

Rethinking the Keynesian Revolution: Keynes, Hayek, and the Wicksell Connection

Tyler Beck Goodspeed, *Rethinking the Keynesian Revolution: Keynes, Hayek, and the Wicksell Connection*. New York: Oxford University Press, 2012. 193 pp. \$55 (hardcover), ISBN: 978-0-19-984665-8.

Reviewed for EH.Net by Roger W. Garrison, Professor Emeritus, Department of Economics, Auburn University, Auburn, AL USA

The *Rethinking* that crystallized into a new view of J. M. Keynes and F. A. Hayek earned the author of this dense but intriguing dissertation first class honors at the University of Cambridge. The notables in the subtitle of Goodspeed's book account for its relevance to current policy debates and identify the basis for its particular perspective.

The most recent episodes of unsustainable booms (centered on digital technology in the 1990s and housing in the 2000s) have rekindled interest in the clash between Keynes and Hayek. Which one had it straight about business cycles? In Goodspeed's view, "the Wicksell connection," a phrase drawn from the title of a 1981 article by Axel Leijonhufvud, turns the Keynes-Hayek dissonance, as perceived during the 1930s by the principals – and by everyone else – into consonance. Owing to the Wicksell connection, there was, in the author's view, "a fundamental *convergence* of Keynes's and Hayek's respective theories of money, capital, and the business cycle during the course of the 1930s" (*emphasis original*, p. 3). This claim stands in stark contrast to the more common understanding that by the end of that decade, Hayek's views were buried under the *Keynesian Avalanche* (McCormick, 1992).

In detailing the relationship between *Interest and Prices* (1898), Knut Wicksell distinguished between the "natural" rate on interest, which keeps saving and investment in sync, and the bank rate of interest, which may be below (or above) the natural rate – depending upon the rate of credit expansion. As discussed in Goodspeed's Chapter 1, Wicksell's "cumulative process" is triggered by a low bank rate and consists of multiple rounds of increased borrowing, increased spending, and rising prices. The process continues as long as the bank rate is held below the natural rate. Wicksell's extended exposition is rooted in Böhm-Bawerkian capital theory, which allows scope for changes in intertemporal resource allocation during the cumulative process. But, as the title of Wicksell's 1898 book suggests, his primary focus was on credit-induced changes in the level of prices.

In his Chapter 2 Goodspeed compares Keynes's *Treatise on Money* ([1930] 1950) with Hayek's *Prices and Production* ([1935] 1967). Here, establishing a Wicksell connection is fairly straightforward. But so too, I would contend, is identifying the critical Keynes-Hayek disconnect. Keynes explicitly recognizes that his "Fundamental Equations" give play to a possible Wicksellian divergence between saving and investment. As quoted by Goodspeed (p. 50), "In substance and intention, Wicksell's theory is closely akin ... to the theory in this *Treatise*." But, assuming full employment and lacking an underlying theory of capital, Keynes could conceive of an equilibrating process (bringing saving and investment into alignment) only in terms of

adjustments in his equations' two price levels (pertaining to consumption goods and investment goods).

Hayek's *Prices and Production*, which was based squarely on Austrian, i.e., Böhm-Bawerkian, capital theory, might well have been titled *Interest and the Intertemporal Allocation of Capital*, mimicking Wicksell's title but shifting the focus from price-level adjustments to changes in the temporal pattern of resource allocation. According to Goodspeed, "there is nothing in Wicksell's framework that explicitly aspires to a theory of the credit cycle" (*emphasis original*, p. 40). By contrast Hayek's focus on the *misallocation* of capital during the unsustainable boom, which is followed by a bust and capital *reallocation*, constitutes what came to be known as the Austrian theory of the business cycle. Clearly, Keynes's *inattention* and Hayek's attention to interest-rate effects on intertemporal capital allocation account for a fundamental Keynes-Hayek disconnect.

After a Sraffian interlude that constitutes Chapter 3, Goodspeed turns to Keynes's *General Theory*, where the going gets a little tougher. The task here is to establish a Wicksellian connection despite the fact that Keynes explicitly distanced himself from Wicksell. "I am no longer of the opinion that the concept of the 'natural' rate of interest, which previously seemed to me a most promising idea, has anything very useful or significant to contribute to our analysis" (Keynes, [1936] 1964, p. 243). While recognizing that Keynes doesn't use Wicksellian language, Goodspeed sees Keynes's Marginal Efficiency of Capital as a reincarnation of the natural rate, and he sees the rate of interest determined by the supply and demand for liquidity as the market rate. Once again, we have a divergence between the level of saving (based mostly on income) and the level of investment (confined by an interest-inelastic MEC), and we have an adjustment mechanism, this time consisting in quantity adjustments rather than price adjustments. As we've learned through the textbooks, this process is diminishingly cumulative, ending in an equivalence of the "natural" and "market" rates of interest, the alignment of saving and investment levels, and, typically, a less-than-full level of employment.

Goodspeed gets high marks for the internal consistency of his rethinking, but the notion of a 1936 Wicksellian Keynes is a stretch. To stipulate that the natural rate is the MEC is to stipulate that it is not at all anchored in economic reality but rather is based wholly on psychological factors – Keynes's "animal spirits." We can well imagine Keynes actually arguing that, given the unknowable future, an unanchored MEC is in fact "natural," but this doesn't make him a Wicksellian or imply a convergence of his theory with Hayek's.

Turning once again to Hayek, this time to his *Pure Theory of Capital* (1941), Goodspeed treats us to his longest and most difficult chapter – even for someone who has actually read the *Pure Theory*! Unfortunately, Hayek took the bait thrown out by Sraffa in the form of doubts, Cambridge-style, about the notion of quantifying Böhm-Bawerkian roundaboutness. Hayek fully recognized the problem of ranking physically defined production processes in terms of their roundaboutness but ultimately concluded, according to Goodspeed, that "the issue was not only insoluble but irrelevant" (p. 128). Still, Goodspeed was able to find consonance in Hayek's analysis of the optimum degree of roundaboutness and Keynes's "Sundry Observations about the Nature of Capital" (Keynes, [1936] 1964, Chapter 16).

Despite the obvious differences between Keynes and Hayek, clearly sensed if not fully understood in the 1930s, there is an important lesson in Goodspeed's *Rethinking*. In my judgment, the most revealing question is: "How could Keynes and Hayek have failed to see at the time the similarities that Goodspeed now sees? The answer, I believe, is that Keynes and Hayek didn't have – and couldn't have had – the vantage point that Goodspeed now does have. The dominant macroeconomic framework today is based upon "dynamic stochastic general equilibrium" modeling (p. 1), a Walrasian framework that continues to do well in the most prestigious economic journals but provides no basis for explaining how real-world economies might go right or go wrong. Clearly, Goodspeed himself, sensing the sterility of current macroeconomic thinking, is "suggest[ing] a reorientation of current economic research. Indeed," says Goodspeed, "to those who might ask whether we ought to go back to Keynes or rather Hayek in order to move forward in economics, my answer is yes" (p. 10). His answer makes us realize that the difference between Keynesian theory and Hayekian theory, however great, are small in comparison to the difference between those two theories and the macroeconomic theory that now dominates academia.

References:

Hayek, Friedrich A. ([1935] 1967), *Prices and Production*. 2nd ed., New York: Augustus M. Kelley.

_____ (1941), *The Pure Theory of Capital*. Chicago: University of Chicago Press.
Keynes, John M. ([1930] 1950), *A Treatise on Money*. London: Macmillan and Co.

Keynes, John M. ([1936] 1964), *The General Theory of Employment, Interest, and Money*. New York: Harcourt, Brace and World.

McCormick, Brian (1992), *Hayek and the Keynesian Avalanche*, New York: St. Martins Press.

Leijohufvud, Axel (1981), "The Wicksell Connection: Variations on a Theme," in Leijonhufvud, *Information and Coordination: Essays in Macroeconomic Theory*. New York: Oxford University Press, pp. 129-202.

_____ (1968), *On Keynesian Economics and the Economics of Keynes*. New York: Oxford University Press.

Wicksell, Knut ([1898] 1962), *Interest and Prices: A Study of the Causes Regulating the Value of Money*, trans. by R. Kahn. New York: Augustus M. Kelley.

Roger W. Garrison is Emeritus Professor of Economics, Auburn University, Auburn, AL. He is the author of *Time and Money: The Macroeconomics of Capital Structure*, London: Routledge, 2001 and co-editor (with the late Norman Barry) of *The Elgar Companion to Hayekian Economics*, Cheltenham, UK and Northampton, MA US: Edward Elgar, forthcoming.