FULL EMPLOYMENT, PLANNING AND INFLATION

By F. A. HAYEK

The contributor of this article, Professor F. A. Hayek, is world-renowned as the author of "The Road to Serfdom". This book, which was published in 1944, was the first comprehensive top-level intellectual assault on the socialist position and perhaps created more stir than any politico-economic publication of the day. For this reason, Professor Hayek probably stands out more than any other figure as the champion of individualism against the pronounced collectivist tendencies of the last decade.

Professor Hayek was born in Austria; he served in the Austrian Civil Service from 1921 to 1926, and as Director of the Austrian Institute for Economic Research from 1927 to 1931. From 1931 until just recently, when he took up a position at the University of Chicago, he was Professor of Economic Science and Statistics at the London School of Economics.

In this article Professor Hayek makes an important new contribution to the present-day problems of overall government planning and inflation which have accompanied the policies of full employment in many countries. The Institute is proud to have the first opportunity of publishing this paper by so distinguished an authority.

I

IN the five years that have elapsed since the war, central planning, "full employment," and inflationary pressure have been the three features which have dominated economic policy in the greater part of the world. Of these only full employment can be regarded as desirable in itself. Central planning, direction, or government controls, however we care to call it, is at best a means which must be judged by the results. Inflation, even "repressed inflation," is undoubtedly an evil, though some would say a necessary evil if other desirable aims are to be achieved. It is part of the price we pay for having committed ourselves to a policy of full employment and central planning.

The new fact which has brought about this situation is not a greater desire to avoid unemployment than existed before the war. It is the new belief that a higher level of em-

ployment can be permanently maintained by monetary pressure than would be possible without it. The pursuit of a policy based on these beliefs has somewhat unexpectedly shown that inflation and government controls are its necessary accompaniments—unexpected not by all, but by probably the majority of those who advocated those policies.

Full employment policies as now understood are thus the dominant factor of which the other characteristic features of contemporary economic policy are mainly the consequence. Before we can further examine the manner in which central planning, full employment, and inflation interact, we must become clear about what precisely the full employment policies as now practised mean.

II

Full employment has come to mean that maximum of employment that can be brought about in the short run by monetary pressure. This may not be the original meaning of the theoretical concept, but it was inevitable that it should have come to mean this in practice. Once it was admitted that the momentary state of employment should form the main guide to monetary policy, it was inevitable that any degree of unemployment which might be removed by monetary pressure should be regarded as sufficient justification for applying such pressure. That in most situations employment can be temporarily increased by monetary expansion has long been known. If this possibility has not always been used, this was because it was thought that by such measures not only other dangers were created, but that long term stability of employment itself might be endangered by them. What is new about present beliefs is that it is now widely held that so long as monetary expansion creates additional employment, it is innocuous or at least will cause more benefit than harm.

Yet while in practice full employment policies merely mean that in the short run employment is kept somewhat higher than it would otherwise be, it is at least doubtful whether over longer periods they will not in fact lower the level of employment which can be permanently maintained without progressive monetary expansion. These policies are however constantly represented as if the practical problem

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were not this but as if the choice were between full employment thus defined and the lasting mass unemployment of the nineteen-thirties.

The habit of thinking in terms of an alternative between "full employment" and a state of affairs in which there are unemployed factors of all kinds available is perhaps the most dangerous legacy which we owe to the great influence of the late Lord Keynes. That so long as a state of *general* unemployment prevails, in the sense that unused resources of *all* kinds exist, monetary expansion can be only beneficial, few people will deny. But such a state of general unemployment is something rather exceptional, and it is by no means evident that a policy which will be beneficial in such a state will also always and necessarily be so in the kind of intermediate position, in which an economic system finds itself most of the time, when significant unemployment is confined to certain industries, occupations, or localities.

Of a system in a state of general unemployment it is roughly true that employment will fluctuate in proportion with money income, and that if we succeed in increasing money income we shall also in the same proportion increase employment. But it is just not true that all unemployment is in this manner due to an insufficiency of aggregate demand and can be lastingly cured by increasing demand. The causal connection between income and employment is not a simple one-way connection so that by raising income by a certain ratio we can always raise employment by the same ratio. It is all too naive a way of thinking to believe that, since, if all workmen were employed at current wages, total income would reach such and such a figure, therefore, if we can bring income to that figure, we shall also necessarily have full employment. Where unemployment is not evenly spread, there is no certainty that additional expenditure will go where it will create additional employment. At least the amount of extra expenditure which would have to be incurred before the demand for the kind of services is raised which the unemployed offer, may have to be of such a magnitude as to produce major inflationary effects before it substantially increases employment.

If expenditure is distributed between industries and occupations in a proportion different from that in which labour is distributed, a mere increase in expenditure need not increase employment. Unemployment can evidently be the consequence of the fact that the distribution of labour is different from the distribution of demand. In this case the low aggregate money income would have to be considered as a consequence rather than as a cause of unemployment. Even though, during the process of increasing incomes, enough expenditure may "spill over" into the depressed sectors temporarily there, to cure unemployment, as soon as the expansion comes to an end, the discrepancy between the distribution of demand and the distribution of supply will again show itself. Where the cause of unemployment *and* of low aggregate incomes is such a discrepancy, only a re-allocation of labour can lastingly solve the problem in a free economy.

III

This raises one of the most crucial and most difficult problems in the whole field; is an inappropriate distribution of labour more likely to be corrected under more or less stable or under expanding monetary conditions? This involves in fact two separate problems; the first is, whether demand conditions during a process of expansion are such that, if the distribution of labour adjusted itself to the then existing distribution of demand, this would create employment which would continue after expansion has stopped; the second problem is whether the distribution of labour is more likely to adapt itself promptly to any given distribution of demand under stable or under expansionary monetary conditions, or, in other words, whether labour is more mobile under expanding or under stable monetary conditions.

The answer to the first of these questions is fairly clear. During a process of expansion the direction of demand is to some extent necessarily different from what it will be after expansion has stopped. Labour will be attracted to the particular occupations on which the extra expenditure is made in the first instance. So long as expansion lasts, demand there will always run a step ahead of the consequential rises in demand elsewhere. And in so far as this temporary stimulus

to demand in particular sectors leads to a movement of labour, it may well become the cause of unemployment as soon as the expansion comes to an end.

Some people may feel doubt about the importance of this phenomenon. To the present writer it seems the main cause of the recurrent waves of unemployment. That during every boom period a greater quantity of factors of production is drawn into the capital goods industries than can be permanently employed there, and that as a result we have normally a greater proportion of our resources specialised in the production of capital goods than corresponds to the share of income which, under full employment, will be saved and be available for investment, seems to him the cause of the collapse which has regularly followed a boom. Any attempt to create full employment by drawing labour into occupations where they will remain employed only so long as credit expansion continues, creates the dilemma that either credit expansion must be continued indefinitely (which means inflation), or that, when it stops, unemployment will be greater than it would be if the temporary increase in employment had never taken place.

If the real cause of unemployment is that the distribution of labour does not correspond with the distribution of demand, the only way to create stable conditions of high employment which is not dependent on continued inflation (or physical controls), is to bring about a distribution of labour which matches the manner in which a stable money income will be spent. This depends of course not only on whether during the process of adaptation the distribution of demand is approximately what it will remain, but also on whether conditions in general are conducive to easy and rapid movements of labour.

IV

This leads to the second and more difficult part of our question, to which, perhaps, no certain answer can be given, though the probability seems to us to point clearly in one direction. This is the question whether workers will on the whole be more willing to move to new occupations or new localities when general demand is rising, or whether mobility

is likely to be greater when total demand is approximately constant. The main difference between the two cases is that in the former the inducement to move will be the attraction of a higher wage elsewhere, while in the second case it will be the inability to earn the accustomed wages or to find any employment in the former occupation which will exercise a push. The former method is, of course, the more pleasant, and it is usually also represented as the more effective. It is this latter point which I am inclined to question.

That the same wage differentials, which in the long run would attract the necessary greater number of new recruits to one industry rather than another, will not suffice to tempt workers already established in the latter to move, is in itself not surprising. As a rule the movement from job to job involves expenditure and sacrifices which may not be justified by a mere increase in wages. So long as the worker can count on his accustomed money wage in his current job, he will be understandably reluctant to move. Even if, as would be inevitable under an expansionist policy which aimed at bringing about the adjustment entirely by raising some wages without allowing others to fall, the constant money wages meant a lower real wage, the habit of thinking in terms of money wages would deprive such a fall of real wages of most of its effectiveness. It is curious that those disciples of Lord Keynes, who in other connections make such constant use of this consideration, regularly fail to see its significance in this context.

To aim at securing to men who in the social interest, ought to move elsewhere, the continued receipt of their former wages can only delay movements which ultimately must take place. It should also not be forgotten that in order to give all the men formerly employed continued employment in a relatively declining industry, the general level of wages in that industry will have to fall more than would be necessary if some of the workers moved away from it.

What is so difficult to understand here for the layman is that to protect the individual against the loss of his job may not be a way to decrease unemployment but may over longer periods rather decrease the number which can be em-

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ployed at given wages. If a policy is pursued over a long period which postpones and delays movements, which keeps people in their old jobs who ought to move elsewhere, the result must be that what ought to have been a gradual process of change becomes in the end a problem of the necessity of mass transfers within a short period. Continued monetary pressure which has helped people to earn an unchanged money wage in jobs which they ought to have left will have created accumulated arrears of necessary changes which, as soon as monetary pressure ceases, will have to be made up in a much shorter space of time and then result in a period of acute mass unemployment which might have been avoided.

All this applies not only to those maldistributions of labour which arise in the course of ordinary industrial fluctuations, but even more to the task of large scale re-allocations of labour such as arises after a great war or as a result of a major change in the channels of international trade. It seems highly doubtful whether the expansionist policies pursued since the war in most countries have helped and not rather hindered that adjustment to radically changed conditions of world trade which have become necessary. Especially in the case of Great Britain the low unemployment figures during recent years may be more a sign that necessary change has been delayed than of true economic health.

The great problem in all those instances is whether such a policy, once it has been pursued for years, can still be reversed without serious political and social disturbances. As a result of these policies, what not very long ago might merely have meant a slightly higher unemployment figure, might now, when the employment of large numbers has become dependent on the continuation of these policies, be indeed an experiment which politically is unbearable.

V

Full employment policies as at present practised attempt the quick and easy way of giving men employment where they happen to be, while the real problem is to bring about a distribution of labour which makes continuous high employment without artificial stimulus possible. What this distribu-

tion is we can never know beforehand. The only way to find out is to let the unhampered market act under conditions which will bring about a stable equilibrium between demand and supply. But the very full employment policies make it almost inevitable that we must constantly interfere with the free play of the forces of the market and that the prices which rule during such an expansionary policy and to which supply will adapt itself, will not represent a lasting condition. These difficulties, as we have seen, arise from the fact that unemployment is never evenly spread throughout the economic system, but that at the time when there may still be substantial unemployment in some sectors, there may exist acute scarcities in others. The purely fiscal and monetary measures on which current full employment policies rely are, however, by themselves indiscriminate in their effects on the different parts of the economic system. The same monetary pressure which in some parts of the system might merely reduce unemployment will in others produce definite inflationary effects. If not checked by other measures, such monetary pressure might well set up an inflationary spiral of prices and wages long before unemployment has disappeared, and—with present nation-wide wage bargaining—the rise of wages may threaten the results of the full employment policy even before it has been achieved.

As is regularly the case in such circumstances, the governments will then find themselves forced to take measures to counteract the effects of their own policy. The effects of the inflation have to be contained or "repressed" by direct controls of prices and of quantities produced and sold: the rise of prices has to be prevented by imposing maximum prices and the resulting scarcities must be met by a system of rationing, priorities and allocations.

The manner in which inflation leads a government into a system of overall controls and central planning is by now too well known to need elaboration. It is usually a particularly pernicious kind of planning, because not thought out beforehand but applied piecemeal as the unwelcome results of inflation manifest themselves. A government which uses

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inflation as a means of policy but wants it to produce only the desired effects is soon driven to control ever increasing parts of the economy.

VI

The connection between inflation and controls and central planning is however not only a one-way connection. That inflation leads to controls is nowadays widely seen. But that once an economic system has become cluttered up and encumbered with all sorts of controls and restrictions, continued inflationary pressure is needed to keep it going is not yet generally understood but no less important. It is indeed a fact of crucial importance for the understanding of the self-perpetuating and self-accentuating character of the modern tendencies in economic policy.

Since the measures intended to counteract inflation are designed to damp the uplift which the inflationary stimulus would cause, it is inevitable that they should also act as a damper to the spontaneous forces of recovery as soon as the inflationary pressure is relaxed. If most of the post-war economies do not show a greater resiliency and spontaneous strength, this is largely due to the fact that they are smothered by controls and that, whenever improvement flags, instead of a removal of all those hindrances an even stronger dose of inflation is demanded which sooner or later leads to further controls.

This tendency of the existing controls to produce a further demand for inflationary pressure is especially important in view of the widely held view that, if only the inflationary tendencies could be brought under control, the restrictive measures will subsequently prove unnecessary and readily be removed. If the connection between inflation and controls is a mutual one as here suggested, this view would prove to be incorrect and to act on it necessarily lead to failure. Unless the controls are removed *at the same time* when expansion is discontinued, the pressure for its resumption will probably be irresistible as soon as the deadening effect of the controls makes itself felt.

An economy paralysed by controls needs the extra stimulus of inflation to keep going at anything near full rate. Where

the controls deprive the entrepreneur of all scope for initiative, freedom of choice and the assumption of responsibility, where the government in effect decides what and how much he is to produce, he must at least be assured of a certain sale if it is to be worth his while to carry on. It is because extensive government controls have almost always been accompanied by more or less inflationary conditions that they have not as completely paralysed all economic activity as seems inevitable to the outside observer, who learns of the maze of permits and licences through which any manufacturer who wants to do anything has to find his way.

To such an observer it seems at first impossible that an entrepreneur so largely deprived of the control of his costs and the nature and the quantity of his products should still be willing to run any risks. The answer is that he is in fact relieved of the main risk by the creation of conditions in which almost anything which can be produced can also be sold. The inefficiency of such a "planned economy" is concealed by the effects of inflation.

But as soon as inflationary pressure disappears the whole force of all these impediments to successful production makes itself felt. The very controls which in the first instance were imposed to keep the effects of inflation under control make it thus more difficult to stop inflation. If, while the controls remain, stable monetary conditions were restored, unemployment would at once make its appearance. The impression would be created that continued expansion is an indispensable condition for maintaining a high level of employment, while in fact what is needed is the removal of the controls which hamper trade, even if as a result some of the hitherto concealed effects of inflation should become apparent.

VII

If these considerations are correct, they cannot but make one feel very pessimistic about the prospects of a reasonable economic policy being adopted in the foreseeable future. In the present state of public opinion they are most unlikely to be listened to. The habit of inflation has often been compared to the addiction to a stimulating drug. But the position of a society which has become addicted to the drug of

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inflation is even worse than that of an individual in the corresponding case. One has to conceive of a position in which the administration of, say, morphium to sufferers were to be decided under the influence of mass psychology and where every demagogue who knows just a little more about these things than the crowd would be able to offer an effective means to relieve present suffering while the more remote harm his remedy causes is understood only by few.

The rapidity with which the full employment ideology has taken hold of public imagination, the manner in which in the course of the process a subtle although probably mistaken theoretical reasoning has been turned into a crude dogma, and not last the way in which certain bigots of the new doctrine who ought to know better represent the issue as if it were a choice between long lasting mass unemployment and the wholesale application of their prescriptions, make one sometimes despair about one of the gravest issues of our time: the capacity of democratic institutions to handle the tremendous powers for good and evil which the new instruments of economic policy place into their hands.

If the outcome of economic policy is not to be altogether different from what has been desired, if we are not to be driven from one expedient to another, economic policy more even than any other must be long range policy, governed less by the pressing needs of the moment than by an understanding of the long period effects. It was certainly wise that at a time when the scope and objectives of monetary policy were much more limited, its direction was placed in the hands of bodies not directly subject to political control. It is understandable and perhaps inevitable that once the much greater use of these powers is recognised, it should become a major political issue. But it must appear more than doubtful whether in the nature of democratic institutions it is possible that democratic governments will ever learn to exercise that restraint, which is the essence of economic wisdom of not using palliatives for present evils which not only create worse problems later but also constantly restrict the freedom of further action.