the abandoned standard to make it possible to conduct trade across new boundaries?

John Hicks has observed that “Monetary theory is less abstract than most economic theory; it cannot avoid a relation to reality, which in other economic theory is sometimes missing. It belongs to monetary history, in a way that economic theory does not always belong to economic his-

²Graham Hutton, *Danubian Destiny* (London: George G. Harrap, 1939), pp. 5–6.

tory. . . . So monetary theories arise out of monetary disturbances”.³ Hayek concurs: “In the past, periods of monetary disturbance have always been periods of great progress in [monetary theory]. The Italy of the sixteenth century has been called the country of the worst money and the best monetary theory”.⁴

The collapse of the gold standard during the first World War contributed to two calamitous monetary disturbances of the mid-twentieth century: the inflation—hyperinflation in Germany and Austria—immediately following the war, and the deflation and depression in much of the world in the 1930s. At the end of the First World War, confined within the narrow boundaries of the left-over Austria, the Vienna in which Hayek began his university studies found itself near starvation and without electricity. With the dissolution of the Hapsburg empire, Vienna could no longer obtain from within its own domain Hungarian wheat or Czech coal. The boundaries which confined Austria to its hapless condition were imposed upon it by the terms of the Treaty of St. Germain, largely dictated by the determination of the French to create Slav states to contain a resurgent Germany.

With gold and other financial reserves exhausted by the war, the new republican government of Austria, under attack by socialists, resorted to printing money, banknotes which were no longer acceptable in the regions upon which Vienna depended for provisions. The resulting inflation destroyed much of the professional middle class—the class to which Hayek belonged—which had loyally purchased government bonds to finance the war effort. To say that Hayek was affected by this financial catastrophe is only to acknowledge the obvious; of more importance for the role it played in the development of his economic theories was the insight he gained thereby into the multiple effects—sometimes crude and immediate, but often subtle and prolonged—that inflation inflicts upon a society. The fate of Austria in the twentieth century also left Hayek less eager to accept the borders of nations imposed by governments of questionable legitimacy as also determining the boundaries of economies.

This introduction to Hayek’s ideas about money is in large measure directed to the map reader that each of us becomes when exploring unfamiliar territory. Hayek’s monetary theory rested on assumptions about

³John Hicks, “Monetary Theory and History—An Attempt at Perspective”, in *Critical Essays in Monetary Theory* (London: Oxford at the Clarendon Press, 1967), p. 156.

⁴F. A. Hayek, *Prices and Production* (London: Routledge & Kegan Paul [1931], 2nd edition, 1935), p. 2.

the workings of a non-monetary economy (which, perforce, would be in theory only) that we cannot take for granted in current economic thinking, which neglects much of the implications of the ancient debate over just why and how money ‘matters’,⁵ and which assumes only that money is provided by governments and that only our expectations about increases or decreases in the supply of money matter. Embedded in this approach is the assumption that the supply of money is an exogenous variable, that is, an institutional matter, but the demand for money can be construed as amenable to theoretical analysis. This modest approach to money is perhaps the result of a certain fatigue with the inconclusive debates between ‘monetarists’ and ‘Keynesians’ which petered out in the 1980s when no empirical regularities could be found between increases in the supply of money and employment.⁶

Hayek’s intellectual heritage came from two primary sources, the Austrian tradition of Menger and Mises, and the ‘classical’ tradition of Adam Smith and David Hume, to which Hayek added Richard Cantillon and Henry Thornton.⁷ In his approach to money Hayek retained a theory of value based on the subjective choices of individuals; but value theory survived in the macroeconomics of the ‘monetarists’ and the ‘Keynesians’ only through questionable methods of composition: the use of statistical

⁵Charles P. Kindleberger traces common elements of a debate over money as far back as the sixteenth century and continuing in following centuries in debates between, for instance, Lowndes and Locke, the Banking and Currency Schools in Britain, and between Friedman and Keynes. “But the dichotomy is not between any particular views of those great economists. It is rather far more general, between one school worried about inflation and deflation of prices and the quantity of money, and the other more about output and employment. . . .” *Keynesianism vs. Monetarism and Other Essays in Financial History* (London: George Allen & Unwin, 1985), p. 1.

⁶The debate was launched with *Studies in the Quantity Theory of Money*, Milton Friedman, ed. (Chicago: University of Chicago Press, 1956). Friedman wrote of a surviving tradition at the University of Chicago “. . . in which the quantity theory [of money] was connected and integrated with general price theory and became a flexible and sensitive tool for interpreting movements in aggregate economic activity and for developing relevant policy prescriptions”. Milton Friedman, “The Quantity Theory of Money: A Restatement”, *ibid.*, p. 52. The emphasis here, in contrast to Hayek, is on aggregate economic activity. The statistical investigation of aggregate economic activity in an attempt to find predictable regularities began with Wesley Clair Mitchell and the founding of the National Bureau of Economic Research where Milton Friedman began his career. On Hayek’s relationship to Mitchell, see *Good Money, Part I*, Introduction.

⁷Carl Menger (1840–1921) was the founder of the Austrian school of economics, which traced the source of economic value to the subjective choices of individuals; Ludwig von Mises (1881–1973) directly influenced Hayek through his writing on money and socialism, as well as through personal contact and discussion, most notably in a seminar which gathered together several of the most promising young economists of the period. See F. A. Hayek, *The Fortunes of Liberalism* (1992), Peter G. Klein, ed., being vol. 4 of the Collected

aggregates or theoretical ‘functions’. Here the primary influences—those which set macroeconomists apart from their predecessors—included American institutionalists from whom was developed a methodology that depended upon statistical aggregation.⁸ It is not easy to characterize Hayek’s dislike of the uses made of statistical inferences, but he suffered serious aggravation when what he regarded as particular and necessarily individual economic choices were conflated by mechanical numerical means into the methodological solecism of ‘aggregate demand’.⁹

In 1930, Irving Fisher presented a concise justification of the reasoning that permitted him to substitute for the subjective qualities of individual choices the real goods which individuals received; and for this real income its cost in money, which permitted Fisher to construct the statistically contrived indices which are now used to determine the ‘value’ of money.¹⁰ This reasoning owed as much to the growing ‘positivistic’ bent

Works of F. A. Hayek (Chicago: University of Chicago Press, and London: Routledge), Part One.

Adam Smith (1723–1790) is honored as the founder of classical economics and, with David Hume (1711–1776), is the leading figure in the Scottish enlightenment. Richard Cantillon (c.1680–1734) received belated recognition for his pioneering account of the way money effects changes in an economy. Henry Thornton (1760–1815) came to be regarded as the foremost monetary theorist of the nineteenth century. On Cantillon and Thornton, see F. A. Hayek, *The Trend of Economic Thinking* (1991), W. W. Bartley III, and Stephen Kresge, eds, being vol. 3 of the *Collected Works of F. A. Hayek*, op. cit.

⁸An overlooked link between Keynes and the American monetarists was John Rogers Commons (1862–1945), who taught at the University of Wisconsin from 1903 to 1945 and was the leading exponent of an institutionalist view of economics, particularly in respect to the role of laws and legal institutions. Hayek was influenced by his view of Federal Reserve policy—see *Good Money, Part I*, chapter 2. According to Robert Skidelsky, Commons was an important if unacknowledged influence on Keynes; Keynes wrote to Commons in 1927 that “there seems to me to be no other economist with whose general way of thinking I feel myself in such general accord”. See Robert Skidelsky, *John Maynard Keynes, The Economist as Savior, 1920–1937* (London: Macmillan, and New York: Allen Lane, Penguin Press, 1992), p. 229. Skidelsky observed that “Psychological and institutional *observation* was the foundation of Keynesian economics. . . Keynes always stressed the crucial importance of ‘vigilant observation’ for successful theory-construction—theory being nothing more, in his view, than a stylised representation of the dominant tendencies of the time, derived from reflection on the salient facts”. *Ibid.*, pp. 220–221.

⁹“If, therefore, monetary theory still attempts to establish causal relations between aggregates or general averages, this means that monetary theory lags behind the development of economics in general. In fact, neither aggregates nor averages do act upon one another, and it will never be possible to establish necessary connections of cause and effect between them as we can between individual phenomena, individual prices, etc. . . .”. F. A. Hayek, *Prices and Production*, op. cit., pp. 4–5.

¹⁰“To recapitulate, we have seen that the enjoyment income is a psychological matter, and hence cannot be measured directly. So we look to real income instead; but even real income is a heterogeneous jumble. It includes quarts of milk, visits to the moving picture

of the social sciences, particularly behavioral psychology (which eventually succeeded in transforming hedonistic individuals into calculating ‘agents’), as it did to the failure of prior attempts to compare interpersonal utility. Hayek was prepared, as were his fellow proponents of marginal utility theory, to reason in terms of real incomes, but not at a level of aggregation that would deny the very basis of utility. Hayek’s monetary theory is, however, directed to exposing the deficiencies in any attempt to make money costs and incomes serve as unqualified surrogates for real income.

The sticking point is that if the distribution of income in any of the three ‘modes’ is to be equivalent to the distribution of income in the other two, then what is logically true of any one theory of distribution of income must hold for the others. Otherwise, contradictions may arise to the effect that a gain of real income might entail a loss of subjective income, and likewise with money income.

Hayek began his theoretical investigations with an attempt to introduce time and money into a theory of value the formal demonstration of which was based on a simultaneous solution of equations of an indefinite but finite number of ‘indifference curves’ representing subjective preferences for real goods.¹¹ The solution to the given set of equations, in which a ‘numeraire’ is randomly or arbitrarily selected, constitutes equilibrium for the system, and although Hayek does not in his early essay on the subject provide a technical description of such a theory of value it is clear that for his purposes it could not vary in any significant way from the accepted theory of general equilibrium. Given the assumption of simulta-

house, etc., and in that form cannot be measured easily or as a whole. Here is where the cost of living comes in. It is the practical, homogeneous measure of real income. As the cost of living is expressed in terms of dollars it may, therefore, be taken as our best measure of income *in place of* enjoyment income, or real income. Between it and real income there are no important discrepancies as there are between money income and real income. Money income practically never conforms exactly to real income because either savings raise money income above real income, or deficits push money income below real income”. Irving Fisher, *The Theory of Interest* (New York: Macmillan, 1930), p. 12. Fisher’s methodological bent did not lead him to pose the question whether the non-conformity of money and real income through the possibility of savings or deficits might not be traceable to a non-conformity between real income and the subjective basis of individual choice. The possibility reenters monetary discussion through questions of foresight and risk.

¹¹In a letter to W. C. Mitchell, June 3, 1926, Hayek wrote, “It seems to me now as if pure theory had actually neglected in a shameful way the essential differences between a barter economy and a money economy and that especially the existing theory of distribution needs a thorough overhauling as soon as we drop the assumption of barter and pay sufficient regard to *time*”. The text of the letter may be found in *Good Money, Part I*, op. cit., Introduction.

neity, one cannot quarrel with the logic of a general equilibrium solution to the problem of how prices are formed; but there cannot therein be introduced any such concept as a price *level*, since in the theory to which Hayek refers, goods are traded simultaneously for goods.¹²

Hayek's first approach to monetary problems was to search for a way to neutralize the effects of supply of and demand for money which were independent of or at odds with the supply and demand for real goods: a concept of 'neutral' money.¹³ As it works out, this becomes a strict interpretation of a quantity theory of money, virtually paradoxical in that no change in the supply or demand for money could take place without affecting *relative* prices; that is, it could not be neutralized. His most succinct statement of this view can be found in a letter to John Hicks, written long after his original work on monetary theory and trade cycles, but in response to new questions about that work. He wrote to Hicks that in an economy reacting to an influx of new money

it seems to me altogether impossible that all prices rise (or fall) at the same time and in the same proportion. But if they change in a certain order of succession, however rapidly the individual changes may follow upon each other, but each as a consequence of another having changed before, it must be true that so long as the process of change lasts the relations between the prices will be different from what it has been before the process of change in the quantity of money has started or will be after it has ceased. This is what already Cantillon and Hume objected [to] in the crude Lockean quantity theory and what seems to me equally to apply to any argument assuming that during a process of inflation or deflation relative prices will continue to be determined by real causes only.¹⁴

Hayek challenged the automatic application of quantity theories, particularly when embodied in indices of prices, with what we may call the

¹²"From the moment at which the analysis is no longer concerned exclusively with prices which are (presumed to be) simultaneously set, as in the elementary presentations of pure theory, but goes on to a consideration of the monetary economy, with prices which necessarily are set at successive points in time, a problem arises for whose solution it is vain to seek in the existing corpus of economic theory". F. A. Hayek, "Intertemporal Price Equilibrium and Movements in the Value of Money", *Good Money, Part I*, chapter 5, p. 187.

¹³See *Good Money, Part I*, chapter 6.

¹⁴F. A. Hayek, letter to John Hicks, December 2, 1967. The full text of the letter together with a letter from John Hicks to Hayek is printed in this volume as an addendum to chapter 1. The correspondence was initiated by Hicks when he undertook a reassessment of Hayek's theory of trade cycles, published as "The Hayek Story" in John Hicks, *Critical Essays in Monetary Theory*, op. cit. Most of the correspondence has been preserved in the Hayek archive at the Hoover Institution, Stanford University.

Cantillon effect.¹⁵ His quarrel with quantity theorists is about the path that monetary change must follow from one point of time to a subsequent one.¹⁶ He insisted that conditions of real production, particularly the formation of capital, inhibit an instantaneous and uniform adjustment of prices in response to monetary changes. Here, too, do the Keynesians and monetarists differ, particularly in respect to the rate of interest as a function of real investment.¹⁷

A careful reader of Hayek's work may note one omission: He does not apply the Cantillon effect to financial assets, such as stocks, bonds, mortgages, etc., the prices of which, given the means for supplying new money and credit to an economy, are likely to be immediately responsive. Applying the Cantillon effect to these prices does not invalidate any of Hayek's conclusions about the effects of purely monetary changes on real economic values; rather it strengthens his claims about disturbing effects of changes in liquidity, the false expansions of an elastic currency.

For a quantity theory of money to have any explanatory content, boundary conditions must be supplied: Initial conditions of the stock variables must be ascertained together with some specification of their price interrelationships within a set period of time. Simply put, the determination of boundary conditions is both a theoretical problem (which all formal treatments of economic variables must specify) and a practical and

¹⁵Following Mark Blaug: "[T]he Cantillon Effect, which denies 'the homogeneity postulate' by asserting that changes in the price level produced by cash injections vary with the nature of the injection, and that the change in absolute prices is almost always associated with alterations in relative prices". Mark Blaug, *Economic Theory in Retrospect*, 3rd edition (Cambridge: Cambridge University Press, 1978), p. 159.

¹⁶The strict form of the so-called equation of exchange ($MV=PQ$), raises the troubling possibility that the advocates of stabilization of the value of money, beginning with Irving Fisher, rested their case on an equation that is unstable. The variable of velocity (of money transactions) is a function of time, that is, a rate or flow. Whereas the combined sum of prices and quantities exchanged may be either a flow, that is, something equivalent to 'national' or 'domestic product' or it may be a stock, a simple aggregation measured at some point in time. The form of the equation does not tell us which is to be the case. In any case, as long as there remains one time-dependent variable, the equation produces the anomaly that it must be true for some given period of time but cannot be found to be true at any one instant of time. In their eagerness to utilize indices of prices to measure changes in the value of money, Fisher and his followers neglected this logical point, which means that the determination of boundary conditions is always arbitrary.

¹⁷As Skidelsky points out, "Keynes would develop a distinction between interest as the 'price of money' and the 'natural rate' (though he abandoned the term) as the 'price of capital'. Hayek's role in the Keynesian Revolution was thus to force out of him the logical distinction between a money and a 'real exchange' economy". Robert Skidelsky, *John Maynard Keynes, The Economist as Savior, 1920–1937*, op. cit., p. 458. As to how the forcing was done, see F. A. Hayek, *Contra Keynes and Cambridge* (1995), Bruce Caldwell, ed., being vol. 9 of the Collected Works of F. A. Hayek, op. cit.

political problem which markets and governments must confront. It is a problem of considerable complexity, as Hayek noted in a later essay on the topic of complex phenomena:

What we single out as wholes, or where we draw the ‘partition boundary’, will be determined by the consideration whether we can thus isolate recurrent patterns of coherent structures of a distinct kind which we do in fact encounter in the world in which we live.¹⁸

The economist, then, speaks of ‘economies’ or of ‘markets’ or ‘communities’, taking for granted that these abstractions exist in some actual location; terms such as ‘region’, ‘domain’, even ‘nation’ are used without specifying how the boundaries of any space-time location are determined. Yet in the political realm, boundaries become only too specific, to the point where it may be virtually impossible to adopt a model of social and economic behavior that is applicable to a region which is not confined within a national boundary to one which is. The difficulty increases when we must identify regional or national boundaries along with temporal divisions. Eventually, the theorist must bow before history.

Monetary Nationalism

In 1937, Hayek was invited to Geneva to give five lectures “on some subject of distinctly international interest”. Published under the title of *Monetary Nationalism and International Stability* (included in this volume as chapter 1), the lectures are in large measure an extension of Hayek’s ideas of the 1920s about the methods of monetary control—then generally referred to as ‘stabilization’—applied to the difficulties of the international exchange of currencies. These ideas had their roots in a PhD thesis Hayek began, but did not complete, at New York University in 1923–24. The title of the thesis was, “Is the function of money consistent with an artificial stabilization of its purchasing power?” The essays collected in *Good Money, Part I* are largely directed to this topic and are decidedly critical

¹⁸F. A. Hayek, “The Theory of Complex Phenomena”, [1964], reprinted in F. A. Hayek, *Studies in Philosophy, Politics and Economics* (Chicago: University of Chicago Press, and London: Routledge & Kegan Paul, 1967), p. 27. Compare also Nicholas Georgescu-Roegen, “As is natural we should begin with the basic co-ordinates of the analytical representation, its boundary which completely identifies the process—*no boundary, no process*. . . . And it goes without saying that the boundary must have two dimensions, a geographical one and a temporal one, both finite if we wish to use this construction for economic policy”. “Time in Economics”, in Harald Hagemann and O. F. Hamouda, eds, *The Legacy of Hicks* (London and New York: Routledge, 1994), p. 245.

of theories underlying various proposals for monetary policies directed to the stabilization of some average price and/or wage level.

Hayek defined monetary nationalism as the “doctrine that a country’s share in the world’s supply of money should *not* be left to be determined by the same principles and the same mechanism as those which determine the relative amounts of money in its different regions or localities”.¹⁹ Whatever that mechanism is—he does not provide a description—we are encouraged to draw the conclusion that if stabilization is problematical for a closed system, however its boundaries are determined, it would surely be more problematical when attempted in terms of two or more currencies.

Hayek takes for granted that the benefits of international trade accrue generally; he writes of “sharing in the advantages of the international division of labor”.²⁰ His basic assumption is that “it is clear that changes in the demand for or supply of the goods and services produced in an area may change the value of the share of the world’s income which the inhabitants of that area may claim”.²¹ By ‘world’s income’ (a concept open to challenge by the proponents of monetary nationalism on the grounds that by far the larger component of income cannot under any terms be shifted from region to region), Hayek means real income, the actual goods and services produced and consumed by the world’s population. His argument throughout these lectures follows the course of his previous work on monetary theory, that the equivalence of real income and money income (*pace* Fisher) is asymmetrical: Changes in real conditions of production, consumption, and saving must determine the values expressed in money wages and prices and that monetary means cannot be used to induce, alter, or compensate for real economic changes. In his earlier argument for ‘neutral’ money, he held an even stronger position: Any use of money, because of the elasticity of its supply, would distort the structure of relative prices in ways that underlying ‘real’ conditions would not support. This elasticity of the supply of money comes into the discussion of *Monetary Nationalism* through the mechanism of ‘liquidity’: the equivalence and convertibility of forms of currencies and credit. He observes that, “It is probably much truer to say that it is the difference between the different kinds of money which are used in any one country, rather than the differences between the moneys used in different countries which constitutes the real difference between different monetary systems”.²²

¹⁹This volume, chapter 1, p. 41.

²⁰This volume, chapter 1, p. 84.

²¹This volume, chapter 1, p. 50.

²²This volume, chapter 1, p. 45.