Hayek, Deflation and Nihilism

Published July 23, 2017 deflation , Great Depression , Hansjorg Klausinger , Hayek , Larry White , secondary deflation 14 Comments
Tags: David Laidler, Gottried Haberler, Wilhelm Roepke

In the discussion about my paper on Hayek and intertemporal equilibrium at the HES meeting last month, Harald Hagemann suggested looking at Hansjorg Klausinger's introductions to the two recently published volumes of Hayek's Collected Works containing his writings (mostly from the 1920s and 1930s) about business-cycle theory in which he explores how Hayek's attitude toward equilibrium analysis changed over time. But what I found most interesting in Klausinger's introduction was his account of Hayek's tolerant, if not supportive, attitude toward deflation — even toward what Hayek and other Austrians at the time referred to as "secondary deflation." Some Austrians, notably Gottfried Haberler and Wilhelm Roepke, favored activist "reflationary" policies to counteract, and even reverse, secondary deflation. What did Hayek mean by secondary deflation? Here is how Klausinger ("Introduction" in *Collected Works of F. A. Hayek: Business Cycles, Part II*, pp. 5-6) explains the difference between primary and secondary deflation:

> [A]ccording to Hayek's theory the crisis is caused by a maladjustment in the structure of production typically initiated by a credit boom, such that the period of production (representing the capitalistic structure of production) is lengthened beyond what can be sustained by the rate of voluntary savings. The necessary reallocation of resources and its consequences give rise to crisis and depression. Thus, the "primary" cause of the crisis is a kind of "capital scarcity" while the depression represents an adjustment process by which the capital structure is adapted.

The Hayekian crisis or upper-turning point of the cycle occurs when banks are no longer willing or able to supply the funds investors need to finance their projects, causing business failures and layoffs of workers. The turning point is associated with distress sales of assets and goods, initiating a deflationary spiral. The collapse of asset prices and sell-off of inventories is the primary deflation, but at some point, the contraction may begin to feed on itself, and the contraction takes on a different character. That is the secondary deflation phase. But it is difficult to identify a specific temporal or analytic criterion by which to distinguish the primary from the secondary deflation.

> Roepke and Haberler used the distinction – often referring to "depression"" and "deflation" interchangeably – to denote two phases of the cycle. The primary depression is characterized by the reactions to the disproportionalities of the boom, and accordingly an important cleansing function is ascribed to it; thus it is necessary to allow the primary depression to run its course. In contrast, the secondary depression refers to a self-feeding, cumulative process, not causally connected with the disproportionality that the primary depression is designed to correct. Thus the existence of the secondary depression opens up the possibility of a phase of depression dysfunctional to the economic system, where an expansionist policy might be called for. (*Id*. p. 6)

Despite conceding that there is a meaningful distinction between a primary and secondary deflation that might justify monetary expansion to counteract the latter, Hayek consistently opposed monetary expansion during the 1930s. The puzzle of Hayek's opposition to monetary expansion, even at the bottom of the Great Depression, is compounded if we consider his idea of neutral money as a criterion for a monetary policy with no distorting effect on the price system. That idea can be understood in terms of the simple $MV=PQ$ equation. Hayek argued that the proper criterion for neutral money was neither, as some had suggested, a constant quantity of money (M), nor, as others had suggested, a constant price level (P), but constant total spending (MV). But for MV to be constant, M must increase or decrease just enough to offset any change in V, where V represents the percentage of income held by the public in the form of money. Thus, if MV is constant, the quantity of money is increasing or decreasing by just as much as the amount of money the public wants to hold is increasing or decreasing.

The neutral-money criterion led Hayek to denounce the US Federal Reserve for a policy that kept the average level of prices essentially stable from 1922 to 1929, arguing that rapid economic growth should have been accompanied by falling not stable prices, in line with his neutral money criterion. The monetary expansion necessary to keep prices stable, had in Hayek's view, led to a distortion of relative prices, causing an overextension of the capital structure of production, which was the ultimate cause of the 1929 downturn that triggered the Great Depression. But once the downturn started to accelerate, causing aggregate spending to decline by 50% between 1929 and 1933, Hayek, totally disregarding his own neutral-money criterion, uttered not a single word in protest of a monetary policy that was in flagrant violation of his own neutral money criterion. On the contrary, Hayek wrote an impassioned defense of the insane gold accumulation policy of the Bank of France, which along with the US Federal Reserve was chiefly responsible for the decline in aggregate spending.

In an excellent paper, Larry White has recently discussed Hayek's pro-deflationary stance in the 1930s, absolving Hayek from responsibility for the policy errors of the 1930s on the grounds that the Federal Reserve Board and the Hoover Administration had been influenced not by Hayek, but by a different strand of pro-deflationary thinking, while pointing out that Hayek's own theory of monetary policy, had he followed it consistently, would have led him to support monetary expansion during the 1930s to prevent any decline in aggregate spending. White may be correct in saying that policy makers paid little if any attention to Hayek's pro-deflation policy advice. But Hayek's policy advice was what it was: relentlessly pro-deflation.

Why did Hayek offer policy advice so blatantly contradicted by his own neutral-money criterion? White suggests that the reason was that Hayek viewed deflation as potentially beneficial if it would break the rigidities obstructing adjustments in relative prices. It was the lack of relative-price adjustments that, in Hayek's view, caused the depression. Here is how Hayek ("The Present State and Immediate Prospects of the Study of Industrial Fluctuations" in *Collected Works of F. A. Hayek: Business Cycles, Part II*, pp. 171-79) put it:

> The analysis of the crisis shows that, once an excessive increase of the capital structure has proved insupportable and has led to a crisis, profitability of production can be restored only by considerable changes in relative prices, reductions of certain stocks, and transfers of the means of production to other uses. In connection with these changes, liquidations of firms in a purely financial sense of the word may be inevitable, and their postponement may possibly delay the process of liquidation in the first, more general sense; but this is a

> separate and special phenomenon which in recent discussions has been stressed rather excessively at the expense of the more fundamental changes in prices, stocks, etc. (*Id*. pp. 175-76)

Hayek thus draws a distinction between two possible interpretations of liquidation, noting that widespread financial bankruptcy is not necessary for liquidation in the economic sense, an important distinction. Continuing with the following argument about rigidities, Hayek writes:

> A theoretical problem of great importance which needs to be elucidated in this connection is the significance, for this process of liquidation, of the rigidity of prices and wages, which since the great war has undoubtedly become very considerable. There can be little question that these rigidities tend to delay the process of adaptation and that this will cause a "secondary" deflation which at first will intensify the depression but ultimately will help to overcome those rigidities. (*Id*. p. 176)

It is worth noting that Hayek's assertion that the intensification of the depression would help to overcome the rigidities is an unfounded and unsupported supposition. Moreover, the notion that increased price flexibility in a depression would actually promote recovery has a flimsy theoretical basis, because, even if an equilibrium does exist in an economy dislocated by severe maladjustments — the premise of Austrian cycle theory — the notion that price adjustments are all that's required for recovery can't be proven even under the assumption of Walrasian *tatonnement*, much less under the assumption of incomplete markets with trading at non-equilibrium prices. The intuitively appealing notion that markets self-adjust is an extrapolation from Marshallian partial-equilibrium analysis in which the disequilibrium of a single market is analyzed under the assumption that all other markets remain in equilibrium. The assumption of approximate macroeconomic equilibrium is a necessary precondition for the partial-equilibrium analysis to show that a single (relatively small) market reverts to equilibrium after a disturbance. In the general case in which multiple markets are simultaneously disturbed from an initial equilibrium, it can't be shown that price adjustments based on excess demands in individual markets lead to the restoration of equilibrium.

> The main problem in this connection, on which opinions are still diametrically opposed, are, firstly, whether this process of deflation is merely an evil which has to be combated, or whether it does not serve a necessary function in breaking these rigidities, and, secondly, whether the persistence of these deflationary tendencies proves that the fundamental maladjustment of prices still exists, or whether, once that process of deflation has gathered momentum, it may not continue long after it has served its initial function. (*Id*.)

Unable to demonstrate that deflation was not exacerbating economic conditions, Hayek justified tolerating further deflation, as White acknowledged, with the hope that it would break the "rigidities" preventing the relative-price adjustments that he felt were necessary for recovery. Lacking a solid basis in economic theory, Hayek's support for deflation to break rigidities in relative-price adjustment invites evaluation in ideological terms. Conceding that monetary expansion might increase employment, Hayek may have been disturbed by the prospect that an expansionary monetary policy would be credited for having led to a positive outcome, thereby increasing the chances that inflationary policies would be adopted under less extreme conditions. Hayek therefore appears to have supported deflation as a means to accomplish a political objective – breaking politically imposed and supported rigidities in prices – he did not believe could otherwise be accomplished.

Such a rationale, I am sorry to say, reminds me of Lenin's famous saying that you can't make an omelet without breaking eggs. Which is to say, that in order to achieve a desired political outcome, Hayek was prepared to support policies that he had good reason to believe would increase the misery and suffering of a great many people. I don't accuse Hayek of malevolence, but I do question the judgment that led him to such a conclusion. In *Fabricating the Keynesian Revolution*, David Laidler described Hayek's policy stance in the 1930s as extreme pessimism verging on nihilism. But in supporting deflation as a means to accomplish a political end, Hayek clearly seems to have crossed over the line separating pessimism from nihilism.

In fairness to Hayek, it should be noted that he eventually acknowledged and explicitly disavowed his early pro-deflation stance.

> I am the last to deny – or rather, I am today the last to deny – that, in these circumstances, monetary counteractions, deliberate attempts to maintain the money stream, are appropriate.
>
> I probably ought to add a word of explanation: I have to admit that I took a different attitude forty years ago, at the beginning of the Great Depression. At that time I believed that a process of deflation of some short duration might break the rigidity of wages which I thought was incompatible with a functioning economy. Perhaps I should have even then understood that this possibility no longer existed. . . . I would no longer maintain, as I did in the early '30s, that for this reason, and for this reason only, a short period of deflation might be desirable. Today I believe that deflation has no recognizable function whatever, and that there is no justification for supporting or permitting a process of deflation. (*A Discussion with Friedrich A. Von Hayek: Held at the American Enterprise Institute on April 9, 1975*, p. 5)

Responding to a question about "secondary deflation" from his old colleague and friend, Gottfried Haberler, Hayek went on to elaborate:

> The moment there is any sign that the total income stream may actually shrink, I should certainly not only try everything in my power to prevent it from dwindling, but I should announce beforehand that I would do so in the event the problem arose. . .
>
> You ask whether I have changed my opinion about combating secondary deflation. I do not have to change my theoretical views. As I explained before, I have always thought that deflation had no economic function; but I did once believe, and no longer do, that it was desirable because it could break the growing rigidity of wage rates. Even at that time I regarded this view as a political consideration; I did not think that deflation improved the adjustment mechanism of the market. (*Id*. pp. 12-13)

I am not sure that Hayek's characterization of his early views is totally accurate. Although he may indeed have believed that a short period of deflation would be enough to break the rigidities that he found so troublesome, he never spoke out against deflation, even as late as 1932 more than two years the start of deflation at the end of 1929. But on the key point Hayek was perfectly candid: "I regarded this view as a political consideration."

This harrowing episode seems worth recalling now, as the U.S. Senate is about to make decisions about the future of the highly imperfect American health care system, and many are explicitly advocating taking steps calculated to make the system (or substantial parts of it) implode or enter a "death spiral" for the express purpose of achieving a political/ideological objective. Policy-making and nihilism are a toxic mix, as we learned in the 1930s with such catastrophic results. Do we really need to be taught that lesson again?

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14 Responses to "Hayek, Deflation and Nihilism"

lambsanger
July 23, 2017 at 10:36 pm

Oh boy, this is a really good post on the historical developments of ABCT in the face of the Great Depression. The idea of some sort of "deflation that would break wage rigidity" reminds me of the bias of ABCT always assuming FFR are always under the natural rate.

Btw, since you name drop a lot of other Austrians in this post, who do you consider to be your personal favorites outside of Buisness cycle theory?

Lars Christensen
July 24, 2017 at 12:16 am

David,

This is a very good piece and it is very easy to see how we have heard very similar "arguments" since 2008.

Bob Roddis
July 24, 2017 at 7:59 am

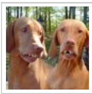
Hayek's stated views on "deflation" are a mess of contradictions. During the same period, he clearly stated that he wanted an end to "monetary policy".

Hayek: "Of course their [government's] ability to pursue something like monetary policy depends on this monopoly. Abolishing the government monopoly of the issue of money would deprive governments of the possibility of pursuing monetary policy. That is what I want to see but most people believe that monetary policy is an essential tool of government."

Kevin Erdmann
July 24, 2017 at 8:53 am

Great post.

dilbert dogbert
July 24, 2017 at 10:38 am



MMMMM??? Read a bit, not all. Interesting. Reminds of operators of a nuclear power plant observing that the reaction is running away and deciding it best to let it go to meltdown.

Spencer

July 24, 2017 at 1:20 pm

"is lengthened beyond what can be sustained by the rate of voluntary savings"

Tripe. Unless voluntary savings are expeditiously activated and put back to work, completing the circuit income velocity of redistribution, a dampening economic impact is generated and metastases… This is the singular source of both stagflation and secular strangulation.

Take the "Marshmallow Test": (1) banks create new money, and incongruously (2) banks loan out the savings that are placed with them.

Never are the commercial banks financial intermediaries (conduits between savers and borrowers), in the savings-investment process. From a system's belvedere, commercial banks (DFIs), as contrasted to financial intermediaries (non-banks, NBFIs): never loan out, & can't loan out, existing deposits (saved or otherwise) including existing transaction deposits, or time/savings deposits, or the owner's equity, or any liability item.

When CBs grant loans to, or purchase securities from, the non-bank public, they acquire title to earning assets by initially, the creation of an equal volume of new money (demand deposits) – somewhere in the payment's system. I.e., commercial bank deposits are the result of lending, not the other way around.

All savings originate within the framework of the payment's system. Saver-holders never transfer their savings outside of the payments system unless they hoard currency or convert to other National currencies. The only way to galvanize savings is for their owners to invest/spend directly, or indirectly via non-bank conduits (aka the U.S. Golden Era in economics). Otherwise, all bank-held savings are impounded and ensconced, lost to both investment and consumption, indeed to any type of payment or expenditure.

The expiration of the FDIC's unlimited transaction deposit insurance is prima facie evidence, viz., the resultant "taper tantrum". The 1966 S&L credit crunch (where the term "credit crunch" was first coined), is the antecedent and paradigm. Remunerating IBDDs exacerbates this theoretical error. Can you say very stupid?

Alan Thiesen

July 24, 2017 at 2:12 pm

Thanks for an excellent post.

I would like to comment on something you mentioned in passing. Hundreds of web pages claim that either Lenin or Stalin said "You can't make an omelet without breaking eggs," but I have been unable to find any concrete evidence that either dictator said this. The statement is associated with Stalin apparently because it was used by pro-Stalin apologist Walter Duranty. The saying dates back at least to 1796; it was reportedly uttered by French Royalist soldier François de Charette during his trial. See https://books.google.com/books?id=Z7wRAAAAYAAJ&pg=PA411&dq="omlets+are+not+made+without+breaking+eggs", http://listserv.linguistlist.org/pipermail/ads-l/2011-February/106508.html, and http://www.weeklystandard.com/pulitzer-winning-lies/article/4040

jpd
July 26, 2017 at 5:03 am

Reblogged this on DAMIJAN blog.

Spencer
July 26, 2017 at 8:46 am

Copper's up. Oil's up. I.e., money flows are trending up. Sept/Oct is the top of "reflation".

It's simple. Most people stop short of looking beyond their noses, including me. But the income inequality, TFP error, etc. (i.e., stagflation and secular strangulation), stems from the fact: (1) Banks do not loan out existing deposits (2) Banks create new money when they lend/invest (3) Bank-held savings, aka, Jeffrey Sniders' "missing money", are lost to both consumption and investment (contrary to Alan Greenspan's increasing entitlements answer).

That's it. And the answer is simple too. Drive the commercial banks out of the savings business (increasing the bank's ROE and ROI, the non-bank's NIMs, and the lower quintiles' incomes (decreasing social unrest and violence)…

In their pea brains, economists try and separate the bank's time deposit operations from their payment's function, relating say, mortgages with large CDs (a pseudo economic relationship).

See SA: "How Accurate Is Bernie Sanders' Diatribe Against Big Banks?" – Jeremy Blum

https://seekingalpha.com/article/3969971-accurate-bernie-sanders-diatribe-big-banks

The Fed's IOeR policy sets the banking system up similar to what it was like right before the Great Depression. It has once again, skewed IBDDs and core deposits.

See SA author: Charles Hugh Smith

http://charleshughsmith.blogspot.com/2017/07/the-two-charts-that-dictate-future-of.html

Henry
July 28, 2017 at 7:35 pm

David,

You have made many references in various posts, on your blog over the last few years, to the "insane" policies of the Bank of France in the late 1920s.

The weight of scholarly opinion on the matter of the accumulation by the Bank of France of a disproportionate share of gold reserves is with you. I would note, however, that the source of this current scholarly opinion is mainly individuals born well after the events in question occurred. You do of course call on the writings of Cassel and Hawtrey.

However, from what I have seen you have been singularly intent on presenting only a onesided version of the argument, although you have occasionally looked at the writings of Friedman and Hayek on the matter and discarded them.

There are of course the views of those witness to the events of the late 1920s who wrote on these matters. Their views dissent from those you promote.

For instance, Aftalion argued that the Bank of France adopted a range policies designed to mitigate the importation of gold into France.

Mlynarski (Professor of Banking at the Academy of Commerce in Warsaw, formerly Vice-Governor of the Bank of Poland), argued that the gold accumulation of the Bank of France was not the singular cause, if at all, of the late 1920s deflation. He also questioned Cassel's argument that there was a shortage of gold and that this underwrote the deflation of the late 1920s.

Aftalion, Professor Albert, "The Causes and Effects of the Movements of Gold into France", League of Nations, Selected Documents on the Distribution of Gold, Submitted to the Gold Delegation of the Financial Committee.

Mlynarski, Dr. Feliks, "The Functioning of the Gold Standard", League of Nations, Memorandum Submitted to the Gold Delegation of the Financial Committee.

Tom Brown
August 2, 2017 at 10:16 am

David, I happened to read this article just this morning. You might find it interesting: https://www.thenation.com/article/nietzsches-marginal-children-friedrich-hayek/

David Glasner
August 7, 2017 at 5:58 pm

lambsanger, Thanks. I agree with your point about ABCT and FFR. My favorite is certainly Hayek, but I also have great respect for Kirzner. Machlup and Haberler were certainly great economists, but they obviously strayed from the fold.

Lars, Thanks. Yes we have been hearing a lot of the same arguments over and over.

Bob, I could be mistaken, but I think the desire for an end to monetary policy was expressed much later, when he believed in private currency competition. In his late writings on currency competition he actually conjectured that currency competition would generate stable prices, not falling prices.

Kevin, Thanks.

dilbert dogbert, Interesting analogy.

Spencer, I agree that there are conceptual problems with the idea that banks finance investment in excess of voluntary savings, but I don't follow your critique. The question is whether an increase in investment at full employment requires that household try to reduce the fraction of their income that they try to consume for the increase in investment to be "sustainable."

Alan, Thanks for the references.

Henry, Thanks for pointing out other authorities that supported the Bank of France policies. Albert Aftalion was certainly an economist of outstanding reputation, though I have no first hand knowledge of his writings. In all modesty, I have to say that I think that I have shown fairly conclusively that Hayek's defense of the policy of the Bank of France was completely without merit. I suspect that if I read the relevant works of Aftalion and Mlynarksi, I would not be persuaded that I, much less Hawtrey and Cassel, am in any way mistaken in my assessment of the role of the Bank of France.

Tom, Many thanks for the reference. I still have not read it, but I do hope to do so, and perhaps write about it.

Henry
August 8, 2017 at 4:52 am

David,

Aftalion normally wrote in French. His referenced contribution to the League of Nations report is in English, so it is highly accessible.

The Final Report of the Gold Delegation of the Financial Committee of the League of Nations (1932) was dissented to by three of the Delegation's members, viz. Messrs Janssen, Mant and Strakosch. Their dissenting note boils down to saying that the Gold Exchange Standard broke down because of war reparations (mainly to France) and debt repayments (mainly to the US). Prior to 1928, the US made loans to Germany which helped finance its reparation payments. After 1928, for a range of reasons, this flow of funds to Germany dried up. This forced these reparation payments to be made in gold because France was not willing to take German goods in payment for these reparations. Interestingly, Cassel, who also wrote a dissenting statement, said he agreed with the general views of Janssen et al and in particular with the view that German war reparations were central to the pressures put on the Gold Exchange Standard.

It should be noted, that additionally, the UK and France repaid war debts to the US in gold.

It should also be noted, that the Bank of France, prior to 1929, had a policy of accumulating gold, designed to restore its gold stock to the level extent prior to the War. Gold imports after this time were largely of a private nature as capital flowed into France, France being seen as a stable country in a world becoming increasingly dangerous as the world economy fell into a severe slump.

Cassel's belief that there was a general shortage of gold does not stand scrutiny. He had argued that gold supply had to increase some 2.8% pa to avoid deflation. The record shows that there was adequate increases in gold supply to meet this requirement.

To argue that the inordinate accumulation of gold by the Bank of France was the cause of the breakdown of the world payments system and the deflation of the late 1920s is a far too facile an argument to mount. The collapse of the world monetary order was the result of a process of economic and financial degeneration beginning with the end of the War.

To talk about the "insane" policy of the Bank of France is inane. The US had been accumulating gold reserves at a high rate from the beginning of the War. Why was the policy of the Fed not labelled "insane"?

The forces that led to the slump and deepening of the Depression were pervasive, cumulative and multifaceted.

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Trackback on July 25, 2017 at 11:53 am

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