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History of Economic Thought

XI. Mises and Keynes, Money and Crises

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XI. Mises and Keynes

1. John Maynard Keynes
2. The Keynesian System
3. Ludwig von Mises
4. Praxeology, Liberalism, and Business Cycles
5. Friedrich von Hayek and the London School
6. The Keynesian Revolution

1. John Maynard Keynes

The Man

- Born 1883, son of Neville Keynes, died 1946
- Eton, King's College, Cambridge (maths and classics)
- Marshall's favourite student

The Work

- Entered the civil service 1906 (India Office)
- Lecturer at Cambridge 1908
- Key works: *Treatise on Money* (1930) and *The General Theory of Employment, Interest and Money* (1936)

The Cambridge Apostles

Secret Society

- Student group devoted to pursuit of truth
- Disciples of the philosopher G. E. Moore
  - No objective ethics
- The highest good: pleasure and friendship
- The elect can evaluate what right behaviour is case-by-case

Rejection of Ethics and Norms

- Rejected the ruling norms and culture of England / the wider western world generally
  - Lytton Strathey's *The Victorians*
  - "I remain, as I have always been an immoralist" – Keynes
- In economics, the idea of laissez-faire rejected

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The Symptomatic Keynes

Nothing was more contemptible in the eyes of the post-Victorian English than the ideas of laissez faire that had multiplied England's population and secured to the average Englishman the highest standard of living in Europe. Lords and commoners, divines and atheists, manufacturers and union members, Fabians and Colonel Blimps all agreed in rejecting the "dismal science." They hated the theory according to which there was but one means toward the general improvement of people's material well-being, viz., to increase the per head quota of capital invested. They longed for short cuts to an earthly paradise; a protective tariff, a cheap money policy, the closed shop, doles, and social security. They did not want to be told by the economists that it is the policy of the unions that creates unemployment as a lasting mass phenomenon and that the periodical recurrence of crises is the inevitable outcome of the easy money policy. They knew better; all evils were caused by capitalism.

- Mises

Keynes's Career

Government Work

- India Office 1906-08
- Treasury during World Wars
- BoE board from 1941

Academic Career

- Lecturer at Cambridge 1908
- Fellow at King's College from 1909, bursar 1924
- Editor of the *Economic Journal* from 1911, secretary of the Royal Economic Society 1913
- Keynes had great personal influence in economics
  - Few economists, few institutions
- Elevated to peerage 1942 as Baron Tilton

The *Theory of Probability*

Fellowship Dissertation

- Written 1909 for fellowship, published 1921
- Partly in Cambridge tradition
  - Whitehead and Russell in mathematics
- Partly must be seen in light of probability and economics
  - Frank H. Knight, *Risk, Uncertainty, and Profit* (1921)
  - Richard von Mises and Ludwig von Mises

Three Kinds of Events

- Those to which we can assign numerical probability
  - Actuarial risks
  - Throws of dice
- Those to which we can express an informed, non-numerical judgement
- Those about which we know nothing

The *Economic Consequences of the Peace*

Versailles Peace Conference

- Keynes part of the British delegation
- Very disappointed in the outcome, and in the participants
- His book on the peace became instantly popular
  - Partly due to portrayal of the main actors

The Economic Problem according to Keynes

- How could Germany generate the BoP surplus needed to pay?
- This he considered impossible
- The balance of payments would have to become very positive
- This really back to mercantilism: the trade balance is determined completely by real factors

Keynes's Constants

Against Laissez-Faire

- "End of Laissez-Faire" 1926
- Promoted inflationary policies
- Promoted government direction of the economy
- Free-market capitalism neither efficient nor moral

Finishing the Marshallian System

- Adding macroeconomics
- The economy breaks down at the general level – there is no natural tendency toward equilibrium and full employment

Personal Ambition

- Keynes was born to lead British economics, economic policy
- Concerned with a monetary remedy for unemployment
- Wanted an international monetary system under central-bank management
- Wanted a more "flexible" system than allowed for under the gold standard

Say’s Law and Full Employment

Full Employment

- Keynes’s claim: everyone before him assumed full employment
- Classical economics only describes full employment equilibrium
  - But this state does not automatically come about
  - Earlier economists simply assumed it
- But did they? British economists were dealing with the question (Beveridge, Pigou, Hicks)
  - As were the Austrians
  - It had also been central to debates over Say’s Law in the 1820s

Say’s Law

- Keynes’s version: supply creates its own demand
  - Increasing production leads to unemployment, the same output can be produced with fewer workers
- Subsidiary claim: the “classical dichotomy” between money and real factors wrong
  - Money is part of the production process
  - Forerunners: Malthus, Silvio Gesell

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2. The Keynesian System

The Key Goals

- The conclusions remained the same: there is no natural tendency toward equilibrium
- Evolution of Keynes's books from 1923 to 1936 must be seen in this light
- Marshallian method and approach

Savings and Investment

- This distinction is key to the system
- Savings mean money hoarding – spending "leaking out" of the system

Savings and Investment

Difference Between Savings and Investment

- Two separate groups decide the magnitudes: families and entrepreneurs
- Hence, a disequilibrium is possible
- Savers are pretty robotic, inactive
- Entrepreneurs the active element: they invest based on expected returns, fixed capital investment depend on interest rate expectations

Keynes's Psychology

- Investment is volatile because it depends on the "animal spirits" of businessmen
  - Economic cycles caused by the psychology of the investor
- Government intervention necessary: rational rulers stabilize the business cycle
  - Overcome the mood swings of the investors

Aggregate Demand

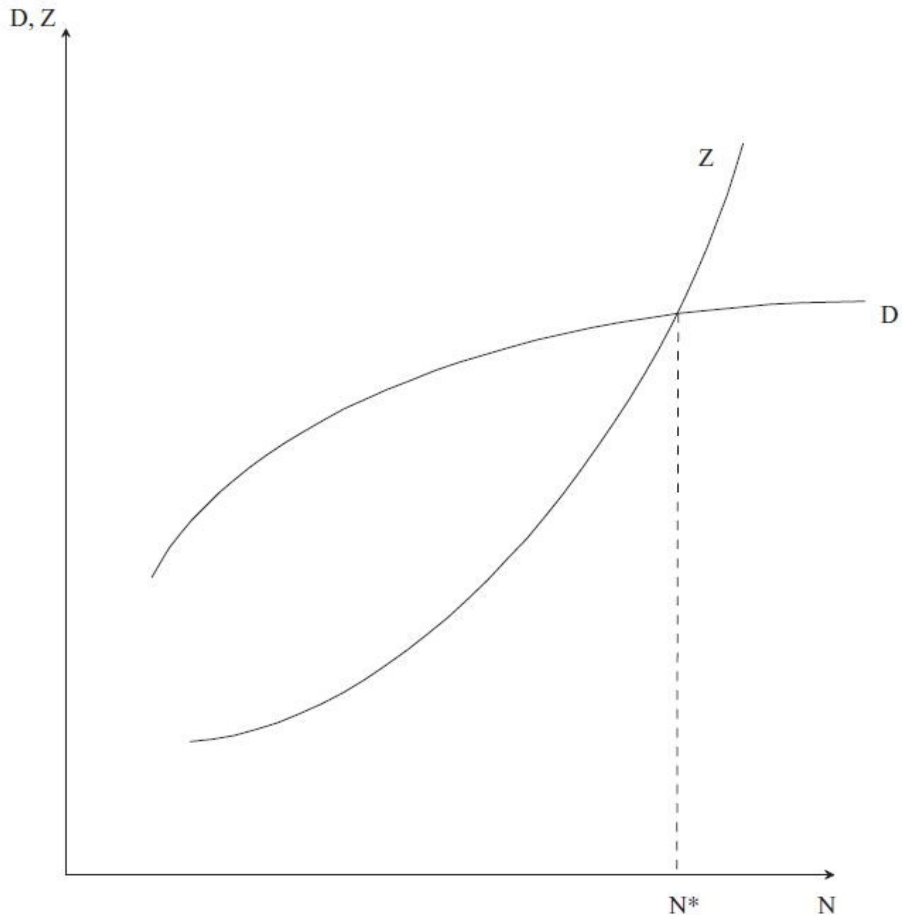
Aggregate Supply and Demand Functions

- Introduced in the *General Theory*
- Different from standard demand and supply curves
  - They don't relate quantity and price
- Number of employed workers related to entrepreneurs' evaluations of costs and revenue

The Functions

- N: number of workers; Z: aggregate supply price of output from employing N men; D: the proceeds entrepreneurs expect from employing N men
- Employment depends on expectations about profitability
  - Short run: driven by consumption
  - Long run: beliefs about profitability and "animal spirits" are dominant
  - Investment the important variable long run
- Point of effective demand: D = Z – shows level of employment and production

Aggregate Demand (Roncaglia 2005, 400)



The Consumption Function

Consumption and Income

- Consumption depends on income
- Circular flow of spending: firms → families (income) → firms (expenses)
- Consumption very stable – consumers are passive, inert

Correlation

- Consumption correlates very closely to income
  - It constitutes a majority of income – 80-90 percent perhaps
  - So we're correlating income to… 90 percent of income
- Investment very volatile in relation to income
  - But again the same problem: we correlate 10 percent of income to income

Investment and the Multiplier

Investment

- Exogenous to the circular flow – depends on expectations
- Investment decisions determine the equilibrium level of income
  - That level of income Y where savings S correspond to investment I
  - Investment level generated by entrepreneurial expectations

The Multiplier

- The propensity to save, $s = S/Y \rightarrow Y = I/s$
- The multiplier is the inverse of the propensity to save
- Hence, if investment is 10 percent of income, the multiplier will be ten
  - Any increase in investment will yield a tenfold increase in income
- More fundamentally, both consumption and savings are passive elements – investments drive the economy

The Rate of Interest and Money

Determining the Rate of Interest

- Investment depends on entrepreneurs' comparison of expected rates of return to money rate of interest
- Rate of interest determined by comparison of money and bonds
- As the rate falls market price of bonds rises, as it rises, bond prices fall
  - Bulls expect falls in interest rate and invest in bonds, bears rises and invest in money

Interest and Money

- Demand for money is an inverse function of the interest rate
  - But financial markets are extremely volatile, so this relationship shaky (animal spirits)
- If expectations are fixed, then a fall in the rate of interest lead to a rise in numbers of investors expecting a rise, thus increasing supply of bonds for money
  - A fall may lead investors to revise their expectations, increasing the demand for bonds
- At bottom, the rate of interest is determined by the liquidity preference of investors
  - Their allocation of resources between financial assets and money
- Financial expectations determine interest, allocation of savings, all other factors secondary
- Rate of interest and long run expectations determine investment

The Role of Government

Twofold Reason for Intervention

- Counteract changes in spending from hoarding of money
- Step in to support aggregate demand when animal spirits lag, investors become depressed

Policies

- Fiscal and monetary policy, but these are really the same policy: inflation
- Monetary policy: boost credit expansion to business to encourage investment
  - Keynes became much more sceptical of this in the *General Theory*
- Fiscal policy: government engages in deficit spending to boost aggregate demand, launch public works projects
  - Even pyramids or similarly useless things, simply to keep nominal spending up
- Counterinflationary policy: when nominal spending increases due to dishoarding, raise taxes to "sop up purchasing power"
- Euthanasia of the rentier class the long-term goal: eliminate animal spirits in the allocation of investment
  - Substitute in the stead of investors government guidance – nationalization of credit

Sticky Wages – an Unproven Assumption

A Key Question

- Why is it necessary to maintain nominal spending at a given level?
- Keynes is not always straightforward, but it is clear that his system assumes a fall in nominal spending to be bad

A Key Assumption

- Sticky wages: employment cannot adjust to a fall in spending because wages are sticky downwards
- Hence, we can have unemployment equilibrium
  - But only because wages are not free to adjust
- This leads to the classic Keynesian "cure" for unemployment
  - Inflation to hollow out the real value of wages
  - This only works until the trade unions realize the scheme
  - Then they push for higher wages/inflation-indexed wages

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I Want to Be a Consumer (*Punch* 1934)

"And what do you mean to be?"
The kind old Bishop said
As he took the boy on his ample knee
And patted his curly head.
"We should all of us choose a calling
To help Society's plan;
Then what do you mean to be, my boy,
When you grow to be a man?"

"I want to be a Consumer,"
The bright-haired lad replied
As he gazed into the Bishop's face
In innocence open-eyed.
"I've never had aims of a selfish sort,
For that, as I know, is wrong.
I want to be a Consumer, Sir,
And help the world along."

3. Ludwig von Mises (1881-1973)

The Man

- Born in Lemberg, died in New York
- Studied in Vienna, obtained doctorate under Carl Grünberg, habilitation under Böhm-Bawerk
- Worked for the Austrian Chamber of Commerce, 1934-40 for the Graduate Institute of International Studies in Geneva

His Work

- Never official professor – his Vienna seminars renowned, however
- Recognised as the key expert on money and socialism
- The culmination of the Austrian school
- Key works: *Theory of Money and Credit* (1912), *Socialism* (1922), *Human Action* (1949)

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Becoming Austrian

Doctorate

- Mises set out with a typical interventionist mindset
- Carl Grünberg his *Doktorvater,* trained in historicist ideas
  - Later founder of the Frankfurt School
- Mises then came across Carl Menger, read his *Principles*
  - Reading Menger "made an economist of me"

Habilitation

- While working, Mises pursued his habilitation under Böhm-Bawerk
- Regularly attended the Böhm-Bawerk seminar
- His 1912 dissertation very controversial, revolutionary – a whole semester dedicated to discussing it

The Theory of Money and Credit (1912)

Marginal Utility

- Thread from Wieser: how can we apply marginal utility to money?
- The Austrian circle

Interest and Monetary Theory

- Mises laid out the connections here, building on Böhm-Bawerk's interest theory
- Clear subjectivist understanding of the money supply
  - Contra Irving Fisher writing at the same time
- Typology of money effectively answered Knapp's theory
  - Commodity vs. fiat money
  - Money, money substitutes, and fiduciary media

Breaking out of the Austrian Circle

Developing Wieser's Theory

- The objective exchange value (OEV) *today* depends on the stock of money and the demand for money
- The demand for money depends on the subjective value of money (SVM)
  - This depends on expectations of its future OEV
  - based on the OEV of the immediate past, *yesterday*
- The OEV *yesterday* depends on the SVM yesterday, which depends on the OEV *the day before*, and so on

The Regression Theorem

- What about the infinite regress? Mises integrates Menger's theory of the origin of money
- We only need to regress to the point in time when none of the monetary commodity's value depended on its use as money
- At this point in time, it's value (price) is fully explained by the "normal" laws of value
  - By supply and demand based on consumption and industrial demand

Value and Capital

What is Capital?

- Critical of Böhm-Bawerk's somewhat objective concept of capital
- Mises went back to Menger's definition of capital
  - Capital as a concept only makes sense in a monetary economy
- Definition: capital is the sum of the money equivalent of all assets minus all liabilities dedicated at a definite date to the conduct of the operations of a definite business unit

Laws of Value and Goods

- Mises adopted threefold division of goods
  - Consumer goods, producer goods, media of exchange
- The laws of value are different for each
  - Consumer goods are valued directly by consumers for their utility
  - Producer goods are valued for their ability to produce consumer goods
  - Media of exchange are valued for their purchasing power, OEV
- All derive their value ultimately from the subjective valuation of the consumers

Imputation Theory

A Lingering Problem

- How is the utility of the consumer goods imputed backwards onto the producer goods?
- Direct imputation of utility seems impossible
- Marginal productivity theory of wages, revenues, at stake

Mises's Solution

- It is not the subjective value of the consumers that is imputed backwards – their valuations only establish the prices of the consumer goods
- Consumer goods *prices* are imputed backwards
  - If a consumer good sells for €100, the total price of all the factors that went into it is also equal to €100
- A clear parallel to Böhm-Bawerk's development of the law of cost
  - He too made clear that it is only in money terms we can speak of any kind of imputation
- Entrepreneurs do not concern themselves with utility: they estimate their expected profits based on expected lower-order goods prices and *then* bid on the factors of production

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A Typology of Money

Three Kinds of Money

- Commodity money, such as gold and silver
- Credit money, claims to any physical or legal person
  - Mises understood e.g., the British suspension 1797-1819 as a case of credit money
  - Credit money cannot be both payable on demand and absolutely secure
- Fiat money: things with a special legal qualification

The Value of Money

- The value of all these kinds follow the general principles of value
- Ultimately derived from commodity money per Menger and Mises
- Fiat money too: the legal claims that became fiat money were initially simply claims to money

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Money and Money Substitutes

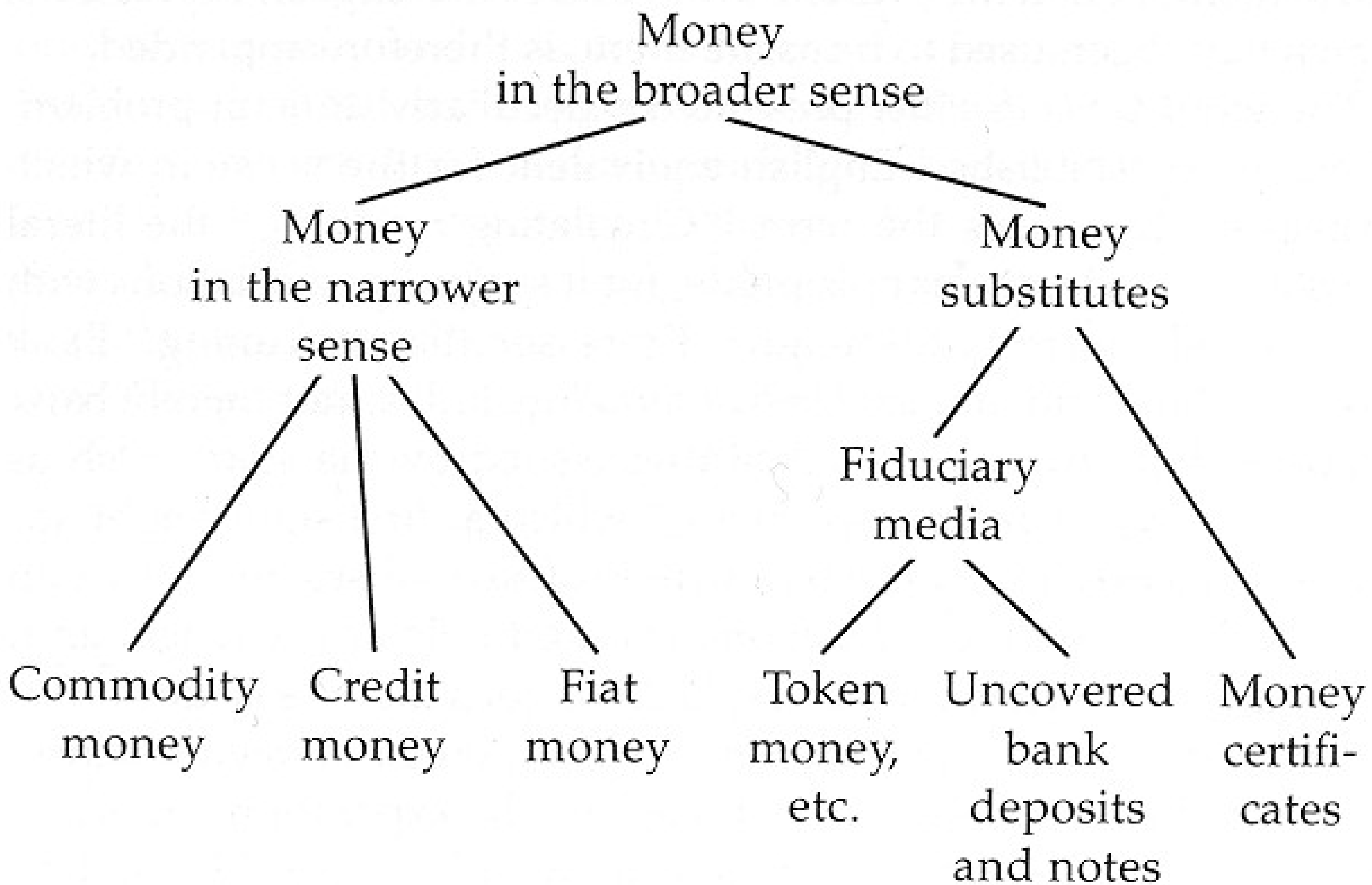
Money and Banking

- Mises showed the clear connection between money and banking
- Banks are important for monetary theory insofar as they issue claims to money (bank notes, bank deposits) that circulate as money
    - They increase the money supply in the broader sense

Money Substitutes and Fiduciary Media

- Fully backed bank money have no influence on the money supply
- Fiduciary media is bank money issued in excess of reserves
    - The issue of which increases the money supply
- Mises is here explicitly building on the British currency school

Mises's Money Typology



Mises's Money Typology

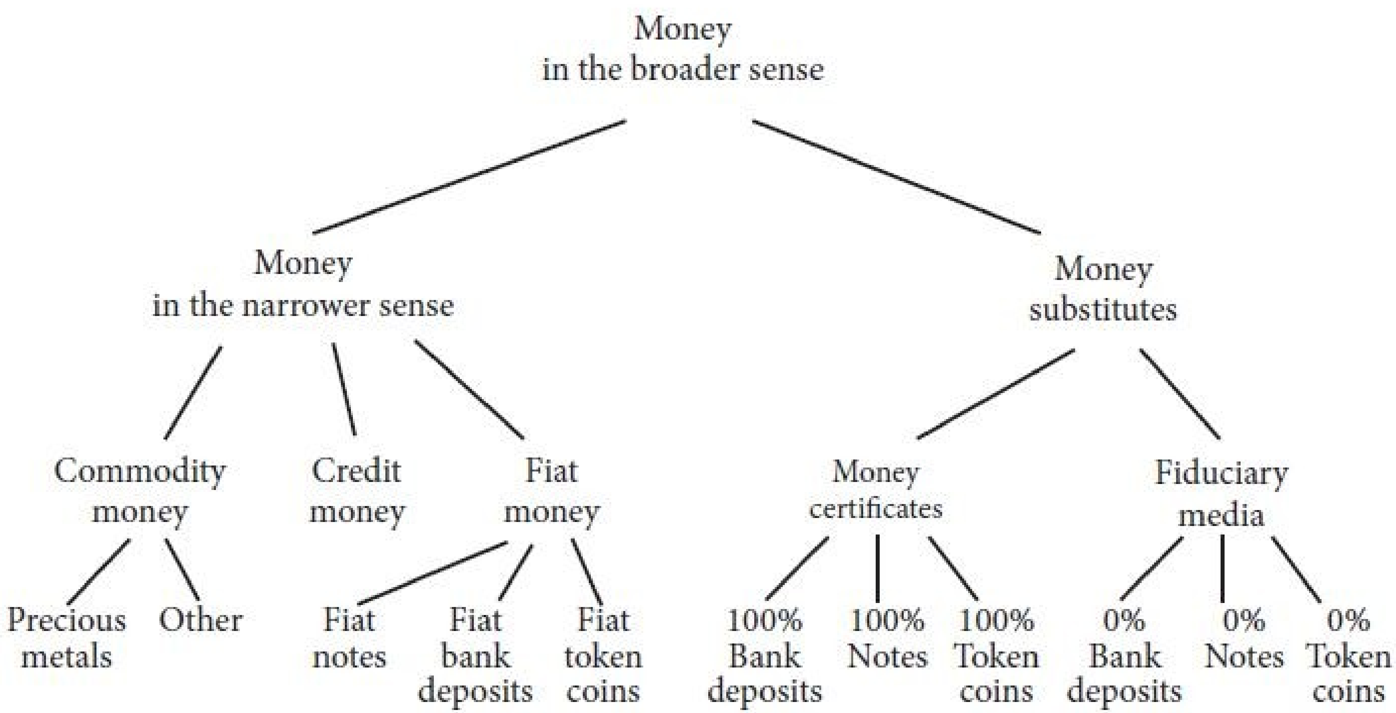


Figure 2

CLASSIFICATION OF MONETARY GOODS ACCORDING TO MISES

4. Praxeology, Liberalism, and Business Cycles

The Science of Human Action

- Developing the nature and method of economics
- In opposition to positivism and scientism of the age

Liberalism

- Reviving a dying tradition
- A radical laissez-faire theorist

Business Cycles

- Developing the monetary explanation of business cycles

Praxeology

Developing the Austrian Views

- Beginning in the 20s and 30s, Mises began laying out the distinctly Austrian view of the nature of economics
- Economics is a qualitative science; there are no quantitative laws
- Subjectivism: value simply means preferring one thing to another, it is completely subjective and ordinal
- Methodological individualism

Praxeology

- In *Human Action* (1949) Mises deduced economics from the axiom of human action
- Logical deduction from first principles leads to valid, universally applicable laws
- The social sciences' method is radically different from natural sciences

Praxeology and History

Praxeology

- The science of human action – describes all human action
- Must be understood teleologically: in terms of means and ends

Catallactics

- Human action within the cash nexus
- The hitherto best-developed parts of economics
- Cannot be clearly demarcated – but this is unproblematic, since the fundamental praxeologically laws always hold

History

- History is the empirical side of the sciences of human action
- Insofar as quantitative methods are applicable, they are tools of historical research
- The main "organ" of the historian is his *Verstehen*, understanding
  - The ability to understand the motives and ideas guiding human action
- The historian is the entrepreneur of the past – the entrepreneur is the historian of the future

Liberalism

The Last Knight of Liberalism

- While other economists turned increasingly interventionists, Mises stuck to classical liberalism throughout
- For the gold standard, against inflation
- Against (coercive) trade unionism, for free markets
- Against protectionism, for free trade

"Pure" Liberalism

- In the tradition of Menger and the earlier 19th century liberals
- But even more extreme or pure: came to regard all government intervention as disruptive, damaging to society
- The state should only be concerned with protecting life and property

Liberalism (1927)

The program of liberalism, therefore, if condensed into a single word, would have to read: *property*, that is, private ownership of the means of production… All the other demands of liberalism result from this fundamental demand.

Side by side with the word "property" in the program of liberalism one may quite appropriately place the words "freedom" and "peace" … Freedom and peace have been placed in the forefront of the program of liberalism, not because many of the older liberals regarded them as coordinate with the fundamental principle of liberalism itself, rather than as merely a necessary consequence following from the one fundamental principle of the private ownership of the means of production; but solely because freedom and peace have come under especially violent attack from the opponents of liberalism.

Money and Business Cycles

Bank Credit Expansion

- Key distinction between money in the narrow sense and fiduciary media
- Banks are free to extend credit beyond real savings through increasing the money supply
- They thus lower the market rate of interest below the natural rate of interest

Consequences

- Businessmen get the impression that more capital is available for investment and they expand production
- The production structure is "lengthened" as especially the higher stages of production are affected, leading to a boom
- At the same time consumption booms, since there has been no increase in savings

The Boom

Developing Boom

- Cluster of errors develop: businessmen invest in production lines that are not sustainable
  - They only appear so due to the inflow of fiduciary media
- The boom proceeds so long as the banking system increases the supply of fiduciary media

The Top of the Boom

- Banks can keep the boom going by increasing the rate of credit expansion
- The rate has to increase – otherwise entrepreneurs could not pay rising input prices
- The supply of complementary factors of production has not increased as much as indicated by the lower rate of interest/higher supply of loanable funds
- Businessmen therefore pay ever-higher prices for the complementary factors
- Either the boom ends in hyperinflation; or the banks stop expansion before then, triggering a crisis

Bust and Depression

Crisis

- Factor prices accelerate ahead of the supply of credit
  - Credit becomes "scarce" → interest rates rise above the natural rate
- Entrepreneurs scramble for cash, throw inventories on market → prices drop
- Revenues dry up, companies can no longer fund production
  - Bankruptcies, price falls and unemployment

Depression

- The malinvestments of the boom period become apparent
- Some factors of production have to be rearranged – their current employment revealed as unprofitable, unproductive
- Hence, unemployment likely, before they are shifted to alternative employments
- Some fixed capital may have to be given up altogether
- The depression is the period where the market clears the rubble from the boom

5. Friedrich von Hayek and the London School

Friedrich von Hayek (1899-1992)

- Educated in Vienna under Wieser
- Director of the Austrian Institute for Business Cycle Research, which he founded with Mises
- Came to LSE as visiting professor, in England 30s-40s

The London School

- The London School of Economics alternative to Cambridge
- Founded by Fabian socialists 1895
- Edwin Cannan, Sir William Beveridge and Lionel Robbins turned it into a centre of free market thought

Friedrich August von Hayek

Early Life

- Studies in Vienna, officer in the World War
- Read Mises's *Socialism* and was converted away from socialism
- Interested in psychology, philosophy

Works

- *Monetary Theory and the Trade Cycle* (1928)
- *Prices and Production* (1931)
- *Monetary Nationalism and International Stability* (1937)
- *Individualism and Economic Order* (1948)
- *Law, Legislation and Liberty* (1973-79)

The London School

Edwin Cannan (1861-1935)

- Professor at LSE 1895-1926, led it in a liberal direction
- Inspired by Jevons and Marshall
- Important monetary theorist: total demand approach

Lionel Robbins (1898-1984)

- Studies, first at University College, then LSE – protege of Cannan
- Professor at LSE from 1929, brought many famous economists there
  - Nicholas Kaldor, John Hicks, Friedrich von Hayek
- *Essay on the Nature and Significance of Economic Science* (1932)
- *The Great Depression* (1934)

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Robbins and Hayek

Robbins in Vienna

- Robbins visited attended Mises's seminar 1928
  - An instant convert to the Austrian school and its business cycle theory
- At the LSE, he built up a very "Austrian" faculty from the 1920s on

Hayek in London

- Invited to the LSE as visiting professor, giving the lectures that became his famous *Prices and Production* in 1931
- He was then hired by the LSE, stayed on till 1950
- Hayek inspired/converted many English economists
- Robbins's *The Great Depression* (1934) was a very Austrian analysis – which he later repudiated

Hayek and Keynes

The Struggle Against Keynes

- Hayek the key challenger to Keynes in the 1930s
- "The Paradox of Saving" in *Economica* 1931
  - How can saving, when it initially causes a fall in consumption spending, lead to economic growth?
  - Lays out the "Austrian" capital theory
- Hayek's two-part review "Reflections on the Pure Theory of Money of Mr. J. M. Keynes" in *Economica* in 1931 convinced Keynes he had to abandon that work

Hayek's Greatest Error

- Hayek later committed what he himself called his greatest error: he did not subject the *General Theory* to the same scrutiny
- Hayek thought it wasn't worth it – Keynes would just have changed his mind by the time the review was published!
- Later on, in the 60s and 70s, Hayek was a key critic of the Keynesian legacy of inflation
- By then, most of the London economists had deserted the Austrian laissez-faire convictions of their youth – the only exception next to Hayek was William Hutt

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William H. Hutt (1899-1988)

A South African Challenge to Keynesianism

- Most important books: *The Theory of Collective Bargaining*, *The Theory of Idle Resources*, *A Rehabilitation of Say's Law*
- Why assume unemployment? Keynes's approach is at least as question-begging as his caricature of "classical" economics is

Unemployment and Depressions

- There need be no employment at all
- A crisis and recession develops in the capital goods industries → entrepreneurs realize they have radically overestimated profits
  - They cannot afford the previous wage rate of, say, €15/hour
  - They can fire a lot of workers – or simply lower wages to €5 or €10/hour
- Some workers decide to leave the labour force, other will remain in the industry
- Then they realize that there are higher wages elsewhere in the economy, e.g., in the consumer goods industries, of €12 or even €15/hour and move there
  - So involuntary unemployment never emerged

Mises's Final Verdict on Keynes (1951)

Lord Keynes had, as his biographer points out, "a very rare combination of gifts; his endowment in any one of them would by itself have made him a notable person." But politics and history are not concerned with the virtues Professor Harrod registers in his detailed catalogue. They ask: Did he enrich mankind's treasure of ideas and did he influence the course of events? The answer to both questions is in the negative. The ideas he professed were untenable and, even so, not original. The books he wrote supported firmly established policies which would have gone on without this support. He was highly renowned, famous and popular in an age of decay and disintegration, but his writings were not the cause of these disasters; they were only symptoms.