SPEECH

THE RELEVANCE OF HAYEKIAN ANALYSIS FOR MONETARY POLICY IN DEVELOPING COUNTRIES*

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I am indeed grateful to the School of Management for giving me this opportunity to give a short presentation to the Faculty and students at the University of Sheffield. As an alumnus of the University it gives me great satisfaction in the evening of my career as a central banker to come in person and express my gratitude for what Sheffield offered to our generation of students.

Friedrich August Von Hayek, the Nobel Laureate of 1974 is acknowledged as one of the most outstanding and fundamental thinkers of the twentieth century. Economic analysis in the nineteen-thirties was replete with the battle of the titans - it was quite a drama - with the theories of Hayek clashing with the theories of Keynes. With the particular circumstances of the nineteen- thirties, with the survival of the fittest, Keynes was clearly the victor banishing Hayek into oblivion. Present day text books relegate the Hayekian theory of the trade cycle to the limbo of forgotton causes. Hayek's defeat appears to have been so complete that even among his followers he is honoured as the author of the **Road to Serfdom** and his later works and little mention is made of the young Hayek, the teacher of economic theory of the inter-war years who wrote **Prices and Production.** It is, therefore, not surprising that students of today are totally unaware of what the controversy was about and its relevance, if at all, to the problems of today. This is not surprising as even in the nineteen-fifties Hayek's early works were unfamiliar to students.

Lest I try your patience let me reveal that in the fifties Sheffield under the leadership of Professor J. C. Gilbert was probably the only University in the UK which stressed that serious students of monetary theory should have a clear understanding of the Hayekian analysis. I sincerely believe that the stress on Hayekian analysis at Sheffield was a most valuable contribution especially when we note that the path breaking retrospect in the sixties by Sir John Hicks, of the controversy of the thirties was long after Professor Gilbert attempted a revival of interest in Hayek's **Prices and Production.**

Although Hayek's **Prices and Production** was a lecture series in English it was not Anglo-Saxon economics and therefore it needed further explanation by those who had closely been associated with Hayek's work. Professor J. C. Gilbert, a student of Hayek, highlighted Hayek's contribution to trade cycle theory in a paper presented to Section F of the British Association in 1953. I would draw heavily on Professor Gilbert's work to illustrate the relevance of Hayekian analysis for present day monetary policy in the developing countries.

Hayek started with the assumption of full employment and explained unemployment as a result of dislocation of the economic system following monetary inflation. It was an over-investment theory of unemployment, expenditure on capital goods having increased in excess of voluntary savings and the reaction leading to unemployment. Keynes started with the assumption of unemployed resources and analysed the forces which would raise the economy to a full employment level. His explanation of unemployment, diametrically opposed to that of Hayek was one of under-investment, expenditure on capital goods being too low in relation to savings for full employment, due to a lack of investment

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opportunities. While Hayek also later on presented an analysis starting with the assumption of unemployed resources, his explanation of the turning point to depression was once again in terms of a reaction to over-investment, the existence of a capital shortage. Professor Gilbert felt that the neglect of Hayek's work was unfortunate as in some ways it was nearer to the theory of growth than that of Keynes.

Hayek had made a fundamental contribution to economic theory. Starting from stationary equilibrium, an increase in investment, the output of capital goods, involved a reduction in the output of consumption goods. Starting from a position of general unemployment the production of capital goods and consumption goods are complementary and it was Keyne's great achievement to stress this simple point.

Hayek showed that from a position of stationary equilibrium investment can be increased (with a reduction in output of consumer goods) by injections of new supplies of money via producers being given credit. The prices of capital goods would rise relative to consumer goods and productive resources would shift from consumer to capital goods industries. The new distribution of productive resources resulting from "forced savings" can only be maintained if bank credit is continually increased. Sooner or later the monetary expansion is brought to an end or there will be hyper-inflation and monetary collapse. If the increase in the quantity of money is stopped, there will be a reversion towards the initial proportion of money spent on capital goods and consumer goods but not exactly the initial proportion because of changes in the distribution of income resulting from inflation; of course the new supplies of money become part of the normal stream as nominal incomes would have risen. The movement away from equilibrium is explained in terms of a money rate of interest below the equilibrium rate. The disturbance to equilibrium results from errors of entrepreneurs of wrong expectation leading to an inappropriate allocation of productive resources. Hayek emphasised that monetary changes are particularly apt to cause wrong expectations and that certain monetary changes are bound to set up expectations which will eventually be disappointed; Hayek took the extreme view that the errors of entrepreneurs caused by such monetary changes are probably the main cause of industrial fluctuations.

Hayek's monetary over-investment theory explains the upper turning point in terms of a capital shortage and the shift in demand from capital goods to consumer goods - a shortening of the production period - results in unemployment and depression. Hayek's basic position is one approximating to full employment, that investment is in excess of savings i.e, a scarcity of capital and there is a lack of correspondence of the intention of consumers and the intention of producers with regard to the shape of the income streams they want to consume and to produce respectively. It is the restraint on the increase in money supply which brings about the reaction, otherwise hyper-inflation would develop. Hayek was heavily criticised for his view that once the cumulative process has been entered upon the end must always come through a rise in profits in the late stages and can never come from a fall in profits or an exhaustion of investment opportunities.

While Professor Gilbert continued to stress to a generation of students at Sheffield that Hayek's contribution should not be ignored in any analysis of the upper turning point of the trade cycle, it is unfortunate that Hayek's work was totally ignored in Anglo-Saxon economic literature. It was only in the late sixties that Hick's reflections in the 'Hayek Story' provide some penetrative insights:

"We can agree that he [Hayek] was doing something - if it was not what he thought he was doing. The Hayek theory is not a theory of the credit cycle, the **Konjunktur,** which need not work in the way that he describes, nor is it, in fact, at all likely to do so. It is an analysis - a very interesting analysis - of the adjustment of an economy to changes in the rate of genuine saving. In that direction it does make a real contribution. But it is a contribution which, when it was made, was out of due time. It does not belong to the theory of fluctuations, which was the centre of economists' attention in 1930; it is a fore-runner of the growth theory of more recent years. In that application we can still make something of it."

Hicks agrees that the ways in which the continued expansion of planned economies get into trouble through shortage of savings are reflective of the Hayekian analysis - the rate of saving which initially seemed adequate to support the expansion proves insufficient to support it at a later stage. Hicks argued that in the industrialised countries so long as there are modest expansions there may not be much danger of the "Hayek effect", but in developing countries seeking to achieve rapid growth, it can be serious danger.

Hicks sums up that under certain conditions the Hayekian prescription may after all be right:

"It can happen that there is unemployment even while there is inflation. ... Such a condition may arise ... when the marginal product of labour, at full employment, has fallen below some customary standard. That again may happen for various reasons; because of capital destruction through war or political upheaval, because of shifts in foreign trade to the country's disadvantage, perhaps because of increasing population ... There may be rapid inflation; but if it is to be kept down to a finite rate of inflation, there must be unemployment. This is the Hayek 'slump'. To such conditions the Keynesian prescription is irrelevant, as irrelevant as Hayek's was in 1931. Hayek's prescription - the direction of policy towards the restoration of the marginal productivity of labour to a normal level, as soon as possible, but with a realization that it cannot be done immediately - will then after all be right."

It is once again unfortunate that the Essays in Honour of Hayek edited by Erich Streissler and contributed by Hayek's friends in the Mont Pelerin Society though covering Hayek's early theoretical work did not take note of Professor Gilbert's heroic effort in the fifties to bring about a revival of interest in Hayekian thought. Nonetheless Streissler also suggests as Hicks does that the Hayekian analysis does have relevance for the developing countries:

"Hayekian entrepreneurs are not only weak and small, they are also poor: They absolutely depend upon credit for financing any extension in plant. They are starved for capital. They always have unfilled investment desires. Therefore, whenever new credit becomes available, they eagerly lap it up. There may even be an unsatiated demand to become an entrepreneur so that cheap credit causes the creation of new enterprises. Development thus proceeds in bumpy way, in leaps and lulls, as it still does in many relatively underdeveloped countries and for exactly the Hayekian reason."

Hayek in his Nobel Memorial Lecture has argued that the theory underlying monetary and financial policy for the past half a century is based on the mistaken belief that we can secure a higher level of employment and output by maintaining total money expenditure at an appropriate level. The increasing of aggregate demand to stimulate output has been the most important single cause of extensive misallocation of resources. The continuous injection of additional amounts of money can create a temporary demand but this effective demand can last only if the increase in the quantity of money continues to accelerate. Such an acceleration of money growth can only result in accelerating inflation which results in an inevitable disorganising of economic activity. When the central bank presses the panic button and slows down the monetary growth, there is an inevitable decline in output and employment. It is unfortunate that ever since the late nineteen-thirties, economists were able to provide 'scientific' quantitative evidence for a false theory and in the process the valid theoretical underpinnings of a sound monetary policy were rejected in the absence of sufficient quantitative evidence. Hayek argued that true but imperfect knowledge is preferable to the pretence of exact knowledge that is likely to be false.

The world-wide inflation since the nineteen-forties occurred precisely because it was believed the world over that financing the Government by creating money was a necessary and lasting effective method of increasing output and employment. The argument in favour of running government deficits was what Hayek calls a 'seductive doctrine' which, governments could not resist. It is here that economists have to bear the blame for having provided a faulty theoretical underpinning for disastrous monetary and financial policies.

In recent years, it is increasingly recognised that debauching the monetary medium can only result in inflation and not growth and a large number of central banks are coming out of the closet to openly declare their position that inflation is public enemy No. 1 and that if a country wishes to attain long-term growth, then inflation must be excoriated from the system. Notwithstanding economists holding an eclectic view on the cause of inflation, more and more central banks are recognising that inflation is, and always is a monetary phenomenon. Accordingly, inflation control is becoming the primary if not only mission of a number of central banks.

The debate of the nineteen-thirties and the ascendancy of the Keynesian prescription of pump priming as a means to bring about a revival of an economy provided a legitimacy to the creation of budget deficits in India as it was felt that creating money was a necessary and lasting effective method of increasing output and employment. The Reserve Bank of India was set up a year before the **General Theory** was published and thus from the outset the Bank was afflicted by the problem of the Government having unlimited access to the Reserve Bank to finance its deficits. It is interesting that the origins of fiscal dependence on the Reserve Bank started in a big way with the financing of World War II. The Government of India built up sterling balances in the UK which were blocked and to be used only after the War. Meanwhile, the Government of India had to make payments for goods and services requisitioned for the war effort and therefore resorted to large scale financing of the budget deficit from the central bank. Once the drug of injecting created money in the system was taken there was a demand for larger and larger financing of the budget deficit and the framework of monetisation of the budget deficit which was evolved for the situation of the war became a legitimate source of financing even in a normal situation thereafter. While the Indian authorities did function responsibly and kept their excesses of created money within limits the unfortunate historical distortion has been that the visceral memories of those that had studied the Keynesian prescription of the nineteen-thirties were strong enough to advocate the printing press as the means of squeezing a little more growth out of the economy. One could, with some nostalgia, reminisce that had the Hayekian theory state gained pre-eminence in the nineteen- thirties the Reserve Bank of India would have had an easier life in the first sixty years of its existence!

While the Reserve Bank of India was able to neutralise the excessive fiscal expansions by strong monetary measures, the system was risk prone and the 1990 Gulf crisis and its aftermath put the Indian economy in a total tailspin. In 1990 and 1991 monetary expansion was far too excessive, the fisc was out of control, there was a haemorrhaging of the foreign exchange reserves and a sharp acceleration of inflation well into double digits. As the authorities put through extremely harsh monetary - fiscal measures as part of a stabilisation programme the growth of the economy, which had risen very rapidly in the nineteen-eighties to well over 5 per cent per annum, collapsed - a typical Hayekian upper turning point reaction.

July 1991 marks a watershed in Indian economic history as for the first time a credible programme of economic reform was formulated. The trade and payments system was revamped from a system of subvention to a market determined system; the government undertook a programme to bring the fiscal deficit into control and a comprehensive financial sector reform has been initiated. An integral part of the programme has been the move by Government to borrow from outside the Reserve Bank of India at market related rates of interest which in turn is giving the Reserve Bank of India greater flexibility to use the more efficient indirect instruments of open market operations rather than direct monetary controls. By far the most important part of the reform has been the formal accord between the Government and Reserve Bank, in September 1994 to phase out in a three-year period the automatic monetisation of the budget deficit by the central bank. The stabilisation and reform measures have been yielding significant results. The liberalised trade and payments system together with a credible monetary-fiscal framework has fully restored international confidence. The economy has now got back to a 5 per cent growth path without artificial monetary-fiscal props. Moreover, the Reserve Bank has for the first time set out that the paramount objective of monetary policy is to control inflation and a specific target of a four percentage point reduction in the inflation rate has been set out as the objective of policy. We are of the view that a consistent, predictable and coherent anti-inflationary monetary policy is the best contribution that the Reserve Bank can make in the pursuit of growth of the economy. I do hope that we have learnt the lessons of Hayek and that Professor Gilbert's efforts have not gone in vain.

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