

A TRIBUTE TO F. A. HAYEK

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What makes us assign any economist to the first rank? To be more specific, why have some famous economists been awarded a Nobel Prize and others, perhaps equally famous, been passed over? The answer cannot be that Nobel Prize winners have provided correct answers to difficult economic questions, while non-prize winners were wrong. This naive view is easily refuted. Nobel Prizes are frequently awarded to economists with sharply conflicting, even diametrically opposed positions. This can be seen vividly by recalling the two corecipients of the Alfred Nobel Memorial Prize in Economics in 1974: Friedrich Hayek and Gunnar Myrdal. So we need a different criterion.

If anything unites all Nobel Prize-winning economists, it is that they advanced economics in a fundamental way. Fundamental advances seldom come through providing new answers to old questions. *Fundamental advances occur when someone poses new questions.* What constitutes a lasting contribution in economics is asking a new question, setting a new direction of research. If you accept this criterion of excellence in economics, then Hayek more than deserved his Nobel Prize.

Asking New Questions

Hayek asked how economies produce and disseminate the information needed to coordinate economic activity. He has posed the question in many different contexts, and in every instance provided us with new insights. He gained early fame for a series of lectures in which he asked the question about intertemporal monetary equilib-

Cato Journal, Vol. 9, No. 2 (Fall 1989). Copyright © Cato Institute. All rights reserved.

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true); it was that, for Hayek, the questions posed were uninteresting or irrelevant.

The Socialist Calculation Debate

The last point can be illustrated by referring to the socialist calculation debate (Hayek 1935b). In this debate, English-speaking economists took up for the first time whether an economic system without prices or markets could allocate resources “rationally.” That is, would such a system be able to systematically allocate inputs to produce the appropriate output? Hayek and his fellow Austrians answered “no,” while many prominent economists of the time said “yes.” To this day, most textbooks say that Hayek and Mises overstated the case against socialism.

Actually, I think Hayek and Mises have been completely vindicated by the events of recent years in Eastern bloc countries, as well as in China. The economies of these countries were generally in a shambles before economic reforms. The limited economic reforms taken thus far—all of which run counter to the professed ideology of the respective governments—have been taken in desperation. We now know that these economies suffer all the worst economic problems seen in Western countries (such as poverty and homeless people), *plus* they simply cannot produce the goods. By any reasonable criteria, old-style socialism is a failure. And it has failed for the very reason Hayek and Mises said it would—without private property and market prices, socialist economies cannot match resources to output in any systematic way.

The basic reason most economists did not understand the theoretical argument against socialism is that they were asking the wrong question. Hayek’s opponents kept asking whether an economic czar could efficiently allocate resources if he had all the necessary information. The answer to that question is, of course, “yes.” Hence, in the mythology of economic history, the defenders of socialism are credited with having “refuted” Mises and Hayek. The defenders did no such thing; they simply posed and answered a different and irrelevant question.

Mises’ original charge, which Hayek took up and amplified, was to discover how a centralized economy would acquire information about preferences and opportunity costs. Our economy does this through prices and markets. By definition, a centralized economy has neither. Mises and Hayek concluded that no social mechanism would exist that could substitute for the information-producing and information-disseminating functions of the price system. Once again,

they hit on the right answer because they discovered the appropriate question to ask.

Choosing a Monetary System

My broader consideration of Hayek's economic contributions has brought us back to the topic of choosing a monetary system. Recall that Hayek's technical work in monetary economics was conventional in its acceptance of optimality as the policy goal. The vast majority of work on monetary policy still attempts to answer the question: What is the optimal policy? By 1976, however, Hayek and a few other economists were beginning to ask a different question. How can we get monetary authorities to do what is right?

Monetary economists have traditionally assumed that, once convinced of the correct policy, monetary authorities will implement it. If the correct policy to follow is uncertain, the uncertainty reflects no more than scientific disagreement. All of what is known as public choice theory disputes this naive view. But monetary economics was a holdout against the insights of Jim Buchanan and his colleagues.

In *Choice in Currency*, Hayek (1976a, p. 16) asks a traditional public choice question: How can we find a way to protect money from politics? By "politics," Hayek means the interest-group politics of modern democracies. As he put it:

I never had much illusion in this respect, but I must confess that in the course of a long life my opinion of governments has steadily worsened: the more intelligently they try to act (as distinguished from simply following an established rule), the more harm they seem to do—because once they are known to aim at particular goals (rather than merely maintaining a self-correcting spontaneous order) the less they can avoid serving sectional interests [Hayek 1976a, p. 14].

I offer two observations about the quotation. First, Hayek is clearly adopting a public choice perspective. The inquiry is not about what the right course of action may be, but about how to get decisionmakers to follow the right course. Second, Hayek clearly is focusing on incentives and constraints. Policymakers do not do the wrong thing because they are either evil or ignorant, but because of the constraint of interest-group politics. Once a policy goal is explicitly stated, interest groups will coalesce to distribute the gains. Whether Hayek's position reflects pessimism or merely realism depends on one's own view. But, I submit, he is asking a far more interesting question than the one typically posed.

There is one feature of Hayek's own recommended policy on which I want to focus. Hayek recommended altering the constitu-

tional rule for money. Money would no longer be produced under monopoly conditions by a government authority, but under competitive conditions. Hayek stated as follows:

At this moment it seems that the best thing we could wish governments to do is for, say, all the members of the European Economic Community, or better still, all the governments of the Atlantic Community, to bind themselves mutually not to place any restrictions on the free use within their territories of one another's—or any other—currencies, including their purchase and sale at any price the parties decide upon, or on their use as accounting units in which to keep books. This, and not a utopian European Monetary Unit, seems to me now both the practicable and the desirable arrangement to aim at. To make the scheme effective it would be important . . . also to provide that banks in one country be free to establish branches in any of the others [Hayek 1976a, p. 17].

Hayek's purpose in making his suggestion was to introduce competition into the production of money. In other areas, of course, competition disciplines producers to supply the best products at the least cost. It has long been thought that the opposite is true for the case of money: "Bad money drives out good," in the words of Gresham's Law. But Gresham's Law applies to only one specific case: that of two monies, one of which is overvalued by fiat relative to the other. The classic example was gold and silver coin whose exchange ratio was fixed at a value inconsistent with market valuations. In this case, debtors and purchasers generally will always prefer paying in the overvalued or depreciated coinage. The valuable coinage will be hoarded.

In the goods market, a kind of Gresham's Law would operate if producers could substitute less-valued commodities for those more highly valued. For example, if an auto dealer could sell BMWs but deliver Yugos, we would have a Gresham's Law for goods. Pretty soon, only Yugos would be available. Actually, price controls produce a situation not unlike this one. The quality of price-controlled goods declines over time. On free markets, however, goods representing value for money received are preferred. Similarly, with competition in currency, good money would drive out bad money.

The public choice basis of Hayek's proposal is clearly drawn out in *Denationalization of Money*.

I should never have wanted to deny that a very wise and politically independent monetary authority might do better than it is compelled to do in order to preserve a fixed parity with gold or another currency. But I can see no hope of monetary authorities in the real world prevailing for any length of time in their good intentions [Hayek 1976b, p. 82].

Hayek wanted to leave the choice of the monetary rule to market forces. He had his own idea what the rule would turn out to be, but he was not attempting to invent a new monetary order out of whole cloth (Hayek 1976a, p. 15). Much of the recent literature on competitive money amounts to doing just this. Once again, Hayek asked a different question: Where should the rule come from? His response was "the market." I find this the most intriguing and attractive aspect of his work. As an economist, I trust market forces, *not* other economists. If we could change the monetary constitution to permit a monetary rule to evolve in the market, the change would have a great deal to recommend it.

Recent events may once again be catching up with Hayek's theoretical analysis. Hayek indicated that freedom for banks to branch within the common market would be a necessary institutional condition for implementing choice in currency. This is because most money is held in the form of deposits, not in currency itself. In fact, the common market is in the process of eliminating branching restrictions. If a bank has a legal charter within one common market country, it will be permitted to branch in all others. Only time will tell if the change will hasten movement toward some type of competition in the provision of money (here viewed in its medium of exchange function). There are obviously a lot of potential political and institutional obstacles to developing competitive currencies. For a good many reasons, however, the economic experiment in Western Europe will be interesting to watch over the next few years.

Conclusion

I would like to close my discussion by considering the direction economic research might take if Hayek's question regarding the choice of a monetary rule is analyzed by more economists. To me, his question suggests a research program grounded more in economic history and less in modeling, and more in comparative institutional studies than in abstract theorizing. Before suggesting fundamental changes in monetary systems, we should look to what has worked in the past. There are an indefinitely large number of rules that can be invented. And there probably exists some set of assumptions that will make each "efficient" within a model. We know, however, that there have been relatively few monetary systems that worked well in history. It seems to me the lessons to be learned will come from more careful examination of monetary history and institutions. Indeed, I think the institutional emphasis is very much in the Hayekian spirit. As I have argued elsewhere, the line of inquiry is one

suggested by Hayek's intellectual mentor and founder of the Austrian school, Carl Menger (O'Driscoll 1986).

The appreciation of Hayek I have offered necessarily covered only a small portion of his contributions to economics (see O'Driscoll 1977). I was able to mention only his important work in political, legal, and social theories. Most notable among these are the three volumes of *Law, Legislation, and Liberty*. But I hope that I have given a flavor of how Hayek's work fits into the topic of alternative monetary regimes. In passing, I also hope that I have indicated that—brilliant theorist that he is—Hayek has also contributed to debate over public policy. We are living in a time of major political and institutional changes that are taking place worldwide. Only now is the importance and relevance of some of Hayek's ideas becoming evident. In a real sense, Hayek has been underappreciated because he was so far ahead of his time. One might say that events are finally catching up with theory.

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