Friedrich August Hayek (1899-1992) was a well-known Austrian economist of his time. In his book *Commanding Heights*, Daniel Yergin called Hayek the “preeminent” economist of the last half of the twentieth century. For a long time, however, Hayek’s ideas were turned down in favor of the ideas of one of his better-known, contemporary peers, John Maynard Keynes (1883-1946). Mention Hayek’s name to non-economists and you will get an odd look; mention Keynes and you will have a good conversation starter. So why does a conveniently forgotten economist matter today?

After World War I, Hayek earned his doctorates in law and political science from the University of Vienna. He was a preacher of the free market system and the laissez faire approach. He believed that the government should play a limited role in the economy through regulations on work hours, the monetary system, and organizations for proper information flow. He asserted that markets can and will fix themselves in a crisis without the intervention of monetary incitements or what we know today as “bailouts.” A government focused on central planning and meddling in economic affairs is only leading the people to depend more on public policy. Central planning was a stepping-stone to a society of peasants, argued Hayek in the work that made him famous in the United States, *The Road to Serfdom*.

Although Hayek seemed like an anarchist, who wanted to tear down governments, his ideas were based on noble causes and stem from his own experience in World War I. His service to Austria during the war inspired a desire in him to help future generations avoid the mistakes that lead to the war. To Hayek, the major economic problem was how people’s actions are coordinated. Like Adam Smith, Hayek noticed that the price system of a free market economy performs a remarkable job of coordinating people’s actions, even though that coordination is unplanned and unintentional.
Keynes was an admirer of Hayek and even recommended his book, but he was also Hayek’s biggest critic. Keynes and Hayek lunched the most intriguing debate of the mid 20th century on the causes of boom and bust in a capitalistic economy. Keynes believed entrepreneurs motivated by “greed” reveal their “animal spirits” to invest heavily into the economy, thus igniting a boom in the stock market. Conversely, when entrepreneurs lose confidence, they initiate a sell-off frenzy, which would push the market into a bust. Keynes’ solution for economic stability involved government “deficit spending” to balance out the fall in business investment. Deficit spending would appeal to the animal spirits of entrepreneurs to invest and make profit. Increased investment would spark a boom in the economy. Subsequently, a bust would occur due to the loss of confidence, stagnation of the cash flow, and reluctance to invest.

Hayek disagreed with Keynes. He asserted that the interest rate policy of the central bank causes the boom and bust cycle. If interest rates are kept artificially low, then there will be higher than a normal demand for loanable funds to finance new investment. If interest rates are kept artificially high, then there will be lower than a normal demand for loanable funds, thus dampening business investment. Hayek opposed the idea that interest rates should be decided by the central bank. He indicated that the balance between demand and supply of loanable funds should set interest rates. The reason for this assertion is that artificially low interest rates act to confound investors as they rely on continued availability of credit. However, their plans are ruined when interest rates rise to curb inflation at the behest of the central bank. Hayek concluded that the government could only trick investors into thinking that the economy is in good shape, causing an increase in investment. The economy would boom for a time and then bust due to the unsustainable nature of deficit spending.

Many economists blame the Federal Reserve’s role in not controlling greedy bankers during the pre-recession period (2000-2006), leading to the creation of a housing-bubble and credit-crunch that caused the Great Recession (2008-2009) and the ensuing sluggish recovery. In this manner, it can be seen that Hayek’s observations of government dependence may be accurate. Typically, households depend on the government in times of both prosperity and calamity. Instead of creating wealth for households, the government creates a cycle where wealth is made and then erased.

Economics is a science where its laboratory is the real world. The best sounding economic theories make their ways to policy making. Hayek’s work went against what most economists were saying and what governments were practicing. In this day and age, the work of Hayek cannot be clearer as Americans have turned to the government to boost social entitlements, inject fiscal stimulus, and keep low interest rates. Today more than ever, the faint echoes of Hayek’s words can be heard as the White House, the Congress, and the Federal Reserve Board plan ways to steer the economy to another period of prosperity. Would Hayek be correct in what comes after a long awaited boom?
Sources:
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