

## **Friedman, Keynes and Hayek**

Milton Friedman, John Maynard Keynes and Friedrich Hayek: the three great famous economists from the middle decades of the 20th century. What were the similarities and differences between them, and how do they stand in the discipline of economics as it develops in the 21st century?

All three were tremendous self-publicists. Keynes had a long involvement in public policy advocacy. Hayek's 1944 book *The Road to Serfdom* sold an incredible 2m copies. Friedman's *Free to Choose* was the bestselling non-fiction book of 1980. All were iconoclasts, never afraid to challenge the conventional wisdom, whether within academia or more widely.

Many of the obituaries of Friedman have focused on his work on monetary policy, on his assertion that inflation, in the long run, is purely a monetary phenomenon. But his monetary work was just one of three areas explicitly mentioned in his Nobel prize citation in 1976. Just as well, because economists and policymakers have subsequently qualified Friedman's hypothesis very substantially. His theory of consumption, probably Friedman's major academic contribution, implied that as rich people save a higher proportion of their income than poor people, the proportion of overall income saved should rise as average incomes do. But this theory has even less empirical support than Friedman's monetary work. If anything, personal savings as a proportion of income have fallen since Friedman put forward his hypothesis in 1957.

Friedman's final Nobel citation was for demonstrating "the complexity of stabilisation policy". It is in this area where his relationship to Hayek and Keynes is most instructive. Friedman argued that it is very difficult for governments to control fluctuations in output and employment. He developed this view at a time when the overwhelming consensus was that he was wrong. These short-run fluctuations, the "business cycle," have been a fundamental feature of western market economies ever since the industrial revolution. But contrary to popular perception, Friedman's position here was very similar to that of both Hayek and Keynes.

In his *General Theory*, Keynes argued that firms' investment decisions were subject to great uncertainty: "the outstanding fact is the extreme precariousness of the basis of knowledge on which our estimates of prospective yield [of a new investment] have to be made." He emphasised that, in the context of the booms and busts of western economies, "it is our innate urge to activity which makes the wheels go round, our rational selves choosing between alternatives as best we can, but often falling back for our motive on whim or sentiment or chance." The synthesis which became "Keynesianism" after Keynes's death in 1946 actually resulted from the efforts of more orthodox economists to force Keynes's theories back into the mainstream.

Hayek believed that the business cycle was even more deeply rooted in individual behaviour. Individual decision-makers form plans under conditions of inherent uncertainty about the future. These plans may be disrupted by external shocks (oil price increases are a modern example). But more fundamentally, it is almost impossible for these various plans to be compatible with one another, regardless of whether shocks are experienced or not. Firms lack knowledge about the future, and their plans cannot be coordinated in advance. So irregular and unexpected fluctuations in total output are inevitable.

So all three believed that the business cycle was extremely difficult to predict and control. Here, the evidence is in Friedman's favour. We now have a track record of over 30 years of economic forecasts for growth and inflation, carried out by both public and private bodies. In general, the average error of these forecasts over time is smaller than the size of the variable being predicted. But it remains large compared to the actual data, and most of the accurate forecasts are made when economic conditions are relatively stable. Forecasts are at their least accurate exactly when they are most needed, at turning points in the economy. And the forecasting record shows little sign of improvement over time. Without accurate forecasts, successful stabilisation policy is not possible.

So Friedman, Keynes and Hayek all identify the problem. It is in their prescriptions of what should be done that they part company.

Here, Keynes and Friedman are bedfellows. Both believed that suitably empowered clever chaps could work out rules of behaviour that would smooth the fluctuations of the business cycle. Friedman came up with the rule of an independent central bank controlling the expansion of money at a fixed rate. Keynes essentially thought that if he and other old Etonians were put in charge, everything would be fine. At the end of the *General Theory*, he writes, "I conclude that the duty of ordering the current volume of investment cannot safely be left in private hands." But Hayek sharply disagreed. He believed that there are inherent limits to knowledge in human social and economic systems which no amount of intellect can overcome.

Developments in economics are taking the subject in the direction of Hayek rather than Friedman and Keynes. The burgeoning areas of behavioural and experimental economics confirm that, for the most part, decision-makers reason poorly and act intuitively rather than rationally. Theoretical models in which actors have very limited, or even zero, understanding of how their environment operates are having striking success in explaining a wide range of phenomena.

Friedman was a brilliant polemicist. He had several highly original ideas about how economies work. Most have proved to be wrong, but at least he had them. And in the one area where he was proved correct, he exercised great influence on policymakers. But even in this area, Hayek's insights go much deeper and offer a better framework for the research programmes of the 21st century.