I want to talk about Friedrich Hayek because I believe he is the only person who has seriously rivaled Keynes in terms of business cycle theory, but who is completely forgotten now. Hayek’s motivation was very straightforward. Having been trained in Vienna he was convinced that Walras was absolutely correct. But he also knew that there were business cycles. Therefore the question was: how do you reconcile Walrasian theory with observed business cycles? In fact he went, on his own money, to Columbia, to learn from Wesley Mitchell how to measure business cycles. He then came back to Vienna and became a Director of the Austrian Institute of Business Cycles.

Hayek said, “Obviously there is something in the world which is missing in Walras, and that is money.” But he was convinced that he did not want to be just a “quantitative theory of money” sort of person; he did not want to believe, as in a standard Walrasian model, that money only explained the absolute level of prices. He wanted to trace the impact of money also on micro-economics in a general equilibrium framework, but also with heterogeneous capital. He really set himself a very ambitious program. The only
other person to have done that was Marx, and he also failed, but that’s another story!

The key lay in the Swedish economist Knut Wicksell’s work; he had come across the same problem in reconciling the worlds of Ricardo and Walras. Wicksell’s theory was that capitalism had this cumulative disequilibrium dynamics of business cycles; it was in the nature of capitalism to have cycles. His cycles were related to a gap between the natural rate of interest and the market rate of interest. (Hayek says that the natural rate of interest is actually the rate of profit, but Marx had given profit such a bad name that economists had to find other words for profit rate.) So the natural rate of interest is the profit rate in the economy. And the market rate is the rate at which people can borrow money. If they are equal, then money is neutral, and there is always equilibrium. But once there is a departure between the two, a disequilibrium sets in; if the market rate is below the natural rate there is a cumulative boom, and if the market rate is above it, there is a cumulative deflation.

Ludwig von Mises then took Wicksell’s model and applied it to banking, asking how bankers gave loans to people. (There is no central bank in this lovely world.) He said that the problem is that bankers choose whether to give money to quick-yielding projects or slow-yielding ones. If the market rate is below the natural rate they are tempted to give money to long-yielding projects, because in Austrian theory the longer the production period, the more productive the technology. Hayek assumed that this was the essence of the problem. He modeled the entire economy as a single integrated firm in which labor was the only original factor of production; all capital was produced in the course of the production process (which began with labor alone in the earliest stage to the final consumption goods stage). In a steadily growing world, savings are always increasing, and this allows the technology (the period of production) to get “longer,” that is, more productive. Thus, the integrated economy smoothly