Friedrich Hayek (pronounced HI-YACK) achieved worldwide recognition as a champion of the free market and opponent of government intervention in economic affairs. His work makes a strong case that individual choice and free exchange through the market yields both economic benefits (greater efficiency) and non-economic benefits (greater liberty and freedom).

Hayek was born in Vienna in 1899. His grandfather was a mountain-climbing companion of Austrian economist Böhm-Bawerk. His father was trained as a physician and taught botany at the University of Vienna, but never became a full-time professor. Hayek grew up hoping to become a university professor, in part because of his father's unfulfilled dreams (Caldwell 2004, pp. 133—35).

During World War I, Hayek served in the Austrian army on the Italian front. Returning from the war he enrolled at the University of Vienna and earned two doctorates — one in law (1921) and one in Statswissenschaft (1923), which is something like political economy. Working on the latter degree, Hayek read Menger's *Principles of Economics*, which hooked him on economics (Caldwell 2004, p. 139).

After the war, Hayek experienced first hand the hyper-inflation that destroyed Germany and Austria. With prices rising several-fold each day, workers would demand half their daily pay at lunchtime so they could go out and buy necessities before prices doubled or tripled during the afternoon. This contributed to Hayek's hatred of inflation and to his fear that Keynesian economics would generate inflationary pressures.

Ludwig von Mises, head of the Austrian Institute of Economic Research, hired Hayek in 1923. Four years later he appointed Hayek to be Director of the Institute. In 1931, Hayek was hired as Tooke Professor of Economic Science and Statistics at the London School of Economics in order to bring economic ideas from Continental Europe to England.

Following publication of the *Road to Serfdom* in 1944 Hayek became a world-renowned social theorist. Receiving many teaching offers, he accepted an appointment at the University of Chicago in 1950. In 1962 he returned to Europe, accepting a position at the University of Freiburg. In 1974 Hayek shared the Nobel Prize for Economics with Gunnar Myrdal. The committee singled out Hayek's original way of advocating political ideas when announcing the award.

During the 1930s Hayek wrote about monetary theory and business cycles. Then he began to focus on the problems of inflation and unemployment. By the mid 1940s Hayek became a strong critic of socialism, government planning, and all government intervention in the economy. He blamed the government for creating economic problems and for making economic problems worse by meddling with the market economy.

Hayek's (1933) first major book examined the role of money in economic expansions and contractions. It attempted to explain and develop the dynamic analysis in Wicksell's (1898) *Interest and Prices*. Hayek argued that monetary factors were a necessary condition for the business cycle, but that changing the...
money supply was not enough to cause fluctuations in output. Another important factor was production, or the supply-side of the economy. Following Böhm-Bawerk, Hayek believed that capitalist economies produce goods in ever more roundabout ways. The length of time it takes to bring goods to market constantly increased because machinery and tools had to be developed before they could be used to produce goods and services.

When money is created by bank loans, but no additional saving takes place, there is immediately a greater demand for consumer goods. This pushes up the price of consumer goods relative to other goods. Attempting to meet this demand, firms adopt less roundabout means of production. But soon after prices begin to rise, interest rates must rise so that banks do not incur great losses when the loans they made are paid back with money that can buy much less than the money they lent out. These higher interest rates then slow down consumer spending. Industries that produce consumer goods go idle and lay off workers. Now past excesses begin to take their toll. The failure to produce more investment goods means that firms producing investment goods cannot absorb the labor no longer needed to produce consumer goods.

This analysis of the causes of unemployment was quite different from that of Keynes. For Hayek it is not a lack of demand that creates unemployment; rather, unemployment stems from the composition of demand, or demand for the wrong types of goods (consumer goods rather than investment goods). It can only be remedied by reducing consumer demand so that extra savings become available for businesses to use for additional investment, enabling them to adopt longer production processes.

For this reason Hayek opposed using Keynesian economic policies to deal with unemployment during the Great Depression. He was against stimulating consumer demand, expanding public works projects, and propping up prices. He later claimed that these policies helped convert what might have been a mild recession into a prolonged depression.

In addition, by creating inflationary pressures, Hayek held that Keynesian policies would ultimately hurt the economy. First, people will spend more immediately in order to beat price increases. As a result, more consumer goods will get produced and less roundabout production employed by business firms. This reduces future economic growth and living standards.

Second, for Hayek (1945) the market system provides important information. Prices tell consumers which goods require less effort and fewer resources to produce; these goods cost less. Prices also tell businesses which inputs and means of production are least costly. Inflation distorts this signaling function of prices. When all prices are continually rising, it is hard to know which goods cost less to produce and how to produce those goods in the least expensive way. Consequently, inflation distorts the economy by moving resources to areas where they should not be employed (inefficient and unwanted activities). This reduces efficiency and the nation's standard of living.

While opposed to inflation, Hayek was even more opposed to using incomes policies, or wage and price controls, as a means of combating inflation (see Galbraith). He saw this as a step towards a totalitarian state. Moreover, incomes policies, like inflation, destroy the informational role of prices. Finally, an incomes policy does not stem the root causes of inflation — too much money being created and then less roundabout production methods being employed. Controls might temporarily suppress inflation, but for Hayek money creation had to be slowed in order to eradicate inflation.

Excessive money creation, Hayek (1976a) argued, resulted from government monopolization of the
printing and circulation of money. Monopoly control over money creation by the government leads to inflation for two reasons. First, the government will be tempted to print more money in order to pay its bills. Second, the government will be tempted to print money and create inflation so it can repay borrowed money with money that is worth much less (because it can purchase fewer goods).

To keep governments from deliberately creating inflation, Hayek (1976a) proposed letting private businesses issue their own currency. Large firms, or more likely large banks, would be allowed to print up their own money. People and firms would choose to hold those currencies they expect to be most accepted by others and least likely to decline in value. This, Hayek felt, would keep inflation in check because it would control the inflationary tendencies of government. In addition, private money issuers would need to be concerned about their reputation and the value of the money they created. As a result, he thought that they would not issue too much money. Here Hayek may have pushed his case against government intervention too far. Worried about the burden of inflation on firm efficiency, he ignored efficiency losses from continually having to pay attention to the value of private money that each firm accepted and held.

In the 1940s Hayek began promulgating the view that economic problems arise due to government intervention, and used philosophical and psychological insights to make a case against government involvement in economic affairs. He stressed that there were finite limits to the amount of knowledge any individual or institution can acquire, as well as limits to human reason. We can understand general economic relations, but not the precise relationships operating at any time. Hayek (1955, pp. 53—63) also stressed that the social sciences were fundamentally different from the natural sciences. People do not obey psychological or economic laws the way that matter obeys the laws of physics; so attempts to control society the way that science controls the physical environment could only lead to problems. Both these beliefs have implications for economics, and each supports Hayek's case against government intervention in economic affairs.

The case for economic planning during the 1930s and 1940s was that planners could figure out the supply and demand for all goods in the economy and manipulate prices accordingly. Going further, some economists argued that because the economy was so complex, planners with a good mathematical model could do better than the market in setting prices (Lange and Taylor 1964). Others (see Galbraith) argued that as firms became more monopolistic, government planning was needed to counter their economic power.

Hayek turned these arguments upside down. He pointed out that the complexity of the economy meant no one could understand the workings of the whole economy. Supply and demand equations could not be known by planners, and so planning could only lead to inefficiencies. Moreover, planners would respond slowly to changes in supply or demand. They would have to wait until reports about shortages or surpluses were confirmed. In contrast, people react quickly and, even if they make mistakes, will learn quickly from them (Hayek 1948, p. 45). Similarly, Keynesian macroeconomic management (or fine-tuning) was flawed since policy-makers could not understand all the intricacies and subtleties of the market.

The main problem, according to Hayek, was that knowledge requirements were too great for any government bureaucrat, and human knowledge in a changing and uncertain world was limited. Instead of improving economic performance, government policy would only stifle the economic system that is responsible for improving our living standards. Before making any decision, a socialist government or
ministry of economic planning would have to gather an immense amount of information. Hayek (1935) estimated that planners would need hundreds of thousands of equations to understand the whole economy. To find market clearing prices, they would have to solve these equations. By the time this was done, the economy would have changed and the information upon which the solution was based would be obsolete. Planners would then have to re-estimate all the equations and solve this new set of equations. Of course, by the time this was done, the economy would have changed again and the prices set by the economic planning board would again be out of date.

Hayek also turned upside down the case that government power had to be used to counter the monopoly power of firms. He held that monopoly power is usually the result of government actions. For example, domestic producers lobby the government to keep out imports and restrict entry into an industry or profession through licensing requirements. Hayek also thought that, even if large firms become powerful, potential competition (or the threat of new rivals starting up) would force firms to operate efficiently and produce the goods demanded by their customers at the lowest possible cost. But Hayek (1944) went even further than this. He felt that governments limit individual freedom, taking us down The Road to Serfdom. This applies to socialist economies as well as capitalist economies that plan for the future or attempt to reduce unemployment.

It is also true of government policies that attempt to redistribute income in the name of economic justice. For Hayek (1976b) it is illegitimate to describe market outcomes as either just or unjust. Income distribution is a fact about the world, the result of impersonal market forces. The notion of justice does not apply to such situations. In addition, attempts by the government to redistribute income will do more harm than good. The poor are hurt by such policies because they reduce economic incentives and shrink the economic pie. This leaves less for everyone, wealthy and poor alike. The poor are also hurt because the wealthy perform important economic functions like taking risks, supporting the arts and education, and testing new and expensive products that, if successful, get mass produced at lower prices.

Going even further, Hayek (1944; also see Butler 1983, ch. 4) opposed government attempts to provide equal economic opportunity to all individuals. If the government attempted to give all children an equal starting point, it would require redistributing the wealth of their parents so that no child starts out ahead of others. It would also mean keeping the income of all parents equal so that no children gain an unfair advantage. Once again, in seeking to provide equal opportunity, governments become more totalitarian.

Although he opposed equality of outcomes and opportunity, Hayek did support equity in another sense. He thought all men and all women should be treated as equals before the law. Equality of the law, or rules that apply to all citizens, would preserve liberty against the coercive power of government (Hayek 1976b).

Hayek's main economic contribution was to stress the benefits of free markets and the crucial information provided by prices. His case for free markets led him to oppose all attempts to alter or control markets. Such actions limit individual freedom, reduce economic efficiency, and lower living standards. Markets, for Hayek, were self-regulating devices that promoted prosperity. Government policy and other attempts to hinder the workings of markets could only make us worse off economically and reduce individual liberty.

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