



BULGARIAN NATIONAL BANK

The Economic Philosophy of
Friedrich Hayek
(The Centenary of His Birth)

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DISCUSSION PAPERS

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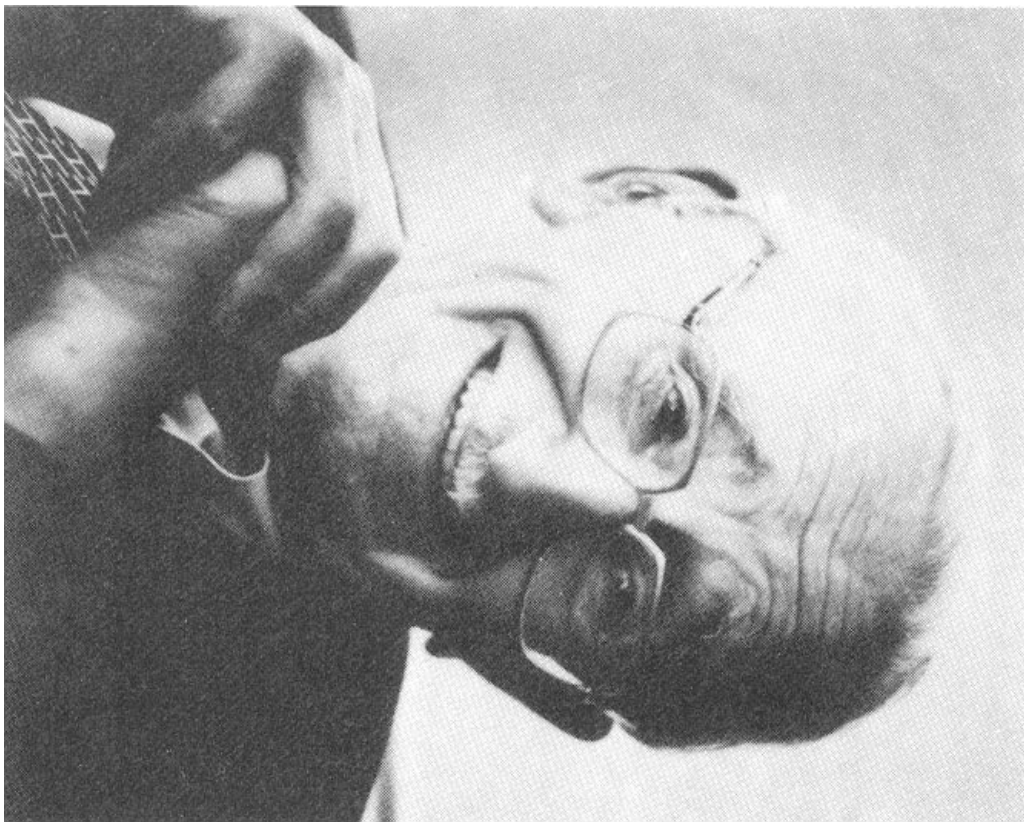
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SUMMARY: THE EIGHTH OF MAY MARKED THE CENTENARY OF THE BIRTH OF FRIEDRICH HAYEK, PROBABLY THE MOST PROMINENT FIGURE OF TWENTIETH CENTURY LIBERALISM. THIS ESSAY TRACES HAYEK'S LIFE AND HIGHLIGHTS HIS CONTRIBUTIONS TO THE SOCIAL SCIENCES. THESE CONTRIBUTIONS ARE CONSIDERED IN THE LIGHT OF FOUR DISCUSSIONS: SPONTANEOUS ORDER VERSUS CONSTRUCTED ORDER, METHODOLOGICAL INDIVIDUALISM VERSUS MACROECONOMICS AND ECONOMIC POLICY, DISPERSED KNOWLEDGE AND IMPERFECT INFORMATION VERSUS SOCIALISM AND PLANNING, FREE MONEY VERSUS CENTRAL BANKING.

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*"Order is not a pressure imposed upon society from without,
but an equilibrium which is set up from within."*

Ortega y Gasset

(quoting Hayek's *The Constitution of Liberty*)

The eighth of May marked the centenary of the birth of Friedrich Hayek (1899 – 1992), probably the greatest figure of Twentieth Century liberalism. Hayek lived sufficiently long, and preserved sufficient sagacity into old age¹ to witness the whole 'life cycle' of his works: from rejection of his ideas and losing the debate with Keynes and Lange in the 30s, through long isolation in the postwar period, to ultimate triumph with the collapse of the socialist system in the late 80s.²

Hayek's scientific heritage involves not only economic theory but also social philosophy and political sciences, law and anthropology, the philosophy of science and psychology: a total of 25 books and 130 articles translated into different languages.³ Despite the Nobel Prize

¹ *It suffices one to read one of his last works The Fatal Conceit: though written by an 88-year-old, it is as vigorous as it would be if written by a youth. See Hayek, F. (1988)*

² *On 5 February 1981 then British Prime Minister Margaret Thatcher said addressing the opposition in Parliament: "I am a great admirer of Professor Hayek. Some of his books – The Constitution of Liberty, and the three volumes Law, Legislation and Liberty – would well be read by some honorable members." See McCormick, B. (1992), p. 235.*

³ *Boettke, P. (1992) It is interesting to note that two of Hayek's fundamental works, The Constitution of Liberty and Prices and Production, were translated into Chinese in 1966 and 1975 respectively. See the full bibliography of Hayek's books to 1988 in: Dostaler, G., D. Ethier, ed. (1989).*

awarded to him in 1974 for the development of cycle and money theory, he has never been recognized by fellow economists.⁴ The explanation is rather simple: he is in another paradigm (if we should make use of Kuhn's methodology) and possibilities of communication with the ruling paradigm are insignificant. The rejection of neoclassical analysis and classical rationality, macroeconomics and economic policy, modeling and the application of mathematical methods in management make Hayek equally unacceptable to scholars, teachers, civil servants and politicians: they see him as a threat to their existence. Is it not provocative of him to say that "the curious task of economics is to prove to people how little they actually know about what they think they can project."⁵ This is the true reason why Hayek has been accepted neither by Keynesians, nor monetarists, nor by exponents of newer trends in economics: those of rational expectations and the real business cycle.

I. Hayek's Life Road: Vienna – London – Chicago – Freiburg

Friedrich von Hayek was born in Vienna on 8 May 1899 in the family of intellectuals. On his father's side he inherited an interest in biology and the natural sciences: his grandfather was a biologist, and his father a professor in medicine and botany. This tradition extended to Hayek's brothers: one a professor of anatomy and the other of chemistry, as well as to his children: his daughter is a biologist and his son a pathologist. On his mother's side Hayek was influenced by his grandfather: a professor in constitutional law and later president of the Austrian Imperial Chamber of Statistics.⁶

Hayek started his academic career at Vienna University where the intellectual climate was imbued with the Austrian school of economic analysis. The beginning was set by Karl Menger with his *Principles of Economics* (1871) and his theory was developed further by Eugen Böhm-Bawerk, Friedrich Wieser, and Ludwig Mises in particular. Though Wieser was his first teacher, Hayek himself stated "there is no

⁴ The refusal of the Chicago University Economics Department to offer a chair to Hayek in 1950 is well-known; he became a professor in Social Sciences and Ethics. The attacks of one of the most popular economists, Paul Krugman, who recently expressed the opinion that Hayek has not contributed to the development of economics thought and is not therefore worthy of respect, are indicative in this regard. See **Krugman, P.** (1998).

⁵ **Hayek, F.** (1988).

⁶ **Machlup, F.** (1977).

single man to whom I owe more intellectually,”⁷ something which also applies to Mises’ book, *A Theory of Money and Credit* (1912). Hayek obtained two subsequent doctorates in 1921 and 1923, in Law and Economics, becoming a *privatdozent* in political economy in 1929. Between 1922 and 1927 he worked under the guidance of Mises, actively participating in his private seminar,⁸ and from 1927 to 1931 was Director of the Institute for Business Cycle Research.⁹ During this period he visited the USA several times and was amazed at the “naivety” of American economists in their treatment of economic crisis and economic conditions.¹⁰

In 1930 – 1931 Lionel Robbins invited Hayek to the London School of Economics where the four lectures he delivered were met with great interest. They were later published in a separate book, *Prices and Pro-*

⁷ **Boettke, P.** (1992), p. 1. Wieser was a Fabian which initially attracted Hayek but later alienated him, making him accept the anti-socialist stance of Mises. In recent years attempts have been made to oppose Hayek to Mises by asserting Mises as the true liberal and declaring that Hayek’s theory is strongly influenced by his student years in Wieser’s class. Thus within the framework of the Austrian school of economics there existed two trends: the first, Misesian, of the classical Austrian school gathered around Rothbard, Salerno, Hoppe, De Jasay et alia (mostly publishing in *The Review of Austrian Economics*), and the second, that of the new Austrians, Hayekianians like Kirzner, Boettke, White, Down, Selgin, et alia, publishing in *New Austrian Economics*. See, for instance the critiques of Hayek in **Hoppe, H.** (1994), **De Jasey, A.** (1996), **Salerno, J.** (1999). There are certain differences in the methodology of the two scholars: Mises is a traditional rationalist using the methodology of praxeology while Hayek, in his own words, is ‘an evolutionary rationalist’ by contrast with ‘constructive rationalism.’ Despite the ‘irrational’ elements in Hayek’s theory, it may definitively be assumed that under the influence of Popper and Hayek’s own interest in psychology he developed a personal view of human behavior; further developed by Simon in his ‘procedural rationality.’ On the whole **the author** cannot see any considerable contradictions between the general views of the two on human activity and social development. See the interesting analysis of liberalism and its classification into utilitarianism (Friedman), rationalism (Mises) and evolutionism (Hayek) made by the Polish author Legutko (1995).

⁸ In 1921 Hayek, then 22, launched together with Fürth a private seminar, **Geisteskreis**, discussing issues from all fields of life, including music, literature, and the theory of relativity. At that time Hayek was in contact with the great Austrian philosopher Wittgenstein, this contributing to his interest in philosophy.

⁹ For a long time the Institute consisted of three persons and was sponsored by the Rockefeller Foundation. After Hayek moved to London, its director became Oscar Morgenstern, during whose term in office the Institute expanded and came to apply quantitative methods.

¹⁰ Hayek departed for the USA with a recommendation from Schumpeter. He stayed there 14 months mainly at New York and Columbia Universities, and began writing his doctoral thesis: “Is a stabilization of the value of money compatible with its function?,” which was to stay unfinished. He attended Clark’s and Mitchell’s seminars. Autobiographical notes on Hayek’s life may be found in: **Gamble, A.** (1996) and **Dostaler, G.** (1989).

duction (1931). To reinforce his stance against Keynes, Robbins invited Hayek to England and assisted in his appointment as Professor of Economics and Statistics.¹¹ His stay in England was marked by two great intellectual fights. The first was with Keynes, Sraffa and Kaldor concerning the causes of the cycle and the role of money. Those three took the view that the driving force of a crisis is underconsumption and that to avoid it aggregate demand should be encouraged, thus in essence justifying inflationary stimulation of the economy. Hayek, on the contrary, argued that crises are caused by overconsumption leading to credit growth which destroys natural interest rate levels and creates an imbalance between supply and production. In his opinion, inflation decomposes relative prices which are the principal information signals.¹² The second dispute was with Lange, Lerner, Taylor and Dickinson on market socialism and the possibilities of forecasting under a centralized economy. The four argued that under a centralized government the planning authority may use so-called 'shadow prices' parallel to market prices in a market economy. The outcome of the first dispute was Hayek's book *The Pure Theory of Capital* (1941) and the second produced the books *The Road to Serfdom* (1944) and *Individualism and Economic Order* (1948). In both disputes Hayek was the loser which made him reconsider his scientific program and shift to areas outside the scope of economics.

¹¹ *The relationship between Hayek and Keynes is quite interesting. Despite their fierce debates they had mutual liking for one another. In Hayek's own words, this was due mostly to the fact that both of them regarded their preoccupation with economics as supplementary and searched for explanations of things far beyond economics. There are many scientific ingredients that unify the economic views of Hayek and Keynes, among them uncertainty, emphasis on the time factor; the importance of expectations, and the role of money. Hayek's opinions of Keynes are contradictory. In his memoirs he writes that during his last meeting with Keynes (two weeks before the latter's death) he confided being disappointed with his disciples and "I could be assured that he would like to quickly bring about a change in public opinion," Hayek, F. (1978a), p. 287. In one of his last interviews Hayek explains Keynes' methodological mistakes with the fact that his knowledge of economic literature (and of classics in particular) was cursory and he was still a "dilettante and a self-taught economist." Keynes' activism is explained by Hayek by a disregard for conventional moral values, synthesized in his words: "I am and shall remain amoral." Nevertheless, after Keynes' death, Hayek intimated to his wife that Keynes "was probably the best-known economist living." The meetings between Hayek and Keynes are described by Hayek himself (Hayek, F., 1994), and also by Dostaler, G. (1990, pp. 135 – 162, 1997).*

¹² *Mises and Hayek's aversion to inflation may also be explained by their personal experience: as a result of the 1923 hyperinflation their families lost a significant portion of their savings. See Polanyi, K., M. Mendell (1989).*

In 1950 he settled in Chicago, staying there until 1962 as Professor of Social and Political Sciences. A product of his research was the book *The Counter-Revolution of Science* (1952), probably the best one written by him, as well as the most systematic exposition of his libertarian views: *The Constitution of Liberty* (1960).

Hayek returned to Europe as Economics Professor (he took over the chair from Walter Eucken) at the University of Freiburg, Germany, where he retired in 1967. During this period Hayek devoted his time to elaborating his theory of spontaneous order and published the three-volume collection *Law, Legislation and Liberty* (1973 – 1979). Subsequently he accepted an Honorary Professorship at the University of Salzburg, Austria, until 1974. In 1971 Vienna University awarded him an Honorary Senatorship and in 1974 he shared the Nobel Prize in economics with Gunnar Myrdal.¹³ During his last years Hayek returned to his favorite subject on money and in 1977 published his book *The Denationalisation of Money* (1977, 1978) which evoked discussions on the centralization of currency issuing. In 1988 he published *The Fatal Conceit: The Errors of Socialism*, the product of his preparation for a sweeping but unaccomplished intellectual debate with socialists in Paris.

Friedrich Hayek has never made efforts to impose his views and has never aspired to administrative or consulting office.¹⁴ Universities and the academic community were his only and most natural habitat.

In April 1947 he together with 39 European and American scientists founded the Mont Pèlerin Society with the objective of discussing “the risks from destruction of free society.” Its Articles of Association expressly state that its members shall not engage in “propagandizing their ideas and shall not belong to any party.”¹⁵ They should only “exchange

¹³ At the reception after the Nobel Prize awards Hayek confessed he had opposed receiving it and had long hesitated whether to accept it for it was unreasonable to attach so great significance to any economist.

¹⁴ Except for several years when together with Mises he worked at the Vienna Chamber of Commerce, due to pecuniary difficulties, Hayek has never ceased his research. It should be noted that it was then that Mises and Hayek established their Institute for Business Cycle Research which was located for a long time at their workplace at the Chamber of Commerce.

¹⁵ In his essay *Why I am not a Conservative* Hayek defines the functions of a scientist as follows: “the task of a political philosopher can only be to influence public opinion not to organize people for action. He will do so effectively only if he is not concerned with what is now politically possible but consistently defends the general principles which are always the same.” See *Hayek, F.* (1993), p. 406.

ideas to ensure that free society is saved.”¹⁶ Hayek chaired the Society until 1960 and then became its honorary chairman.

Hayek died on 23 March 1992.

II. Spontaneous Order versus Constructed Order

If there is one thing that is immediately associated with Hayek’s name, that is his theory of spontaneous order and the evolutionary development of society. According to Hayek, major institutions like morality, law, the state, the market, money, *et alia*, arise spontaneously from human action rather than resulting from deliberate human effort. Hayek’s institutionalism is very close to the theory of evolutionary games (supergames) in which institutions are perceived as a solution to games (Shotter) and are not set *ad hoc* (Shubik).¹⁷ Spontaneous order derives from the self-organization of society and the economy which draws it closer to the modern theory of chaos, the formation of complex and sophisticated structures (Prigogine).

Human society is governed by rules. According to Hayek, “man follows rules rather than pursue goals.”¹⁸ “Individuals are not required to contend on ends, but only on means suitable to serve a great number of ends that everyone hopes to use effectively to achieve his own ends.”¹⁹ Man “follows rules which he has not invented and often does not know in detail; yet is in a position to follow.”²⁰ Spontaneous order is the result of selection of such rules and is the opposite of constructed order where rules are imposed by force. Spontaneous order is the other word for the emerging, growing order (*cosmos*) as the antonym of constructed order, of the established society (*taxis*). These two types of social dynamics are closely interwoven with the two types of rationality: evolutionary and constructive. The first assists society, the second destroys it. The mechanism of spontaneous order cannot be comprehended let alone be reconstructed artificially and it is this that “often causes panic and calls for government action.”²¹

Rationalism, in Hayek’s opinion, has its limitations: human behav-

¹⁶ **Machlup, F.** (1977), p. XII – XIII.

¹⁷ **Mirowski, P.** (1993) *Institutions as a Solution Concept in a Game Theory Context*. ed. G. Hodson, pp. 241 – 260; **Hodson, G.** (1998), pp. 166 – 192.

¹⁸ **Hayek, F.** (1996b), vol. 1.

¹⁹ **Hayek, F.** (1998), vol. 2.

²⁰ **Hayek, F.** (1996b), vol. 1.

²¹ *ibid*, vol. 1.

ior is a combination of different types of rationality and irrationality, of knowledge and ignorance. It is not possible therefore to set up institutions, codes of behavior according to a preset plan. To do so would be “abuse of mind.” Hayek argues that social engineering, which seeks to transfer exact science methods into the social sciences by setting scientifically estimated goals and tries to achieve them by tools specifically designed to fit the purpose, is the cause of instability and the slow development of mankind. The Austrian scholar calls this “the servility of social science to exact sciences.”²² For Hayek traditional rationalism leads to a number of delusions like: “(1) the idea that it is unreasonable to follow what is unjustifiable from a scientific point of view or cannot be proved by observation, (2) the idea that it is unreasonable to follow what we do not understand, (3) the idea that it is unreasonable to follow a direction unless its destination were thoroughly known *apriori*, (4) the idea that it is unreasonable to do something unless its results are not entirely known beforehand, being both entirely observable and beneficial (utilitarians).”²³

The only possible development is evolutionary culture dynamics where, drawing on their mistakes and success, individuals and social groups discover those rules that bring them greater economic benefits. Evolution cannot be just, and ‘social justice’ is a scientific and terminological nonsense.

The theory of the spontaneous, growing order is an extension of the liberal ideas of Spinoza, Locke, Mandeville and classical English liberalism of the 18th and 19th Centuries. In a sense it is a continuation of the epistemological critique of Menger in the 1870s against the historical method in social sciences, giving priority of the concrete to the abstract and based on collecting empirical evidence.

On many occasions Hayek made public his leanings to Kant, his theory of knowledge imbued with subjectivism and scepticism, opposing them to the objectivism and totalitarianism of Hegel. The spontaneous order closely approximates Karl Popper’s philosophical system of the ‘open society’: yet another great liberal of the 20th Century (and another Austrian).²⁴

²² Hayek, F. (1952), p. 12.

²³ Hayek, F. (1988).

²⁴ In 1946 Hayek helped Popper to move from New Zealand, where he had been forced to emigrate, to London. In his memoirs Popper suggests that Hayek had saved his life twice. When after a year his book *The Open Society* had not been accepted by any publish-

III. Methodological Individualism versus Macroeconomics and Economic Policy

The underlying proposition in Hayek's system is methodological individualism which asserts that any public development or process derives from an individual's conduct and his actions. A fundamental part of this approach is *subjectivism* understood as an inability to define the objects of human activity outside the context of people's assessment of them. Thus the rejection of macroeconomics comes logically: "neither aggregates, nor aims and means respond; rather these are the individual actions of people who govern them." Hayek rejects the existence of macroeconomics and economic policy altogether, not only its Keynesian version (as is often argued). To him, the disputes between monetarists and Keynesians, the school of rational expectations and the school of imbalances, are disputes over the details within constructed economic reality. To Hayek the very concepts used by macroeconomics such as GDP, consumer price indices, unemployment rates, aggregates of investment and savings, monetary aggregates, and so on are nonsensical: devoid of meaning.

Hayek regards macroeconomics as a powerful tool for the construction of an economy according to a prior plan: something thoroughly illusory and wrong. Macroeconomics presupposes a holistic vision of development, where the whole precedes the parts and does not arise spontaneously from their interaction. This vision justifies the establishment of special authorities: in this case the state, which should keep the whole from collapsing and guide it "in the right direction according to a scientifically grounded plan." In the framework of macroeconomics, aims are set to a greater or lesser degree, tools are constructed and at-

*ing house in the USA, Popper appealed to Hayek who helped him publish it in England. The interaction between Hayek and Popper was two-way. It should be remembered that Popper published his first major article, The Poverty of Historicism, in the **Economica** whose chief editor was Hayek. See **Popper, K.** (1998) and **Watkins, J.** (1997) pp. 645 – 684. According to Popper, he and Hayek have had two enemies throughout their creative lives: historicism and scientism. They regard historicism as a specific kind of determinism and scientism where the past and present determine the future, which contradicts the principles of open society. There is substantial difference between Hayek and Popper in terms of their philosophical systems: Popper is an objectivist and realist while Hayek is a subjectivist. In the area of scientific methods Hayek draws on the falsifiability of theories and scientific development through problem displacement. They have quite a similar stance to information, knowledge, learning by trial and error, and the role of imitation.*

tempts are made to achieve the aims through them by studying their relationships. In the course of enlarging and extending this relationship, tools become intermediate targets, and aims: ultimate goals. Thus the chain of goals and tools reaches absurd dimensions and loses all sense. Economists make tremendous intellectual efforts to study macroeconomic dependencies and whole generations of economists dedicate their lives to study just one macroeconomic link in detail. According to Hayek, the absurdity has grown apace since macroeconomists and politicians started believing themselves and fighting aggressively for their *raison d'être*.

Let us take the example of the ISLM model which is still very popular and present in most textbooks. Despite a number of modifications, this model remains an example of manipulation and intervention in human choice. It assumes that government knows more than other economic agents, and that the private sector and the market are unstable. The logic of this model is simple: the interest rate emerges simultaneously in both savings and investment market (incorrectly called *real*) and money supply and demand (called money market). Under this model the government represented by the central bank can manipulate money supply (against a given money demand) and convert savings into investment “in the right direction and at the required volume.” This may be done by replacing the real interest rate by a nominal one (equal to the real interest rate plus expected inflation), i.e. by ‘inducing’ inflation. This misleads economic agents since the real interest rate (a result of the choice for present or future consumption) has been replaced by a nominal interest rate which cannot be exactly forecast. Thus government control over money supply interferes with the major human choice between consumption and savings, and with the basic economic link between savings and investment. It may be definitely concluded that there is no better example of a replacement than this: a real quantity is supplanted by another with a view to accumulate and rechannel individuals savings, hence breaking the optimum distribution of resources.

The dispute between Hayek and Keynes in the 30s about the nature of the economic cycle and reasons for economic crises (probably the most significant dispute on macroeconomics issues in the 20th Century) may be viewed in the light of the discussion about the existence of macroeconomics and economic policy. Keynes contended that crises result from market imperfections and that the role of macroeconomics

policy was to save capitalism. Hayek's view was just the opposite: crises were a result of "too much government" in the economy and the destructive force of economic intervention at the beginning of the century. According to Hayek, Keynes' attempts in his *Treatise on Money* (1930) to prove that aggregate quantities reflect the economic choice of individuals, had failed.

Hayek's criticism of macroeconomics fundamentally diverges from that of Robert Lucas, a Nobel Prize Laureate. He does not reject macroeconomics *per se* but asserts that macroeconomics goals cannot be achieved. This statement is based on the hypothesis that economic agents are rational in decision making (the entire information available is taken into account). This helps them incorporate government objectives and instruments into their expectations, hence changing the parameters of the economic macromodel and neutralizing the result projected by government. There are two paradoxical aspects in this approach: *first*, in this model economic agents' expectations are based *again* on the rules of the macroeconomics model learned at university, by word of mouth or the newspapers; and *second*, no one knows which model will be included in economic agents' expectations: they can choose various models (monetarist, Keynesian or even Marxist). Lucas' model works provided all economic agents are monetarists (similar to the statement that if money supply grows, prices will inevitably increase at the same rate). Lucas criticizes macroeconomics inwards, while Hayek criticizes it outwards. According to Hayek, economic agents are irrational, or as he puts it, "evolutionary rational" and due to the decentralization of knowledge and the imperfection of information they are unable to forecast. In this context Lucas' criticism is a senseless exercise, since macroeconomics itself is a conceptual nonsense.²⁵

IV. Dispersed Knowledge and Imperfect Information versus Socialism and Planning

Within the second significant debate (on the capabilities of socialism) in 1937 Hayek published *Economics and Knowledge*: one of his most significant essays, in which he posed the question of the nature of

²⁵ In one of his interviews Lucas said he considered himself a Haykenian for a long time but that after he had read Kevin Hoover's book he was disappointed. See **Snowdon, B., H, Vane, P.** *Wynarczyk* (1994), p. 244.

human knowledge and information.²⁶ According to Hayek, knowledge and information are dispersed, decentralized and cannot be concentrated in one or several centers: each element of the system carries the knowledge required for its functioning. In Hayek's view division of knowledge is of the same key significance as division of labor in Adam Smith's system. All social and economic categories may be derived from the structure of knowledge and information. The market, later replaced by 'catallaxy' is the major instrument for creation, transmission and destruction of information as a result of relative price movements (according to Hayek general price levels or aggregate price indices are harmful fiction and they do not exist as categories). The market is a complex structure, a permanent process, a "procedure" to be discovered using the trial and error method. Planning may exist only on an individual level. Therefore, Hayek considers equilibrium as coordination of individual plans, dependent on distribution of information (Hayek rejects the general equilibrium model of Walras, Arrow and Debreu as abstract, holistic, providing for centralized government and leading to socialism). In his earlier books Hayek used the term "a tendency toward equilibrium," while later he preferred the term "order" which better reveals the nature of competition.²⁷ According to Hayek, the latter is a process of discovery which "is of much greater importance for developing countries."²⁸

Hayek's theory of dispersed knowledge and the impossibility of centralized measuring and calculation of relative prices directly contradicts the theory and practice of socialism and macroeconomic planning.²⁹ The application of Hayek's methodology to socialism finds expression in his most popular book, *The Road to Serfdom* (1944) with the indicative subtitle: *Devoted to Socialists of all Parties*. The absence of prices as guides and attempts to concentrate information into one center, Hayek said, would be a fatal flaw.

²⁶ Hayek, F. (1937), pp. 33 – 54. Hayek himself considered this article his best economics work. Hayek's book *The Use of Knowledge in Society* may be treated as a sequel to Economics and Knowledge, Hayek, F. (1945), pp. 519 – 530. Recently the debate was restored with the publication of an article by Cockshott, W., A. Cottrell (1997), pp. 177 – 202 in which Hayek's arguments in his 1945 article were analyzed and criticized in details.

²⁷ Hayek, F. (1968), pp. 254 – 265.

²⁸ *ibid.* p. 13.

²⁹ See Boettke's article on difficulties related to calculation in socialism: Boettke, P. (1998).

In fact, problems associated with calculation under socialism have not been found by Hayek (as he admitted). This is a continuation and further development of the ideas of Weber, Brutzkus and mostly Mises. According to Pareto and his adherent Barone (their theory was later used by Lange, Taylor, Lerner and Dickinson) socialist economics is theoretically workable, provided that the mechanism of equalization of subjective marginal utilities, the so-called ‘shadow’ prices in allocation of resources, is followed. In fact they both consider that the manner of resource allocation does not depend on the form of ownership: private or state-owned.

On the contrary, according to Hayek and Mises the *mechanism of allocating resources is inseparable from the form of ownership*. Hayek and Mises thought socialism is impossible due to these reasons, “calculation difficulties” result from the absence of a *property right market*, primarily the right of ownership on the means of production. This narrows the room for competition, money and prices which guide individuals’ orientation and are the base for enterprise and initiative.

According to Mises and Hayek capitalism is the only system providing for calculation but on the individual and not macroeconomic level. Capitalism is more flexible than socialism since capitalist government is decentralized unlike the centralized socialist one. Mises and Hayek sharply criticized both socialism and the contemporary practice of developed countries.

V Free Money Versus Central Banking

In 1936 under the guidance of Hayek, Vera Smith defended a dissertation on the *Rationale of Central Banking*. This work includes both a historical review of central banks emergence and the mechanism of ‘private money’.³⁰ In this dissertation it is unambiguously stated that the emergence of central banks was not based on the economic nature of money and that they emerged as a result of brutal government intervention in banking. According to Smith, decentralized money supply is the natural state of the monetary system. In 1977, influenced probably by Smith’s book and the articles of Klein and Rockoff on free money published in 1974, Hayek’s new book *The Denationalisation of*

³⁰ *Smith, V. (1936).*

³¹ *Klein, B. (1974); Rockoff, H. (1974).*

*Money*³² renewed the discussion of the necessity of central banks. Literature on competitive money issue dramatically increased, with decentralized issue *modus operandi* being discussed to the smallest detail. Currently, these discussions have shifted within the framework of the new theory.³³

Hayek's approach to the institutional structure of monetary organization is a logical continuation of his view on the origin, evolution and functions of money. As all other categories in Hayek's economic philosophy, money is studied in the light of evolution, spontaneity, human choice, rules, *et alia*.

Hayek followed Menger's approach, described in his classical article *On the Origin of Money* (1898) where money originated from natural exchange after individuals had realized the advantages of indirect exchange and saved transaction costs.³⁴ Money emerged the winner in natural selection against various other media of exchange and was not a product of social convention. Hayek's view is that money is a result of human consumer choice, a form of saving *always backed by real goods and services*. Therefore, the major task of money is to preserve purchasing power and its value is unchangeable by definition.

The logic of origin also determines the logic of institutional functioning: decentralizing money issue, eliminating existing central banks and monetary policy. The central bank and monetary policy prompt not only inflation or deflation (both equally damaging) but, a major point according to Hayek, they also destroy the system of relative prices by injecting and withdrawing liquidity.³⁵ Money is not *neutral* both in the short run and in the long run. Hayek considers that quantitative theory ($MV = PY$) is not only wrong but also that it says nothing about the influence of money. First, according to Hayek (and Mises), a doubling of money does not result in a doubling of the general price level even in the long run because the increase in money changes the structure of

³² Hayek, F. (1976, 1978).

³³ The reader may get acquainted with the free money discussion and the mechanism of its functioning in the following review books: Down, K. (1993); Selgin, G. (1988); White, L. (1984, 1993, 1995).

³⁴ Menger, K. (1892). *The approach of Menger, Mises and Hayek underlies new macroeconomic theories of endogenous spontaneous emergence of money as a result of exchange, known as the models of Kiyotaki and Wright. In their two major articles they unambiguously showed that the possibility for several types of competitive media of exchange was organically provided as a possibility in the origin of money. See Kiyotaki, N., R. Wright (1989, 1991).*

relative prices and all human behavior variables: the very structure of cash balances changes. Second, quantitative theory does not make sense at all (it even justifies the existence of central banks), because it does not show how money distorts the shape of relative prices. Hayek singles out two proportions as particularly important: the ratio between capital goods' and consumer goods' prices and the ratio between the nominal and real interest rate.

Well-known arguments backing the existence of central banks (chief ones being: intervention in case of systemic risk, money as a public good and its consequences in the monetary sphere, and the necessity of smoothing out the cycle) only theoretically justify the existing system. Hayek and later his followers (in technicalities) disapprove these statements.³⁶

The private money system is not only 'genetically' justified; it is the only system that allows for automatic balancing between money demand and supply. The main adjusting mechanism is clearing between commercial bank notes (often called adverse clearing). Any issue of notes by a particular bank over demand leads to an outflow of reserves to other more conservative banks.

There are two trends³⁷ within the framework of free banking theory. The first, traditional and closer to Mises, considers that private money automatic adjustment is only valid if money is 100% backed by gold or by goods of nonelastic (or low-elastic) value. The other group of economists, closer to Hayek, claims that the adjusting mechanism is also effective with partial backing and even with fiat money. Selgin for example suggests freezing and decentralizing the monetary base whereupon it will circulate between banks in order to compensate the movement in supply of commercial banks and demand for banknotes. Without dwelling upon technicalities and, as Hayek himself claims, "without knowing what exactly will happen," the system of "private money" is

³⁵ On these issues the most important are the following works by Hayek: **Hayek, F.** (1933a, 1933b, 1984).

³⁶ A critique of the main arguments in defense of the central bank may be found in: **Selgin, G.** (1988).

³⁷ The first trend is represented by Mises, Rothbard, Salerno, Hoppe, De Soto, Hulsmann, et alia. See **Rothbard, M.** (1992), pp. 97 – 108; **Salerno, J.** (1994), pp. 71 – 115; **Hoppe, H.** (1994), pp. 49 – 74; **Hulsmann, J.** (1996), pp. 3 – 53. Representatives of the second trend are Hayek, Kirzner, Timberlake, White, Selgin, Down, et alia. See a thorough answer to the entire criticism in: **Selgin, G., L. White** (1996), pp. 83 – 107.

despite popular opinion simple, clear and does not require particular skills by economic agents. In short, monetary and economic stability is gained by eliminating the central bank.

Recently the mass spread of decentralized information technologies and electronic money has put insuperable obstacles before central banks and has given additional argumentation in support of 'private money.' In short, central banking faces two trends which reject it. The first is the spread of numerous money substitutes which leads to liquidity segment shortage, upon which the bank has certain influence. The second one is the spread of electronic money; thus economic agents can settle accounts directly without using the banking system. Besides commercial banks minimize their reserves, held in the central bank and thus the demand for reserve money decreases. This results in rapid shortening of the central bank balance sheet, minimization of seignorage and over a certain period the central bank ceases its 'balance sheet' existence.³⁸

Many scholars (Milton Friedman among them)³⁹ posed the question of whether there is not a contradiction in Hayek's numerous propositions for the change in the order of money, and his theory on spontaneous order and nonintervention in the natural evolution of society. The answer is simple and it is given by Hayek's close friend Fritz Machlup,⁴⁰ who defines the task of a liberal: "In a nonliberal society the liberal has to be a reformer to help establish freedom; in a liberal society he has to be a conservative to help preserve freedom."

*

The 100-year anniversary of Hayek's birth is celebrated in all Economics Departments of almost all universities in Western Europe, the USA and Latin America (it is sufficient to open Internet websites). East European countries also celebrated the anniversary: conferences were held in Zagreb, Ljubljana, Tallinn, Vilnius, Moscow, Riga, Warsaw, Bucharest and even in Belgrade under the air raids.

³⁸ According to Down it is possible for the seignorage to become a negative quantity and the central bank to go bankrupt. For more details see **Down, K.** (1998); **Browne, F., D. Cronin** (1995).

³⁹ **Friedman, M., A. Schwartz** (1986), pp. 37 – 62.

⁴⁰ **Machlup, F.** (1970), p. 212.

It is reasonable to ask why the anniversary of Hayek's birth⁴¹ was not celebrated in Bulgaria, since so many people here describe themselves as liberals.⁴² Under a *smoothly* operating currency board, we could undoubtedly claim that Hayek's recommendations have been followed in the closest possible way in Bulgaria. Monetary policy has been removed, central bank functions limited, and money supply fluctuations smoothed. The role of government is limited and rules dominate over discretion. Why then not celebrate the anniversary of Hayek's birth, all the more so since some of his most significant works are translated in Bulgarian?

The answer is left for readers to surmise. However, the fact that the BNB is publishing this paper indicates the Bank's open nature and speaks well of the direction of development it has adopted.

⁴¹ Some authors qualify Hayek as a social democrat. See **Hoppe, H.** (1999).

⁴² The economic theory of Hayek was subject of analysis in Bulgarian economic literature immediately after World War II. See, **Hristoforov, A.** (1946), pp. 1 – 70. See also **Leonidov, A.** (1988).

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