For a month or so, I have been working on a paper about Hayek's early pro-deflationary policy recommendations which seem to be at odds with his own idea of neutral money which he articulated in a way that implied or at least suggested that the ideal monetary policy would aim to keep nominal spending or nominal income constant. In the Great Depression, prices and real output were both falling, so that nominal spending and income were also falling at a rate equal to the rate of decline in real output plus the rate of decline in the price level. So in a depression, the monetary policy implied by Hayek's neutral money criterion would have been to print money like crazy to generate enough inflation to keep nominal spending and nominal income constant. But Hayek denounced any monetary policy that aimed to raise prices during the depression, arguing that such a policy would treat the disease of depression with the drug that had caused the disease in the first place. Decades later, Hayek acknowledged his mistake and made clear that he favored a policy that would prevent the flow of nominal spending from ever shrinking. In this post, I am excerpting the introductory section of the current draft of my paper.

Few economists, if any, ever experienced as rapid a rise to stardom as F. A. Hayek did upon arriving in London in January 1931, at the invitation of Lionel Robbins, to deliver a series of four lectures on the theory of industrial fluctuations. The Great Depression having started about 15 months earlier, British economists were desperately seeking new insights into the unfolding and deteriorating economic catastrophe. The subject on which Hayek was to expound was of more than academic interest; it was of the most urgent economic, political and social, import.

Only 31 years old, Hayek, director of the Austrian Institute of Business Cycle Research headed by his mentor Ludwig von Mises, had never held an academic position. Upon completing his doctorate at the University of Vienna, writing his doctoral thesis under Friedrich von Wieser, one of the eminent figures of the Austrian School of Economics, Hayek, through financial assistance secured by Mises, spent over a year in the United States doing research on business cycles, and meeting such leading American experts on business cycles as W. C. Mitchell. While in the US, Hayek also exhaustively studied the English-language literature on the monetary history of the eighteenth and nineteenth centuries and the, mostly British, monetary doctrines of that era.

Even without an academic position, Hayek's productivity upon returning to Vienna was impressive. Aside from writing a monthly digest of statistical reports, financial news, and analysis of business conditions for the Institute, Hayek published several important theoretical papers, gaining a reputation as a young economist of considerable promise. Moreover, Hayek's immersion in the English monetary literature and his sojourn in the United States gave him an excellent command of English, so that when Robbins, newly installed as head of the economics department at LSE, and having fallen under the influence of the Austrian school of economics, was seeking to replace Edwin Cannan, who before his retirement had been the leading monetary economist at LSE, Robbins thought of Hayek as a candidate for Cannan's position.

Hoping that Hayek's performance would be sufficiently impressive to justify the offer of a position at LSE, Robbins undoubtedly made clear to Hayek that if his lectures were well received, his chances of receiving an offer to replace Cannan were quite good. A secure academic position for a young economist, even one as talented as Hayek, was then hard to come by in Austria or Germany. Realizing how much depended on the impression he would make, Hayek, despite having undertaken to write a textbook on monetary theory for which he had already written several chapters, dropped everything else to compose the four lectures that he would present at LSE.

When he arrived in England in January 1931, Hayek actually went first to Cambridge to give a lecture, a condensed version of the four LSE lectures. Hayek was not feeling well when he came to Cambridge to face an unsympathetic, if not hostile, audience, and the lecture was not a success. However, either despite, or because of, his inauspicious debut at Cambridge, Hayek's performance at LSE turned out to be an immediate sensation. In his *History of Economic Analysis*, Joseph Schumpeter, who, although an Austrian with a background in economics similar to Hayek's, was neither a personal friend nor an ideological ally of Hayek's, wrote that Hayek's theory

> on being presented to the Anglo-American community of economists, met with a sweeping success that has never been equaled by any strictly theoretical book that failed to make amends for its rigors by including plans and policy recommendations or to make contact in other ways with its readers loves or hates. A strong critical reaction followed that, at first, but served to underline the success, and then the profession turned away to other leaders and interests.

The four lectures provided a masterful survey of business-cycle theory and the role of monetary analysis in business-cycle theory, including a lucid summary of the Austrian capital-theoretic approach to business-cycle theory and of the equilibrium price relationships that are conducive to economic stability, an explanation of how those equilibrium price relationships are disturbed by monetary disturbances giving rise to cyclical effects, and some comments on the appropriate policies for avoiding or minimizing such disturbances. The goal of monetary policy should be to set the money interest rate equal to the hypothetical equilibrium interest rate determined by strictly real factors. The only policy implication that Hayek could extract from this rarified analysis was that monetary policy should aim not to stabilize the price level as recommended by such distinguished monetary theorists as Alfred Marshall and Knut Wicksell, but to stabilize total spending or total money income.

This objective would be achieved, Hayek argued, only if injections of new money preserved the equilibrium relationship between savings and investment, investments being financed entirely by voluntary savings, not by money newly created for that purpose. Insofar as new investment projects were financed by newly created money, the additional expenditure thereby financed would entail a deviation from the real equilibrium that would obtain in a hypothetical barter economy or in an economy in which money had no distortionary effect. That interest rate was called by Hayek, following Wicksell, the natural (or equilibrium) rate of interest.

But according to Hayek, Wicksell failed to see that, in a progressive economy with real investment financed by voluntary saving, the increasing output of goods and services over time implies generally falling prices as the increasing productivity of factors of production progressively reduces costs of production. A stable price level would require ongoing increases in the quantity of money to, the new money being used to finance additional investment over and above voluntary saving, thereby causing the economy to deviate from its equilibrium time path by inducing investment that would not otherwise have been undertaken.

As Paul Zimmerman and I have pointed out in our paper on Hayek's response to Piero Sraffa's devastating, but flawed, review of *Prices and Production* (the published version of Hayek's LSE lectures) Hayek's argument that only an economy in which no money is created to finance investment is consistent with the real equilibrium of a pure barter economy depends on the assumption that money is non-interest-bearing and that the rate of inflation is not correctly foreseen. If money bears competitive interest and inflation is correctly foreseen, the economy can attain its real equilibrium regardless of the rate of inflation – provided, at least, that the rate of deflation is not greater than the real rate of interest. Inasmuch as the real equilibrium is defined by a system of n-1 relative prices per time period which can be multiplied by any scalar representing the expected price level or expected rate of inflation between time periods.

So Hayek's assumption that the real equilibrium requires a rate of deflation equal to the rate of increase in factor productivity is an arbitrary and unfounded assumption reflecting his failure to see that the real equilibrium of the economy is independent of the price levels in different time periods and rates of inflation between time periods, when prices levels and rates of inflation are correctly anticipated. If inflation is correctly foreseen, nominal wages will rise commensurately with inflation and real wages with productivity increases, so that the increase in nominal money supplied by banks will not induce or finance investment beyond voluntary savings. Hayek's argument was based on a failure to work through the full implications of his equilibrium method. As Hayek would later come to recognize, disequilibrium is the result not of money creation by banks but of mistaken expectations about the future.

Thus, Hayek's argument mistakenly identified monetary expansion of any sort that moderated or reversed what Hayek considered the natural tendency of prices to fall in a progressively expanding economy, as the disturbing and distorting impulse responsible for business-cycle fluctuations. Although he did not offer a detailed account of the origins of the Great Depression, Hayek's diagnosis of the causes of the Great Depression, made explicit in various other writings, was clear: monetary expansion by the Federal Reserve during the 1920s — especially in 1927 — to keep the US price level from falling and to moderate deflationary pressure on Britain (sterling having been overvalued at the prewar dollar-sterling parity when Britain restored gold convertibility in March 1925) distorted relative prices and the capital structure. When distortions eventually become unsustainable, unprofitable investment projects would be liquidated, supposedly freeing those resources to be re-employed in more productive activities. Why the Depression continued to deepen rather than recover more than a year after the downturn had started, was another question.

Despite warning of the dangers of a policy of price-level stabilization, Hayek was reluctant to advance an alternative policy goal or criterion beyond the general maxim that policy should avoid any disturbing or distorting effect — in particular monetary expansion — on the economic system. But Hayek was incapable of, or unwilling to, translate this abstract precept into a definite policy norm.

The simplest implementation of Hayek's objective would be to hold the quantity of money constant. But that policy, as Hayek acknowledged, was beset with both practical and conceptual difficulties. Under a gold standard, which Hayek, at least in the early 1930s, still favored, the relevant area within which to keep the quantity of money constant would be the entire world (or, more precisely, the set of countries linked to the gold standard). But national differences between the currencies on the gold standard would make it virtually impossible to coordinate those national currencies to keep some aggregate measure of the quantity of money convertible into gold constant. And Hayek also recognized that fluctuations in the demand to hold money (the reciprocal of the velocity of circulation) produce monetary disturbances analogous to variations in the quantity of money, so that the relevant policy objective was to hold the quantity of money constant, but to change the quantity of money proportionately (inversely) with the demand to hold money (the velocity of circulation).

Hayek therefore suggested that the appropriate criterion for the neutrality of money might be to hold total spending (or alternatively total factor income) constant. With constant total spending, neither an increase nor a decrease in the amount of money the public desired to hold would lead to disequilibrium. This was a compelling argument for constant total spending as the goal of policy, but Hayek was unwilling to adopt it as a practical guide for monetary policy.

In the final paragraph of his final LSE lecture, Hayek made his most explicit, though still equivocal, policy recommendation:

> [T]he only practical maxim for monetary policy to be derived from our considerations is probably . . . that the simple fact of an increase of production and trade forms no justification for an expansion of credit, and that—save in an acute crisis—bankers need not be afraid to harm production by overcaution. . . . It is probably an illusion to suppose that we shall ever be able entirely to eliminate industrial fluctuations by means of monetary policy. The most we may hope for is that the growing information of the public may make it easier for central banks both to follow a cautious policy during the upward swing of the cycle, and so to mitigate the following depression, and to resist the well-meaning but dangerous proposals to fight depression by "a little inflation ".

Thus, Hayek concluded his series of lectures by implicitly rejecting his own idea of neutral money as a policy criterion, warning instead against the "well-meaning but dangerous proposals to fight depression by 'a little inflation.'" The only sensible interpretation of Hayek's counsel of "resistance" is an icy expression of indifference to falling nominal spending in a deep depression.

Larry White has defended Hayek against the charge that his policy advice in the depression was liquidationist, encouraging policy makers to take a "hands-off" approach to the unfolding economic catastrophe. In making this argument, White relies on Hayek's neutral-money concept as well as Hayek's disavowals decades later of his early pro-deflation policy advice. However, White omitted any mention of Hayek's explicit rejection of neutral money as a policy norm at the conclusion of his LSE lectures. White also disputes that Hayek was a liquidationist, arguing that Hayek supported liquidation not for its own sake but only as a means to reallocate resources from lower- to higher-valued uses. Although that is certainly true, White does not establish that any of the other liquidationists he mentions favored liquidation as an end and not, like Hayek, as a means.

Hayek's policy stance in the early 1930s was characterized by David Laidler as a skepticism bordering on nihilism in opposing any monetary- or fiscal-policy responses to mitigate the suffering of the general public caused by the Depression. White's efforts at rehabilitation notwithstanding, Laidler's characterization seems to be on the mark. The perplexing and disturbing question raised by Hayek's policy stance in the early 1930s is why, given the availability of his neutral-money criterion as a justification for favoring at least a mildly inflationary (or reflationary) policy to promote economic recovery from the Depression, did Hayek remain, during the 1930s at any rate, implacably opposed to expansionary monetary policies? Hayek's later disavowals of his early position actually provide some insight into his reasoning in the early 1930s, but to understand the reasons for his advocacy of a policy inconsistent with his own theoretical understanding of the situation for which he was offering policy advice, it is necessary to understand the intellectual and doctrinal background that set the boundaries on what kinds of policies Hayek was prepared to entertain. The source of that intellectual and doctrinal background was David Hume and the intermediary through which it was transmitted was none other than Hayek's mentor Ludwig von Mises.