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Hayek – The Orthodox Face Of Heterodoxy

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Abstract:
This study examines the work of Friedrich Hayek, highlighting his unique position at the intersection between orthodox and heterodox economic theory, focusing on his approach to monetary theory. We analyse three essential pillars in his work: the relationship between the money supply and price levels, the necessity of backing for currency issuance, and the pursuit of economic equilibrium. Despite his association with the Austrian School, we identify an orthodox dimension in his thought, particularly in his analysis of economic crises and monetary policy. This article underscores how Hayek transcends the orthodoxy/heterodoxy dichotomy, offering valuable insights into the challenges of monetary regulation and the role of credit in the modern economy. Although Hayek exhibits orthodox elements, the study concludes that his approach incorporates heterodox perspectives, contributing to a richer understanding of economic cycles and policies to promote stability and economic growth.
***Key Word**: Friedrich Hayek, monetary theory, economic orthodoxy, economic heterodoxy, economic crises.*

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I. Introduction

This study embarks on an investigative journey through the structured principles of orthodox economic theory, particularly its treatment of monetary concerns. It delves into an analysis juxtaposing the established, time-honoured theories against the challenging counterarguments presented by heterodox economic thought. The narrative unfolds around three critical pillars that underpin traditional monetary economics, revealing the intricate fabric of economic discourse where each thread of argument holds its distinctive shade of interpretation. In this academic exploration, we engage with the enduring question of resource scarcity and its monetary implications, the tangible versus the nominal in currency value, and the perpetual quest for economic equilibrium within the complex dynamics of the market. Through this lens, we contemplate the influential work of Friedrich Hayek, whose intellectual legacy transcends the confines of the Austrian School's critical stand on mainstream economics, unveiling a surprising alignment with orthodox principles in analysing economic crises. The juxtaposition of Hayek's insights with the challenges posed by figures such as Sraffa and Minsky, alongside Marx's seminal critique of the credit system, enriches our understanding of the multifaceted nature of economic cycles and the prudent crafting of monetary policy. This treatise not only dissects Hayek's distinct stance within the spectrum of economic orthodoxy and heterodoxy but also considers the broader implications of his work on our grasp of monetary neutrality and the pursuit of economic stability and growth.

II. Orthodoxy And Heterodoxy In Monetary Theory: Navigating The Pillars Of Economic Thought

The study describes the three pillars upon which orthodox economic theory is based, focusing on monetary theory. It addresses both classical foundations and aspects debated within both orthodox and heterodox economic thought, namely:
1. The quantitative concern refers to the idea that resources are scarce, which should correspond to a limited quantity of money. This pillar reflects the Quantity Theory of Money, which establishes a direct relationship between the amount of money in circulation and the general price level. This theory suggests that an increase in the quantity of money can lead to a proportional price increase, assuming the velocity of money and the production volume remain constant. This view is central to orthodox monetary economics, especially within monetarism, which emphasises controlling the money supply to control inflation.

The concern with the tangibility of phenomena in the monetary sphere is expressed by the need for backing and the exogenous creation of money linked to physical issuance. This aspect addresses the idea that money issuance should have a physical backing (such as gold or foreign exchange) or be controlled to prevent currency devaluation and inflation. Although the gold standard and similar physical backing systems were features of earlier periods in economic history, most modern economies operate under a fiat money system, where the currency's value is supported by trust in the issuing government and not by physical backing. Creating exogenous money, especially by central banks, is a common and accepted practice within contemporary monetary policy.

The focus of the economic sphere on achieving equilibrium—seen either as a natural consequence of economic activities or as an objective to be pursued—underscores its distinctness from the real sphere. This distinction is because equilibrium is established through interactions between real variables.

The equilibrium between real economic variables highlights the importance of focusing on tangible aspects of economic activity, such as production, consumption, and employment, discounting the effects of inflation. This phenomenon reflects a view that the economy should be analysed and managed based on its actual capacity to generate goods and services and provide well-being, regardless of price fluctuations or monetary policy.

Equilibrium is a central concept in economics, where it is assumed that markets tend to adjust to balance supply and demand. In orthodox theory, equilibrium also applies to the monetary sphere under the assumption of a natural equilibrium between the supply and demand for money, influencing price levels and interest rates. The idea that economic equilibrium is both a natural condition and a policy objective reflects the view that achieving price stability and fostering economic growth through adjustments in monetary policy is possible.

These pillars, as described, incorporate a blend of principles from classical and neoclassical economic theory, with a particular emphasis on monetary theory. It is important to note that while these concepts are part of orthodox economic thought, economics is a dynamic social science subject to debate and evolution. Furthermore, within heterodox economics, there are critiques and alternatives to these concepts, proposing different approaches to how money and monetary policy impact the economy. Therefore, while these pillars can be seen as components of orthodox economic thought, they represent only a part of the broad spectrum of economic theories and debates.

However, it can be challenging to characterise authors consistently according to these dogmas, as orthodoxy and heterodoxy are not defined rigidly but rather in shades. Classifying theories and authors as orthodox or heterodox in economics is a complex task due to the dynamic and diverse nature of the discipline. Orthodoxy encompasses widely accepted and taught theories, while heterodoxy includes approaches that deviate from these principles. However, many economists and their works do not strictly fit into either of these categories, often adopting elements of both. This situation reflects the richness and complexity of economics as a field of study, where the overlap of ideas and the evolution of economic thought make the boundaries between orthodoxy and heterodoxy fluid and nuanced. Recognising this diversity allows for a complete understanding of economics.

This phenomenon is the situation with Hayek and his theory. It is also not possible to say that Hayek accepted the second pillar, as in his conception of money, credit plays an active role and is practically unbacked by prior savings. Regarding the first pillar, it is also not likely to say that his concerns are merely qualitative, as he focuses on the movement of relative prices. In contrast, the quantitative theory of money only considers absolute prices.

Although Friedrich Hayek is often associated with the Austrian School of Economics, known for its critiques of mainstream economic approaches, an orthodox dimension to his thinking is clearly manifested in his treatment of economic crises. His diagnosis of crises focuses on identifying underlying causes, often attributing them to manipulation of the money supply and state interventions in the economy, which reflects a concern with macroeconomic fundamentals shared by many orthodox economists. By insisting on the importance of understanding the origins of economic imbalances to propose solutions, Hayek highlights the need for policies that favour monetary stability and market freedom. Thus, while unique in many respects, his approach to analysing crises converges with orthodox tradition by emphasising the relevance of market mechanisms and prudence in monetary policy as essential to economic health.

Hence, Hayek is a difficult author to characterise. Generally, he is considered heterodox because he breaks with the third dogma, focusing on explaining crises and articulating between money and crisis. In Hayek's view, it cannot be said that money is neutral as it affects production. Regarding the second pillar, it is also not conceivable to say that Hayek accepted it since credit actively participates in his conception of money and is practically unbacked by prior savings. Regarding the first pillar, it is also not possible to say that his concerns are merely quantitative, as he focuses on the movement of relative prices when the quantitative theory of money only considers absolute prices.

However, there is an orthodox face to Hayek, expressed in his concept of crisis, both in terms of diagnosis made to detect the origin of problems and the proposed solutions. In this sense, he advocates an approach that minimises state intervention in the economy and emphasises the importance of market freedom as a corrective mechanism. Moreover, Hayek attributes a significant part of economic distortions to manipulating the money supply by central banks, advocating for policies that restrict such interventions to promote economic stability and prevent boom-and-bust cycles.

According to Hayek, a crisis is motivated by an increase in credit, which expands the financing capacity of the productive process. This increase in credit boosts demand for production goods, causing their prices to rise relative to consumer goods. This mechanism is the cornerstone of Hayek's theory of economic cycles, where excessive credit plays a critical role at the start of the cycle (Rosner, 1994).

The market's response to increased credit initially manifests in the 'lengthening of production' phenomenon. Producers begin the production of capital goods with longer maturation periods, anticipating future demand. However, as the production of consumer goods does not expand to the same extent, price distortions arise, eventually leading to a 'shortening of production'. Entrepreneurs, misinterpreting the rise in consumer goods prices as a permanent trend, reallocate resources from the capital goods sector to the consumer goods sector.

This reallocation of resources, driven by a misinterpretation of price signals, leads to a disproportion between sectors. The underutilisation of capital stock and overconsumption emerge as symptoms of this imbalance, culminating in an inflationary process. This disproportion between the production of capital goods and consumer goods highlights the complexities of interventions in the credit market and their impacts on the real economy. Caldwell (1988) notes that Hayek emphasised the inherent dangers of excessive credit and the policies of the central bank manipulating interest rates, which can lead to profound economic distortions and subsequent crises.

According to Hayek, such disproportions stem from a decision-making asymmetry among agents, which can cause their expectations about the future to be incompatible, leading to errors. Hayek argues that investments are made with the expectation that the credit supply will continue at the same level for some time. He further explains that the cause of such a crisis would be an entrepreneur's mistaken belief that a temporary increase in the supply of capital is permanent, leading to action based on this expectation. Hayek notes:

The cause of such a crisis would be that the entrepreneur had mistakenly regarded a temporary increase in the supply of capital as permanent and acted on this expectation. (...) the current supply of money-capital is not necessarily identical with the amount of current savings. All sorts of monetary disturbance, shortly described as changes in the velocity of circulation of money but in fact such more variegated in nature than these terms at first suggest, may change the supply of money capital independently of the supply of savings. (HAYEK, p. 237)

If there is an exogenous expansion of credit that disregards consumer voluntarism, the natural interest rate that corresponds to the equality between savings and investment is not achieved. The problem is that money is created within the banking system without backing in prior savings. If the consumer's will were respected, the investment would equal savings.

The result of this must be that the proportion in which entrepreneurs will divide their resources between production for the near future and production for the distant future will be different from the proportion in which consumers in general want to divide their current income between current consumption and provision for consumption at a later date. In such a situation there exists evidently a conflict between the intentions of the consumers and the intentions of entrepreneurs which earlier or later must manifest itself and frustrate the expectations of at least one of these two groups. The situation is certainly not one of equilibrium in the sense defined before. A condition of equilibrium would require that the intentions of the two groups are at least compatible.(...). An equilibrium rate of interest would then be one which assured correspondence between the intentions of the consumers and the intentions of the entrepreneurs. And with a constant rate of saving, this would be the rate of interest arrived at on a market where the supply of money capital was of exactly the same amount as current savings. (HAYEK, p. 238)

Hayek's conception of money is linked to the cause he identifies for economic crises. Hayek's diagnosis points to an exogenously established excess money supply if the currency does not respect consumer voluntarism. Similarly to Friedman (1969), Hayek's prescription calls for a monetary policy that neutralises money. If the currency were neutralised, there would be equilibrium. For Hayek, money is neutral if, and only if, it does not interfere with relative prices.

Sraffa (1960) criticises Hayek, stating that it is not possible to assume a neutral currency in a monetary economy, as described by Lawlor & Horn (1992). This fact would essentially equate to disregarding currency altogether, as it would eliminate all monetary influences on production. Thus, the monetary economy paradigm would be abandoned, as in such an economy, there would be no debts, monetary contracts, or rigid prices, and money would be desired only as a medium of exchange. In this way, not only does Hayek's diagnosis display clear traces of orthodoxy, but it also does not align with the logic of a monetary economy. On this matter, Sraffa provides a reminder:

"... money is not only the medium of exchange, but also a store of value, and the standard in terms of which debts, and other legal obligations, habits, opinions, conventions, in short all kinds of relations between men, are more or less rigidly fixed."

Considering Minsky's concept of credit (1986), it is important to remember that from the perspective of heterodox economics, it would not be correct to claim that credit could be seen as an exogenous element that would disturb the equilibrium between the real variables of saving and investment. Moreover, the improbability of equality between savings (S) and investment (I) in a monetary economy indicates that the fact that credit is not backed does not necessarily pose a problem. As Karl Marx observed:

The credit system, rooted in the social nature of the capitalist mode of production, unfolds as the principal means of expanding production and also as the most complete form of crises and fraudulent schemes. MARX (1894).

According to Marx, credit can accelerate the production process and intensify a crisis, but it would never be the direct cause of the crisis, and it might even postpone it. On the other hand, in Hayek's view, the credit supply seems unlimited and determined solely by the bank's desire to lend. However, banks would not lend if there were no expectation that the loan would be repaid.

Although Hayek's analysis includes aspects deemed orthodox, his work also addresses issues relevant to post-Keynesian theory, especially regarding the concept of time. Hayek attributes significance to time, but more abstractly, differing from the post-Keynesian approach that sees it more concretely and historically. This difference is evident in investment decisions, which, as described by Victoria Chick (1983), in Hayek's framework, tend to focus more on production based on predicted future prices rather than demand expectations. This approach does not incorporate Keynesian uncertainty. Hayek's relationship with money reflects this tendency: although he recognises that money influences the economy, particularly through crises, he underestimates the role of the unit of account and hoarding, viewing monetary influence primarily in negative terms.

III. Final Comments

The analysis of Friedrich Hayek's role at the frontier between economic orthodoxy and heterodoxy reveals the richness and complexity of economic thought. By exploring the three pillars of orthodox economic theory and juxtaposing them with heterodox perspectives, the study highlights Hayek's uniqueness, who, despite being frequently associated with the Austrian School, brings forth an orthodox dimension in his approach to economic crises.

Hayek challenges the conventional boundaries between orthodoxy and heterodoxy by questioning the role of credit and money in the economy and proposing a policy of monetary neutralisation as a solution for achieving economic equilibrium. His arguments suggest a complex interaction between money, credit, and production, underscoring that monetary neutrality in a dynamic and monetary economy is a challenging goal.

On the one hand, Hayek recognises money's influence on the economy, especially in the genesis of crises; on the other hand, he seeks a solution in monetary neutrality, implying an acknowledgement of the limitations of monetary interventions to correct economic imbalances. This stance reflects a deep understanding of economic mechanisms while also highlighting the need for caution in implementing monetary policies.

Commentaries from authors such as Sraffa and Minsky and Marx's critical observations on the credit system enrich the debate by pointing out the complexities and challenges associated with monetary regulation and credit in the modern economy. These perspectives emphasise the importance of considering both economic agents' expectations and the unintended consequences of monetary policies.

In conclusion, Hayek's approach to economic crises and his analysis of money and credit represent a valuable contribution to understanding economic cycles and monetary policy. Although his position may appear orthodox in certain respects, it incorporates heterodox insights that challenge simplistic conceptions of equilibrium and monetary neutrality. Recognising the duality in Hayek's work is crucial for understanding economic dynamics and the policies needed to promote stability and economic growth.

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