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The Collected Works of F.A. Hayek, Vol. 12: The Pure Theory of Capital

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This book, the 12th of a planned 19 volumes of F.A. Hayek's writings from the University of Chicago Press, is a very difficult one indeed. Hayek himself recognized that *The Pure Theory of Capital* (*PTC*) was a failure (Desai, 2006). The book, originally published in 1941, was intended to be the first installment of a project to integrate capital theory, monetary theory, dynamic equilibrium and the Austrian theory of the trade cycle along lines consistent with the 'Wieserian' branch of the Austrian School, i.e., the branch that, following Böhm-Bawerk, engaged general equilibrium theory, as opposed to the 'Misian' branch, which did not. Hayek's 'interests began to wonder to other topics' before he completed the project (Kresge & Wenar, 1994, p. 79).

As is well known, Hayek abandoned his work on money and the trade cycle in the early 1940s, when he moved on to epistemology and his 'abuse of reason project', stemming from his 1945 *American Economic Review* article on 'Use of Knowledge in Society' (the work Hayek considered his most significant contribution to economics). *PTC* was almost completely ignored at the time of its original publication, a victim of bad timing: economists were preoccupied with war work and with the controversial new theory of Keynes. That said, it should be noted that *PTC* addresses Keynesian economics head-on, with a critique of the short-termism and over-simplified assumptions of liquidity preference theory.

This edition of *PTC* is ably edited by the monetary economist Lawrence H. White, whose Introduction places the book in historical context and in relation to Hayek's life's work. White's footnotes to the text ground Hayek's ideas in relation to contemporary and later economic theory, correct bibliographical errors in the original edition, and provide missing references. The volume includes Hayek's three original appendices: one in which Hayek differentiates his work on time-preference from Böhm-Bawerk's views, and the other two using disaggregation to critique, first, the classical treatment of circulating and fixed capital, and second, J.S. Mill's doctrine that 'the demand for commodities is not the demand for labor.' This new edition also reproduces Hayek's brief rejoinder to Friedrich Lutz's *Economica* review of *PTC*; and a 1943 'reconsideration' of time-preference and productivity.

Despite Hayek's disappointment with the book, *PTC* should be respected as the rigorous work of a master. The book's main theoretical advance from his *Prices and Production* is the introduction of heterogeneous capital. Hayek's failure to find a clear way to explicate his conception of dynamic equilibrium led him to disavow the possibility of defining the 'average period of production'—the cornerstone of Austrian capital theory—when the time horizon is infinite and a continuous input-continuous output production framework is assumed. Yet, despite this turn in Austrian School doctrine there are those (including this reviewer) who still believe the average period of production, when applied to discrete moments of time using accounting data based on historical cost, is a useful proxy measure for capital deepening and time-preference. If we take the 'volume' of intermediate goods measured at their historic value based on Generally Accepted Accounting Principles we may indeed derive an average period based on accounting units (inventory, goods in process, manufacturing machinery, factories, research and development) at a moment in time, evaluated over discrete periods, albeit a concept far removed from intertemporal general equilibrium theory.

The first three parts of *PTC* are on the 'real economy'; in these sections, Hayek abstracts from money, and the interest rate is presumed to coincide with the profit rate. As usual, Hayek is very precise in defining his terms. 'Pure capital' is the capital that is required to maintain a constant income stream of real goods; it is differentiated from 'produced means of production' by the inclusion of 'wasting natural resources' (*PTC*, p. 275n). Furthermore, 'Equilibrium requires that the total value of the product shall be equal to the value of the input *plus* interest on every unit of the input, for the known period for which it is invested, at a rate which is equal to that ruling in the system' (p. 201). These are Hayek's requirements for 'pure equilibrium analysis.'

Following the method established in *Prices and Production*, but now including the time dimension of more roundabout stages of production, Hayek then shows how various shocks to the system affect consumption and investment. These exogenous shocks include, but are not limited to: changes in preferences for consumer goods; distributional shocks from policy and monopoly (by which Hayek meant labor unions); and technological changes.

Hayek introduces money in Part IV, The Rate of Interest in a Money Economy, the part of *PTC* that has received the most criticism. Hayek himself acknowledged that his monetary analysis is incomplete: 'A full discussion of the whole complex of problems involved would require another book about the same size as this one—even supposing that, in the present state of our knowledge, any such systematic and exhaustive treatment of these as yet imperfectly explored problems could be attempted successfully' (p. 324). In this section of the book Hayek proposes a long-run chain of causality in which time-preference determines saving, which determines the real rate of profit, which then determines the money interest rate. The exogenous shocks considered by Hayek that might affect consumption and the capital structure include monetary expansion, changes in the profitability of techniques, and changes in the 'credit superstructure', i.e., technological advances in the financial system that reduce the preference to hold money. Hayek's discussion of the ambiguity and interconnectedness of the concepts of the quantity and velocity of money in the classical equation of exchange is insightful and thorough.

Hayek took seriously his 1932 exchange with Piero Sraffa on *Prices and Production* in the *Economic Journal*. In *PTC* Hayek directly addresses specific points raised by Sraffa. One of Sraffa's main targets was Hayek's use of the 'neutrality' of money to assume away any need for analysis of money-created disequilibrium. In *PTC* Hayek writes that 'Money is of course never "neutral" in the sense of being merely an instrument or a servant: it always exercises some positive influence on the course of events' (p. 366). Sraffa's complaint that Hayek ignores price stickiness is addressed through the notion of 'asset specificity' and via extensive discussions on how 'forced savings'—money shocks that reduce consumption by encouraging more roundabout investment—can lead to the destruction of capital when inflationary policies end.

Editor Lawrence White's running commentary shows the relevance of Hayek's work for modern economic theorizing. To take two examples at random: on pp. 92−93, fn 11, White points out how Hayek's use of 'more or less time-consuming' techniques relates to the re-switching debates of the 1960s; and then, on p. 95, fn 15, White notes that land is the missing element in Hayek's comment that 'durable goods' is a misnomer under a general theory of pure capital where only non-wasting natural resources are 'durable'. White, an able historian of thought as well as a monetary theorist, clarifies for the reader some of Hayek's more confusing prose.

I do have one quibble, however, concerning White's statement that Hayek 'was ambivalent toward laissez-faire banking' because he believed that 'the supply of commercial-bank-issued money is elastic, in a way that leads the banking system to amplify business cycles' (p. 355, fn 19). This may have been true at the time Hayek was working within the general equilibrium framework, but later in life he exhibited no ambivalence at all on the issue; in 1977 he declared himself 'more convinced than ever that if we ever again are going to have a decent money, it will not come from government: It will be issued by private enterprise, because providing the public with good money which it can trust and use can not only be an extremely profitable business; it imposes upon the issuer a discipline to which government has never been and cannot be subject' (see Kresge, 1999, p. 230).

Hayek ends *PTC* with a warning that is of particular relevance in today's world of Quantitative Easing and a Federal Reserve System with a multi-trillion dollar balance sheet.

> I cannot help regarding the increasing concentration on short-term effects—which in this context amounts to the same thing as a concentration on purely monetary factors—not only as a serious and dangerous intellectual error, but as a betrayal of the main duty of the economist and a grave menace to our civilization. … Are we not even told that, 'since in the long run we are all dead', policy should be guided entirely by short-run considerations? I fear that these believers in the principle of *après nous le déluge* may get what they have bargained for sooner than they wish. (pp. 368 − 369)

One of Hayek's aims in *PTC* was to demonstrate the unintended consequences of interventionist monetary policy. His specific recommendations for reform in terms of competitive currency issuance did not come until many years later.

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