A Review Essay

Michael Polanyi and the Limits of State Intervention in the Economy: Towards a New Approach to the Keynes-Hayek Debate

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Nicholas Wapshott, *Keynes Hayek: The Clash that Defined Modern Economics*. New York: Norton, 2012 pb (2011 hb). Pp. xiv + 382. ISBN: 978-0393343632. $17.95 ($28.95 hb).

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ABSTRACT

This brief essay summarizes Nicholas Wapshott's Keynes Hayek: The Clash that Defined Modern Economics *and relates the early economic thought of Michael Polanyi to the dispute by raising questions for further reflection: Should we classify Polanyian economic thought as Hayekian or Keynesian, or is it something in between? How can it help us better understand the debate between these two? How is the agenda of the economist and social theorist Polanyi revealed through its connection to one of the most important episodes of the history of economic thought in the twentieth century?*

Introduction

Nicholas Wapshott treats a narrow segment of the history of economic thought in the twentieth century which is widely known as the great dispute between John Maynard Keynes, the defender of state intervention, and Friedrich August von Hayek, one of the last crusaders for classical liberal economic policy emphasizing free market economy. This book avoids painting with a broad brush and differentiates between the shades of liberalism, economics and economic policy. It handles with proper distinction the original writings and the secondary literature as well as the influence of economic ideas on ordinary people. While the book does not describe all the economic theories of the era, it sketches the political, social, and economic background of these particular streams of economic thought. In my review I not only evaluate the presentation of the clash between the economic ideas of Keynes and Hayek, but I also position the early economic thought of Michael Polanyi in the Keynes-Hayek debate. I argue that seeing how the economic thought of Polanyi is related to the two thinkers can be revealing and helpful for interpreting one of the most well-known economic disputes of the twentieth century.

Economics, Faith and Influence

Wapshott's book has eighteen chapters. The first sketches the economic, social, and political situation during and soon after World War I. It also colorfully portrays the personal and professional background of Keynes, showing how the talented Cambridge genius turned to economics from mathematics due to the imposing persuasion of Alfred Marshall, one of the key figures of Neoclassical Economics. We also witness how Keynes entered the budgetary line of the war machine, despite his pacifism, and eventually tired of international politics. His unpleasant experience led him to write the witty and quite acrimonious *Economic Consequences of the Peace* (1920), a book that made him astonishingly popular in the eyes of the common person and at the same time an unwelcome guest in a few elite political circles.

Unfortunately, Wapshott lacks the background in advanced theoretical economics to explain the full range of economic thought at this time, or perhaps he simply did not deem it necessary to present schools other than Keynesian and Austrian economics. The latter could be important because—as Mr. Wapshott also points out—even Keynes himself turned to the discipline due to the encouragement of Alfred Marshall, one of the main figures in Neoclassical economics. Marshall cut off the rough edges of the reigning paradigm, which was based on the micro-perspective of the economy and the concept of marginalism. He introduced a new, consistent economic toolset with his *The Principles of Economics* (1890), that became the most widely used university textbook in economics after the reign of Mill's *The Principles of Political Economy* (1848). Marshall introduced four time periods into economic analysis and frequently used *ceteris paribus* methodology to get more accurate results. His work was mainly responsible for turning political economy into economics using mathematical tools and laid down the solid foundation of the Neoclassical school. Nevertheless, he insisted on considering himself a follower of the great predecessors of the Classical school, also reflected in his motto: '*Natura non facit saltum*!' By the time Keynes and Hayek began to fight their battles, the Neoclassical paradigm was mainstream, so I suggest that Wapshott should have more fully described it in his analysis. Similarly, there is an unfair neglect of the economic concepts of the Historical school. Wapshott needs a more colourful palette to portray the economic thought of the twentieth century to clarify the factors influencing the thought of Keynes and Hayek.

The Historical school primarily focused on the inclusion of ethical and social factors in economic thought, the same factors constituting the core of the normative layer of Keynesian economics. Keynes declared that he entered the arena of theoretical and applied economics to support the helpless who were plunged into poverty by the consequences of World War I. His views eventually became popular, partly because of this agenda. Nevertheless, the popularity of all new post-war economic ideas came from the same root. All addressed the burning questions about the contemporary economy: the poverty, unemployment and inflation caused first by the war, then the treaties, and later the Great Depression. People wanted answers they could not provide themselves. And they wanted them quickly. This helps to explain the *raison d'être* for the advancement of newly emerged economic concepts such as Marxian economic thought (a form of socialism which is not equal to the economic thought of Marx as it also includes the writings of his followers as well as the secondary literature on the topic), the economic thought of the Nazis, and Keynesian economics. The only common thread in these three was the increased role of the state in the dynamics of the economy which could also be seen as some kind of liberation of the people from the burden and responsibility of taking care of their own plight. People saw the smallest chance to break out from their terrible situation and grabbed it tightly. What they did not know is that once Pandora's box is open, things soon go out of control. Although the harmful effects of the Nazi and Soviet economic policy were commonly known, only a few people recognized the danger of Keynesianism and even fewer raised their voice against it. One of them was a lesser known Austrian nobleman, Friedrich August von Hayek.

Loyalty, Money and the Rise of the Austrian School

The second and the third chapters focus on Hayek's life and the intellectual road he took after the outbreak of World War I and the emergence of Keynesian economic thought. As a soldier and an ordinary citizen, Hayek experienced the disastrous economic consequences of the war, so when he read Keynes's early book, *Economic Consequences of the Peace* (1920), he welcomed Keynes's bravery in raising his voice against actions that brought about the complete destruction of the economies of the states that lost the war. As Wapshott points out, the argument of Keynes was not only based on social and ethical reasons, but also emphasized that the *Treaty of Versailles* (1919) allowed no seeds for economic growth to sprout among the defeated nations and was altogether unreasonable. For his outspoken views, Keynes was accused of disloyalty by Austen Chamberlain, the British minister of finance. Keynes then turned to monetary issues in his *A Tract on Monetary Reform* (1924), *The Economic Consequences of Mr. Churchill* (a title that echoed his earlier book) of 1925, and *Treatise on Money* (1930), which made the life of monetary policy-makers easier, on the one hand, but harder, on the other. Wapshott argues that Keynes differentiated between savings and investments and thought that the monetary policy of the central bank is the only tool capable of balancing between these two. If investments exceed savings, the result is economic boom; if savings top investments, companies go bankrupt and economic downturn comes with deflation and unemployment.

Although the young Hayek felt the milder version of socialism (*Sozialpolitik* of Rathenau) was close to his views, he unambigously rejected Marxian socialism. After the end of the war, he began to study the economic ideas of Menger, Böhm-Bawerk, Wieser and Ludwig von Mises at the University of Vienna and soon became one of the most influential Austrian economists with a help of one unexpected ally.

In the fourth chapter, we find out that this unexpected ally was Lionel Robbins, who was determined to defy the economists of Cambridge and establish a new bastion of economic thought at the London School of Economics, where he was the head of the Department of Political Economy. Robbins eventually became (after Polanyi came to England in 1933) a friend of Michael Polanyi and, among other things, helped him by reading and commenting on the manuscript of *Full Employment and Free Trade* (1945). Robbins deemed the theories of the Austrian school promising for addressing contemporary economic problems. He thoroughly prepared the scene for someone who—Wapshott argues—might successfully stand up against Keynes and his devoted young acolytes, the "*Cambridge Circus*," which included Joan Robinson and Richard Kahn. Hayek undertook the role of the debater, even though he probably knew this would be a difficult challenge due to his poor English skills and the excellent argumentative skills of Keynes, as well as Keynes's wide popularity.

Hayek, the fifth chapter makes clear, directly walked into the lair of his Cambridge enemies. Before he delivered his 1931 London lectures, which Robbins invited him to do, he accepted an invitation to make a presentation in Cambridge before the Marshall Society, which included many Keynesian economists. His reception in this hostile environment was cold and unfair, in part because the participants did not completely understand Hayek's English, and in part because what they understood they could not criticize properly. This unfortunate Cambridge adventure was followed by an auspicious series of lectures at the LSE and a long-awaited academic job offer from Lionel Robbins, who grew increasingly certain that he found the counter to Keynes he had been looking for.

The Greater Evil and the Keynesian Curse

In chapters six through nine, Wapshott provides a brief outline of the battle between the two economists, beginning with Hayek's sharply critical review of Keynes' *A Treatise on Money* (1930) in the London School of Economic's journal *Economica* (then edited by Lionel Robbins). The end of Hayek's volley promised a second part and was undoubtedly aimed to get Keynes and his followers to take up the gauntlet, which Keynes did. The Keynes—Hayek debate is still considered to be one of the largest fractures in the history of twentieth century economic thought. In the November 1931 *Economica*, Keynes made his riposte which lacked the air of absolute intellectual superiority generally characteristic of his writing; he took the role of an *ad hoc* defender. Keynes admitted that his ideas evolved and that he had thought otherwise about several things in *A Treatise on Money* (1930) than he thought at the time of the publication of the review. His manner of response shattered the sanctity of the belief in Keynesian economics. The "*Cambridge Circus,*" led by Piero Sraffa, launched a counter-attack on Hayek's 26-page review. The rich correspondence between Keynes and Hayek that followed demonstrates that the two also continued the debate in a more informal way. These letters reflect that they both sought to overcome the other by asking for endless comparative explanations of the meaning of the key terms in their theories. Finally, Keynes refused to prolong the public dispute. Rather he used the time to write a better, more consistent and more insightful book, which became his 1936 magnum opus.

Wapshott, as a provocative journalist, treats the clash between Keynes and Hayek as if each is the nemesis of the other and suggests that their endless warfare in theoretical economics shaped the discipline that we today called modern economics. However, he underestimates the fact that Hayek and Keynes were also brothers-in-arms in the "bastion of light," fighting against dictatorship and totalitarian states. Hayek tried to warn Keynes not to play with dark magic he could not completely control, but Keynes refused to take the advice from the Austrian scholar. Keynes's meddling with the market likely prevented the economy from sudden collapse, but it also put the curse of fiscal deficit and public debt on future generations. We can still not shake this debt. Once Keynes prevailed, Hayek was just regarded as the second herald of pessimistic economic thought after Thomas Robert Malthus. If political economy earned the title of "dismal science" because of the undesirable future Malthus predicted in the 19th century, it might have equally justly earned the title of "cold-blooded science" in the twentieth century because of the sober warning of Friedrich August von Hayek. He was convinced that, regarding state intervention, less is always more. Despite any disastrous situation in the economy, he thought we must wait until the new seeds of the market mechanism sprout and balance is resurrected from the ashes of the dead body of post-war economies. In contrast, Keynes thought it was possible and better to create the resurrection through his interventionist policies and not wait for something he cannot contol. Keynes's views soon became the most influential not just in academia, but in shaping the economic policy of many states. His ideas helped build a new international economic order and his advice today flows from leading think tanks. His magnum opus, *The General Theory of Employment, Interest and Money* (1936), has become a classic text.

Keynes, Hayek and Polanyi in Between

As the ninth chapter emphasizes, *The General Theory* was a remarkable success. Keynes used his time wisely and corrected his previous errors. While Keynes was on a lecturing tour in the United States, during which he became more and more influential, Hayek neglected the mission he was chosen for in the first place and did not provide Robbins the review of *The General Theory*, as Wapshott points out in the tenth and eleventh chapters. He rather struggled to write his own definitive book, which proved to be a difficult task for him.

I don't accept Wapshott's statement that the first theoretical exposition of Keynesian economics was *A Guide to Keynes* published in 1953 by Hansen, for Michael Polanyi had published his *Full Employment and Free Trade* eight years earlier in 1945. In his book, Polanyi made it clear that he intended to write for a wide readership with an aim to increase the popularity and acceptance of Keynesian ideas. As with his earlier film, he wanted to foster common knowledge of economic issues. I am disposed to accept Wapshott's argument in the twelfth chapter stating that Hayek's *Pure Theory of Capital* (1940) was by no means as popular as *The General Theory* because it was difficult to read and understand, and it lacked the optimism and easy solutions people were looking for in wartime conditions. I presume that the distance between Polanyi and Hayek increased in the forties as the latter more and more emphasized that he thought that economists should only deal with theoretical problems and leave the practical issues for other professionals. Polanyi accepted the Keynesian adjustment of the money supply by the central bank as he clearly presented the process in his film of 1940, but he also deemed the market mechanism really important as it fosters a dynamic order in the economy. Unlike Keynes, however, he voted against public works and deficit spending as a means of regulating the economy because he recognised the threats of the politically based misappropriations and bureaucratic empire building that Keynes did not want to notice due to his overflowing optimism.

Keynes and Polanyi had a starkly different concept of the public role of economists than Hayek. Keynes regularly gave interviews on the radio and wrote many articles to newspapers seeking to reach ordinary people, while Polanyi made an easily comprehensible film, gave a series of lectures, and published *Full Employment and Free Trade* (1945) with an explicit aim to address a wider audience. Not surprisingly, the number of the followers of Keynesian economics increased day after day, whereas the rather theoretical economic thought of Hayek languished. Hayek's seemingly lost situation was saved by developing his political philosophy with the new method of public persuasion used in the *Road to Serfdom* (1944). As it is described in the thirteenth chapter, Hayek argued that increased state intervention would likely lead to serfdom through the restraint of public liberty and private freedom. In this chapter (as well as in the fifteenth and sixteenth chapters), Wapshott wrongly states that the top-down perspective of economic thinking later named macroeconomics was discovered by Keynes. The theorists of classical political economy also used a similar perspective beginning at the end of the eighteenth century. We may find similar concepts such as the *Tableau Économique* (1766) of the physiocrats in France or the first essays on inflation in the United Kingdom even before that. The shift in the perspective of political economy is commonly linked to the Marginal Revolution when systematic micro-concepts were introduced to economic thinking. The new perspective gave birth to Neoclassical economics in the last quarter of the nineteenth century, which was greatly improved by Alfred Marshall, who also steered the scientific interest of the young Keynes towards economics. Keynesian economics ought not be seen as the first appearance of macroeconomics, but rather as a successful re-engineering of the earlier perspectives with new methods uniting the abstract mathematical toolset of the Marshallian legacy with his own pragmatic genius.

The fourteenth chapter shows how Hayek became the leading figure of the handful of social theorists who intended to save classical liberalism. They persevered even though the climate of opinion was really malevolent for them. Hayek established the Mont Pélerin Society where he met with fellow thinkers with similar beliefs and attitudes, including Ludwig von Mises, Lionel Robbins, Frank Knight, George Stigler, Milton Friedman, Fritz Machlup, John Jewkes, Michael Polanyi, and Karl Popper. At this point a distinction must be made. As Mr. Wapshott states several times, Keynes also thought himself a liberal, and some of his remarks are without doubt liberal even in the traditional sense. It must be noted here that the liberalisms of Keynes, Hayek and Polanyi are not the same. I think this topic would require a thorough analysis which would exceed the frame of this review. In any case, plenty of differences can be found between the classical, laissez-faire based liberal political economy and the one Keynes and his followers forged.

Michael Polanyi comes into the picture at this point. Polanyi came from a similar cultural background as Hayek. The two were called to the same army under the flag of the Austro-Hungarian monarchy during World War I and witnesssed all the maleficent collateral effects of warfare economies as well as the sudden economic shock experienced in the post-war era. Later they corresponded on many topics including economics. They both worked in the United Kingdom as professors (Hayek at the London School of Economics, Polanyi at the University of Manchester) and tried to save liberalism during the two world wars and afterwards in the Mont Pélerin Society. They agreed as critics of the Soviet economy and the totalitarian state, but disagreed on how to build a better and brighter tomorrow. As a consequence of the triumph of Keynesian economic thought, Michael Polanyi turned from being a thoughtful laissez-faire supporter to a mild Keynesian, which certainly affected his relation with Hayek. Although the Polanyian turn was radical and the faith he had in Keynesian economics was quite firm, he saw the danger of the increasing economic power of the state and offered his own remedy for the Keynesian curse: economics education. To realize his agenda, he published *Full Employment and Free Trade* (1945), which he intended to be an interpretation of Keynesian economics with some unique remarks. He did not accept public works and deficit spending. Rather the flow of money in the economy impressed him, reminding him of the movement of fluids in chemical experiments, and regulating this flow shaped his understanding of economic management.

In 1920, Keynes wrote *The Economic Consequences of the Peace*, which was addressed to a wide audience. Then he focused on works with more complex and technical arguments, which were written primarily to convince economists about his ideas and therefore lacked the simplicity which is essential to reach a lot of people. Fortunately, many followed the footsteps of Keynes, so the secondary literature on his ideas is really vast. Not so fortunately, scientific integrity was often overwritten by simplicity. The essence of the great dispute between Keynes and Hayek is rooted in their fundamentally different attitude towards people, as Wapshott properly states. Wapshott sees Hayek as more pessimistic about people. He doubted that the state bureaucracy could take on more responsibility as it only consists of self-interested individuals, whereas Keynes was rather optimistic about the skill and character of people as well as the efficiency of state intervention. Polanyi thought that spontaneous order is unambiguously better than any kind of corporate order or authoritative guidance for governing economic processes efficiently. However, he saw that the process of spontaneous re-engineering could not start up by itself, so in a depression the economy needs a boost to get its circulation running again. Eventually, he accepted the Keynesian treatment, but only with the restrictions mentioned before.

I argue that the early economic thought of Michael Polanyi is important for gaining a deeper understanding of the Keynes-Hayek debate, because in some ways he was the middleman between the two. He was part of the Mont Pélerin Society and a wholehearted liberal who contributed to the advancement of liberal philosophy in its darkest hours. At the same time, he was a convinced Keynesian on a quest to make economics education better in order to create more educated people who could take responsibility and decide whether the state is running things as it should. He thought that people can be educated in economics in order to be able to make better decisions and provide better checks on the state, which is a rather optimistic view, but he also thought they should be aware of the increasing role of the bureaucracy, which is obviously pessimistic.

The Aftermath of the Keynes-Hayek Debate

The fifteenth chapter underlines that the triumph of Keynesian economic thought continued after the death of Keynes in 1946 and influenced the economic policy of many states, including the United States and the United Kingdom, between 1946-1980. As Wapshott indicates in the sixteenth chapter, Hayekian economic thought mostly influenced economic policy in the Thatcher and Reagan administrations. This might be considered as a milestone, as previously Hayekian thought did not go maintream, nor did it influence significantly practical economic issues. Rather, it remained on a theoretical and academic level. These two chapters are more concerned with economic policy than economics, and while they give us an insightful and fascinating look at the political history and the dynamics of the economic policies of the second part of the twentieth century, they are not an adequate introduction to the advancement of theoretical economics.

As we witness in the last two chapters, the two streams of economic thought continued to oppose each other not only at a theoretical level, but also competed to become more influential in economic policies. Recently the two schools clashed for the role of the saviour from the financial crisis of 2008, and I must agree with Wapshott when he states that the final outcome of the battle is yet undecided. The theories nowadays seem so fragmented that soon new principles might emerge to interlink the remnants of the almost forgotten intellectual warfare and create new consistent theoretical frames from the latter. The economic thought of Michael Polanyi might also help us better to understand and resolve oppositions in the Keynes-Hayek debate. Polanyi undoubtedly turned to Keynesian economics and in some cases accepted state intervention to foster economic growth despite his commitment to spontaneous order and liberalism. He intended to save liberalism from the looming shadow of authoritarianism and continuously looked for solutions to fulfill his mission. Polanyi, Keynes and Hayek all fought for this noble aim, but took different roads toward what they deemed best for society.

Wapshott's book offers us an exciting and colourful journey into one of the greatest debates of the economic thought of the twentieth century. It is therefore excellent for those who have a little or no background in economics or who are more interested in economic policy than economics. He emphasizes the difference between Keynesian and Hayekian economic thought, but forgets that they were also associates with others in the war to save liberalism from the greatest contemporary ideological threats. I therefore strongly recommend this book for those particularly interested in the economic policy of the United States and the United Kingdom in the second part of the twentieth century, but who are not particularly interested in the theoretical and ideological background of these. For those who are deeply interested in theoretical economics or the history of economic thought, I only recommend this book as an admittedly stirring and picturesque outline of a quite narrow segment of modern economics.

ENDNOTES

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