



SPECIAL TOPIC 4

Great Debates in Economics: Keynes versus Hayek¹

FOCUS

- Why are the views of John Maynard Keynes and Friedrich Hayek often compared and contrasted?
- What is the source of economic booms and busts?
- What might be done to reduce the impact of recessions?
- Should the government try to centrally plan the economy?
- Can the political process be counted on to promote economic stability and the efficient allocation of resources?

We've been going back and forth for a century

[Keynes] I want to steer markets,

[Hayek] I want them set free

—Chorus from Keynes–Hayek video

¹Note to instructors: This feature is developed around the Keynes–Hayek video raps (see links in the third paragraph of the following page). It is designed to be a fun exercise that highlights several key points of continuing debate among economists.

John Maynard Keynes and Friedrich August Hayek are two of the most important economists of the twentieth century. Moreover, their scholarly work represents alternative theories and ideas about the central issues of our day, including economic instability, central planning, and the operation of the political process.

Can serious economics be fun? Russell Roberts, a professor of economics at George Mason University, and filmmaker John Papola think it can be. They developed an eight-minute rap video with actors posing as a dueling Hayek and Keynes. The lyrics highlight the contrasting views of Keynes and Hayek on the business cycle, fiscal and monetary policy, and the role of government.



Courtesy of EconStories.tv

The Roberts–Papola video titled “Fear the Boom and Bust: Keynes versus Hayek” has attracted more than 4 million views. It is available at www.youtube.com/watch?v=d0nERTFo-Sk. Roberts and Papola have also done a follow-up rap, “Fight of the Century: Keynes vs. Hayek Round Two,” which is available at www.youtube.com/watch?v=GTQnarzmTOc. Take a break from your studying and have a little fun watching these videos.

The views of Keynes and Hayek provide a vivid contrast on key issues in economics. Nonetheless, both command respect among professional economists. Keynes is widely regarded as the most influential economist of the twentieth century. Hayek was the recipient of the 1974 Nobel Prize in Economics.

Interestingly, Keynes and Hayek were contemporaries at Cambridge University and the London School of Economics in the early 1940s. During World War II, they even spent a night together on the roof of the chapel of King’s College, Cambridge looking out for German bombers.

Keynes’s *General Theory* provided a reasonable explanation of what went wrong during the Great Depression and what could be done to prevent such an event from occurring in the future. His ideas inspired a generation of economists that transformed macroeconomic analysis. Hayek was born in Vienna in 1899, and he was a rising star in the 1930s. The London School of Economics lured him from Austria, at least partly to counter the influence of Keynes and the reputation he brought to rival Cambridge University. In his 1944 book, *The Road to Serfdom*, Hayek argued that the growth of government was endangering freedom and leading to tyranny in the Western democracies, just as it had done in both Nazi Germany and the Soviet Union.

Keynes and Hayek were polar opposites not only in their economic views but also in their personality characteristics. Keynes was outgoing and dominant. Some charged that he was arrogant, but all recognized that his skills as a persuader were supreme. In contrast, Hayek was quiet and unassuming. While Keynes reveled in policy-making, Hayek was content to remain outside of policy circles. Keynes was optimistic, and his message was well suited for the “We’re fixing it” mentality of politicians. On the other hand, Hayek’s message was not one political officials like to hear: Policy-makers have messed things up and it will take time for the market to correct their errors.

A popular PBS video series, *Commanding Heights* (Episode One: “The Battle of Ideas”), also used the contrasting views of these two economists to illustrate how major trends in economic thinking impacted global economic events during the twentieth century.² Following in this tradition, this special topic will use the ideas of Keynes and Hayek, including lyrics from the videos, to explain and contrast their viewpoints and the alternative theories they represent.

²The PBS series was based on the book by Daniel Yergin and Joseph Stanislaw, *The Commanding Heights: The Battle Between Government and the Marketplace That Is Remaking the Modern World* (New York: Simon and Schuster, 1998).

ST04-1 KEYNES, HAYEK, AND GREAT DEBATES IN ECONOMICS

The lyrics of the Keynes–Hayek videos present alternative views with regard to three of the most important debates in economics. Let’s consider these debates and the references to them in the rap lyrics.

ST04-1a WHAT IS THE CAUSE AND CURE FOR THE BUSINESS CYCLE?

The underlying causes of the business cycle and potential effectiveness of policy responses have been a focal point of debate among economists for at least a century. The perspectives of Keynes and Hayek represent alternative viewpoints on this issue.

The Keynesian viewpoint argues that capitalism-based, market economies are inherently unstable. Private investment in particular is fickle and prone to extreme fluctuations driven by changes in business optimism, or what Keynes referred to as “animal spirits.” Moreover, the booms and busts will tend to feed on themselves, and therefore a market economy will swing back and forth between a boom that will lead to inflation and a bust that will generate high rates of unemployment. But there is good news in the Keynesian theory. Government can use fiscal and monetary policy to control aggregate demand and thereby promote economic stability. During a recession, government spending should be increased to offset the weak private investment, taxes should be reduced to stimulate consumption, budget deficits should be used to finance these activities, and finally monetary policy should keep interest rates low.

The Hayekian viewpoint argues that booms and busts are caused by perverse government policy and that the economy would be considerably more stable if political decision-makers followed stable policies and refrained from activist interventions. In his research on monetary theory, Hayek argued that economic booms are the result of excessive credit expansion that pushes interest rates to artificially low levels. At the abnormally low interest rates, businesses are induced to undertake investments that will later prove to be both unprofitable and unsustainable.

Hayekians refer to these inefficient investments as malinvestment. In this view, recessions are a “hangover” or adjustment caused by improper government policy during the preceding boom. Once the government has caused the malinvestment, the proper course is to allow market prices to adjust and allow the malinvestment to be cleansed from the system. Government stimulus spending will merely slow the adjustment process and prolong the recession.

Here are some excerpted lyrics from the Keynes versus Hayek rap videos that illustrate their contrasting views on the business cycle.

[Both] There’s a boom and bust cycle and good reason to fear it.

[Hayek] Blame low interest rates.

[Keynes] No... it’s the animal spirits.

[Keynes] I had a real plan any fool can understand.

The advice, real simple—boost aggregate demand!

C, I, G, all together gets to Y.

Make sure the total’s growing, watch the economy fly.

So if that flow is getting low, doesn’t matter the reason.

We need more government spending, now it’s stimulus season.

The monetary and the fiscal, they’re equally correct.

Public works, digging ditches, war has the same effect.

Even a broken window helps the glass man have some wealth.

The multiplier driving higher the economy’s health.

[Hayek] The place you should study isn’t the bust.

It’s the boom that should make you feel leery, that’s the thrust

Of my theory, the capital structure is key.

Malinvestments wreck the economy.
 The boom gets started with an expansion of credit.
 The Fed sets rates low, are you starting to get it?
 That new money is confused for real loanable funds.
 But it's just inflation that's driving the ones
 Who invest in new projects like housing construction.
 The boom plants the seeds for its future destruction.

So the boom turns to bust as the interest rates rise
 With the costs of production, price signals were lies.
 The boom was a binge that's a matter of fact.
 Now its devalued capital that makes up the slack.
 You must save to invest, don't use the printing press
 Or a bust will surely follow, an economy depressed.
 Your so-called "stimulus" will make things even worse.
 It's just more of the same, more incentives perverted.

[Keynes] So what would YOU do to help those unemployed?
 This is the question you seem to avoid.
 When we're in a mess, would you have us just wait,
 Doing nothing until markets equilibrate?

[Hayek] I don't wanna do nothing, there's plenty to do.
 The question I ponder is who plans for whom?
 Do I plan for myself or I leave it to you?
 I want plans by the many, not by the few.
 Let's not repeat what created our troubles.
 I want real growth not a series of bubbles.
 Stop bailing out losers, let prices work.
 If we don't try to steer them they won't go berserk.

ST04-1b SHOULD AN ECONOMY BE DIRECTED BY GOVERNMENT CENTRAL PLANNING OR DECENTRALIZED INDIVIDUAL PLANNING AND THE INVISIBLE HAND OF MARKET PRICES?

Clearly, the main chorus of the rap lyrics stresses their differing views, as Keynes says, "I want to steer markets," and Hayek replies, "I want them set free."

The Keynesian viewpoint holds that central planning by wise government officials is needed not only to keep the macroeconomy on track but also to correct market failures and assure an equitable distribution of income. Relying on information derived from economists and other experts, Keynesians believe that policy-makers will be able to selectively intervene into markets (or sometimes outright control them entirely) in ways that will improve on market outcomes.

In contrast, Hayekians argue that central planners do not have sufficient information to direct the economy and their efforts to do so will do more damage than good. Decentralized decision-making, directed by market prices, will be a more reliable method of directing resources into productive projects and away from ones that are counterproductive. Instead of centralized planning, individuals should be left free to make their own plans relying on information and incentives communicated by market prices, competitive forces, and the profit and loss system. According to the Hayekian view, a spontaneous order will emerge from the market process that will coordinate the desires of consumers and producers, and of borrowers and lenders. Hayekians believe this will result in both more economic freedom and more rapid economic progress. Hayek highlights this point in his lyrics: "The question I ponder is who plans for whom? Do I plan for myself or I leave it to you? I want plans by the many, not by the few."

Moreover, dynamic competition provides decision-makers with a strong incentive to discover better ways of doing things, improve technologies, and institute practical innovations that will improve our lives. In this view the information necessary to guide the economy is not known to anyone in total, but is instead generated through the process of decentralized market interaction. According to Hayekians, the proper role of government is simply to provide the rule of law, enforce contracts, and protect property rights, leaving the rest to market forces.



Courtesy of EconStories.tv

Here are some excerpted lyrics from the Keynes versus Hayek rap videos that illustrate these points:

[Hayek] His theory conceals the mechanics of change,
That simple equation, too much aggregation
Ignores human action and motivation.
The economy's not a car. There's no engine to stall.
No experts can fix it. There's no "it" at all.
The economy is us. Put away your wrenches, the economy is organic.

[Keynes] Come on are you kidding?
Don't Wall Street gyrations challenge the world-view of self-regulation?
Even you must admit that lesson we've learned
Is more oversight is needed or else we'll get burned.

[Hayek] Oversight? The government's long been in bed
With those Wall Street execs and the firms that they've bled.
Capitalism is about profit and loss.
You bail out the losers; there is no end to the cost.
The lesson I've learned is how little we know.
The world is complex, not some circular flow.
The economy is not a class you master in college,
To think otherwise is the pretense of knowledge.

ST04-1c CAN DEMOCRATIC DECISION-MAKING BE COUNTED ON TO ALLOCATE RESOURCES EFFICIENTLY?

As we discussed in Chapter 6, public-choice analysis provides insights on the operation of the political process. It indicates that the incentives confronted by voters, interest groups, politicians, and bureaucrats will sometimes conflict with sound policy and the efficient allocation of resources. Even when decisions are made democratically, the political process

will often favor well-organized interest groups and shortsighted policies that generate highly visible gains at the expense of costs that are less visible. Predictably, some inefficient use of resources will arise from these forces. Put another way, there is “government failure” as well as “market failure.”

The Keynesian perspective seldom directly addresses this issue. Instead, it is assumed that the job of the economists is to figure out the ideal or optimal solutions, and once these are developed, political decision-makers can be expected to adopt them. Moreover, many Keynesians charge that analysis of how the political process works is outside of the scope of economics and therefore those who address this issue are not really addressing economic issues. Keynes himself had great confidence in his ability to convince policy-makers to adopt his advice. Within the Keynesian framework, it is essentially assumed that political decision-makers will implement policies in a proper manner.

The Hayekian perspective argues that the structure of incentives and institutions exert a major impact on how government works. The government failure described within public-choice theory will be a major problem or barrier to implementing good policy. Thus, it is vitally important to adopt institutions and constitutional rules that bring personal self-interest of policy-makers into harmony with growth and prosperity.

The father of economics, Adam Smith, held a similar view. Smith stated,

The man of system is apt to be very wise in his own conceit. He seems to imagine that he can arrange the different members of a great society with as much ease as the hand arranges the different pieces upon a chess-board; he does not consider that the pieces upon the chess-board have not another principle of motion besides that which the hand impresses upon them; but that, in the great chess-board of human society, every single piece has a principle of motion of its own, although different from that which the legislature might choose to impress upon it. If those two principles coincide and act in the same direction, the game of human society will go on easily and harmoniously, and is very likely to be happy and successful. If they are opposite or different, the game will go on miserably, and the society must be at all times in the highest degree of disorder.³

Interestingly, Hayek makes a reference to this view of Adam Smith in the rap video.

[Keynes] You've been on your high horse and you are off to the races.
I look at the world on a case-by-case basis.
When people are suffering I roll up my sleeves
And do what I can to cure our disease.
The future's uncertain, our outlooks are frail.
That's why markets are so prone to fail.
In a volatile world we need more discretion
So state intervention can counter depression.

[Hayek] People aren't chessmen you move on a board
At your whim, their dreams and desires ignored.
With political incentives, discretion's a joke.
Those dials are twisting – just mirrors and smoke.
We need stable rules and real market prices
So prosperity emerges and cuts short the crisis.

³Adam Smith, *The Theory of Moral Sentiments*, Glasgow Edition of Oxford University Press (Indianapolis: Liberty Fund, Inc., [1790] 1976): 233–34. Also available at www.econlib.org/library/Smith/smMS6.html#VI.II.42.

Keynes and Hayek represent two of the most important strands of economic thinking. You will see their views represented in several of the special topics that follow, including the ones on the 2008 financial crisis, the Great Depression, government deficits and debt, and the health care debate.

KEY POINTS

- John Maynard Keynes and Friedrich Hayek are giants in the economics profession. Their theories and ideas represent contrasting views on several of the central issues of economics.
- Keynes believed that market economies were inherently unstable and government intervention in the form of fiscal and monetary stimulus could be used effectively to promote economic stability. Hayek believed that economic instability was primarily the result of malinvestment generated by monetary and credit expansion and that government stimulus would slow market adjustments and the recovery process.
- Keynes believed that government central planning could improve on market outcomes. Hayek believed that policy-makers simply do not have the information or incentives to plan the economy effectively and that their efforts to do so would be far less efficient than allocation through markets.
- Keynesians believe that the job of the economist is to develop policies that will reduce economic instability and correct market failures. Keynesian analysis largely ignores how economic incentives influence the operation of the political process. Hayekians recognize that the political incentive structure often caters to well-organized interest groups and results in the adoption of shortsighted policies. Thus, they stress the importance of legal and political institutions that will provide both market participants and political decision-makers with incentives to engage in productive rather than counterproductive actions.

CRITICAL ANALYSIS QUESTIONS

1. ***What** is the underlying message of the following lyrics from Keynes?
[Keynes] Public works, digging ditches, war has the same effect.
Even a broken window helps the glass man have some wealth.
The multiplier driving higher the economy's health.
2. Use the following lyrics to describe the difference between Keynes and Hayek on the role of savings in the economy.
[Keynes] So forget about saving, get it straight out of your head.
Like I said, in the long run—we're all dead.
Savings is destruction, that's the paradox of thrift.
Don't keep money in your pocket, or that growth will never lift.
[Hayek] Real savings come first if you want to invest.
The market coordinates time with interest.
Your focus on spending is pushing on thread.
In the long run, my friend, it's your theory that's dead.
Whether it's the late twenties or two thousand and five
Booming bad investments, seems like they'd thrive.
You must save to invest, don't use the printing press
Or a bust will surely follow, an economy depressed.
3. The following lyrics discuss whether the government stimulus efforts in response to the 2008 financial crisis worked and also argue points about government policy during the Great Depression and the subsequent recovery. What are the major areas of disagreement on these issues as illustrated in the lyrics?
[Keynes] Are you kidding? My cure works perfectly fine.
Have a look. The recession ended in '09.
I deserve credit. Things would have been worse.
All the estimates prove it. I'll go chapter and verse.
We could have done better if we'd only spent more.
Too bad that only happens when there's a world war.
You can carp all you want about stats and regression.
Do you deny that world war cut short the Depression?
[Hayek] Wow. One data point and you're jumping for joy.
The last time I checked wars only destroy.
There was no multiplier. Consumption just shrank
As we used scarce resources for every new tank.
Pretty perverse to call that prosperity.
Ration meat. Ration butter. A life of austerity.
When that war spending ended, your friends cried disaster.
Yet the economy thrived and grew faster.
Creating employment is a straightforward craft
When the nation's at war and there's a draft.
If every worker were staffed in the army and fleet