

Methodological individualism, economic behaviour and economic policy

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Introduction

Two issues have occupied economic thought in the recent past: the appropriate method to approach economic problems and the effectiveness of economic policy, particularly those policies that aim at reducing inflation and unemployment. An increasing number of books, new scientific journals and many articles have been published in the last two decades devoted exclusively to methodological and economic policy issues.

There is a general dissatisfaction in the economics profession regarding both issues. No method nor any policy has succeeded in persuading the majority of the economics profession. The discussion on the appropriate methodology and effective economic policy has become very vocal and a number of approaches and policies have surfaced. Hayek's version of methodological individualism along with his peculiar, to say the least, policy recommendations have attracted a lot of attention[1]. Hayek explicitly links his methodology to current economic policy issues[2].

How should economic policy be conducted when individual economic behaviour is consistent with the postulates of methodological individualism? Methodological individualism has been proposed by Hayek as a method to study society. It glorifies atomistic behaviour, putting emphasis on the idiosyncratic nature of information and knowledge. On the other hand, it condemns social action as a conscious attempt to change society. Economic policy is such an attempt and is doomed not only to fail but eventually to make things worse by misdirecting resources (creating an economic disorder). The reason is that social formations (institutions) have been established through time by a myriad individual actions that no (individual) central authority could have been able to design. And, what is more important, no central authority could affect them for the benefit of the society.

Two points are emphasised in this paper. First, Hayek's methodological individualism as it is applied to individual actions is basically correct and it should be considered as an important alternative (complement) to any economic paradigm at both micro and macro level[3]. Second, the application of his methodological approach to economic policy issues is very simplistic[4]. For example, his explanation of unemployment is monistic and very simple.

Contrast this with his methodological claim that all social phenomena are very complex. Unemployment is a complex phenomenon with many causes and consequences. Hayek's explanation of unemployment is close to structural unemployment when there are some impediments to relative price and wage changes. Unemployment is a complex phenomenon and it is caused by a number of factors that require different policy measures. Hayek has emphasized only one aspect of it and, as this is presented and justified, contradicts even his own methodology.

This study has three purposes:

- (1) The approach of methodological individualism is presented as this has been developed by Hayek (section two of this paper).
- (2) The implications of methodological individualism regarding individual economic behaviour are analysed (section three of this paper).
- (3) The effectiveness of economic policy is considered from the methodological individualism point of view (section four of this paper).

Conclusions are presented in the last section.

Methodological individualism: a method to study society

Methodological individualism, a method to investigate social phenomena, was developed by a number of scholars that belong to the Austrian approach to economics. It was established by Carl Menger (1840-1921) in Vienna. Eugen von Bohm Bawerk (1851-1914) and Friedrich von Wieser (1851-1926) developed and propagated Menger's work[5]. Friedrich Augustus von Hayek can be considered as the last, the most famous and the most influential of this long Austrian tradition[6].

As Blaug (1980) correctly points out, it is von Mises and most important of all Hayek that really left their mark in developing this method of scientific inquiry in social sciences[7]. It is, therefore, for this reason that this paper examines the method of methodological individualism as this has been developed mainly by Hayek. This method is related to individual economic behaviour (action) and economic policy (social action). Hayek (1973, p. 8) acknowledges Menger's contribution to methodology:

The consistent use of the intelligible conduct of individuals as the building stones from which to construct models of complex market structures is of course the essence of the method that Menger himself described as "atomistic" (or occasionally, in manuscript notes, as "compositive") and that later came to be known as methodological individualism.

Hayek's own contributions to methodology are ubiquitous in his many writings during the 1930s and the 1940s and can be considered as both a good summary of the Austrian tradition on methodological individualism and an excellent development of this method.

Two of Hayek's books, *Prices and Production and Monetary Theory* and the *Trade Cycle*, contain extensive methodological analysis but were not devoted exclusively to it. However, many of Hayek's articles were devoted to

methodological issues. Two works need special mention. The first was Hayek's Presidential Address to the London Economic Club in 1936 entitled "Economics and knowledge" published in 1937. The second work consists of a series of three articles (1942, 1943 and 1944) entitled "Scientism and the Study of Society" published in *Economica*[8]. Also, his article in the *American Economic Review* in 1945 entitled "The use of knowledge in society" is also important in clarifying some aspects of methodological individualism. The basic tenets of this methodology can be summarized as follows:

- a methodological dualism, the methodology of social sciences should be different from the methodology of physical sciences;
- an atomistic perspective as an – a priori – heuristic postulate which reduces social analysis to individual actions and behaviour;
- an important role for individual planning, expectations and knowledge in determining the economic order (process);
- social (aggregate) planning creates disorder. This is based on the assertion that there is no way that aggregate measures can be constructed in a meaningful way and no stable relationships can be established among aggregate variables;
- a general aversion to statistical and mathematical techniques (tools) as these are applied to economic analysis.

The rest of this section will be devoted to methodological dualism, the first tenet of Hayek's methodological approach[9]. Some aspects of the other postulates are examined in the following sections.

A scientific investigation should use abstraction. Hayek (1943, p. 54) states:

Any discipline of knowledge, whether theoretical or historical, can, however, deal only with certain selected aspects of the real world; and in the theoretical sciences the principle of selection is the possibility of subsuming these aspects under a logically connected body of rules.

Abstraction is necessary for all disciplines but the same methodology cannot be applied to both natural and social sciences. Hayek (1943, p. 54) states:

...the fact that all social phenomena have physical properties does not mean that we must study them by the methods of the physical sciences.

Hayek (1942, p. 279) calls the approach of the physical (natural) sciences "objective" and the approach of social sciences "subjective":

There are no better terms available to describe this difference between the approach of the natural and the social sciences than to call the former objective and the latter subjective.

The need for a different approach arises because individuals have a different role in social sciences from in natural sciences. In natural sciences, there is a clear distinction between "objective facts" and opinions (views, perceptions) of individuals. Opinions play little role in natural sciences. However, in social sciences opinions are part of the investigation process and it does matter, if the

relevant question is a relationship between people and things (i.e. a production function) or a relationship between people (i.e. working relationships). Hayek (1942, pp. 286-287) writes:

A few more remarks must be added about the specific theoretical method which corresponds to the systematic subjectivism and individualism of the social sciences. From the fact that it is the concepts and views held by individuals which are directly known to us and which form the elements from which we must build up, as it were, the more complex phenomena follows another important difference between the method of the social disciplines and the natural sciences. While in the former it is the attitudes of individuals which are the familiar elements and by the combinations of which we try to reproduce the complex phenomena, the results of individual actions, which are much less known – a procedure which often leads to the *discovery* of principles of structural coherence of the complex phenomena which had not (and perhaps could not) be established by direct observation – the physical sciences must needs commence with the complex phenomena of nature and work backwards to infer the elements from which they are composed. The place where the human individual stands in the order of things brings it about that in one direction what he perceives are the comparatively complex phenomena which he analyses, while in the other direction what is given to him are elements from which more complex phenomena are composed which he cannot observe as wholes. While the method of the natural sciences is in this sense analytic, the method of the social sciences is better described as compositive (fn. I borrow the term “compositive” from a manuscript note of Carl Menger who in his personal annotated copy of Schmoller’s review of his *Methods der Socialwissenschaften* ... wrote it above the word “deductive” used by Schmoller) or synthetic (emphasis in the original).

Subjectivism is credited by Hayek as having contributed the most to economic analysis. He has in mind the marginal utility analysis and the role of expectations[10]. Hayek links his methodological approach to a distaste for quantitative methods. Even though it is not our purpose here to develop this link, it should be mentioned that Hayek’s approach is independent of the formalism that characterizes modern economic discourse[11].

In Hayek’s writings it is not clear, apart from strong words against the quantitative methods, whether he was against them *per se* or against the inappropriate use of them[12]. Hayek (1933, p. 37) in his book *Monetary Theory and the Trade Cycle* states:

Often statistical analysis may detect phenomena which have, as yet, no theoretical explanation, and which therefore necessitate either an extension of theoretical speculation or a search for new determining conditions.

And for mathematical tools Hayek (1937, p. 35) states:

My criticism of the recent tendencies to make economic theory more and more formal is not that they have gone too far, but that they have not yet been carried far enough to complete the isolation of this branch of logic and to restore to its rightful place the investigation of causal processes, using formal economic theory as a tool in the same way as mathematics.

On many occasions, Hayek appeals to casual empirical evidence and on others he appeals to empirical economists to support his theoretical conclusions.

He appears to accept as a statistical artefact the aggregate relationship between aggregate demand and unemployment[13]. However, the recent developments in statistical analysis (co-integration) may question such a relationship and a number of empirical studies use more micro-oriented

approaches to explain the phenomenon of unemployment. However, Hayek's dislike for aggregate relationships and social control is based on certain assumptions concerning human economic behaviour which are examined in the following section[14].

Individual economic behaviour: an order of well planned acts

Methodological individualism emphasizes the analysis and the understanding of individual actions: "When we speak of man we refer to one whose actions we can understand"[15].

Hayek (1942, p. 283) states explicitly the role of the individual in his method of subjectivism or methodological individualism:

[W]e must start from what men think and mean to do, from the fact that the individuals which compose society are guided in their actions by a classification of things or events in a system of sense qualities and concepts which has a common structure and which we know because we, too, are men, and that the *concrete knowledge which different individuals possess will differ in important respects*. Not only man's action towards external objects but also all the relations between men and all the social institutions can be understood only in terms of what men think about them. Society as we know it is, as it were, built up from the concepts and ideas held by the people; and social phenomena can be recognized by us and have meaning to us only as they are reflected in the minds of men (emphasis added).

Individual actions should be linked to expectations and equilibrium. Hayek (1937, p. 36) states that "actions of a person can be said to be in equilibrium in so far as they can be understood as part of one plan". He reaches two important conclusions. First, equilibrium at the level of the individual exists if a person's successive actions are part of the same plan. A change in knowledge disrupts the equilibrium between the actions taken before and the actions that will follow. To use modern economic terminology a time-inconsistency problem arises at the level of the individual. Second, the passing of time is directly related to the concept of equilibrium since the latter is defined in terms of actions in time. Thus, a static-timeless approach is not appropriate for equilibrium analysis. Time, however, requires an explicit role for expectations.

Lachmann (1943), keeping within the tradition of Austrian methodology[16], makes the role of expectations in economics very clear. On p. 14 he states:

The Social World consists not of facts but of our interpretations of the facts. Nothing will be achieved in the way of an inductive study of expectations until people's expectational responses to the facts of a situation are made *intelligible* to us, until we are able to understand *why* the acting and expecting individuals interpreted a set of facts in the way they actually did. From this point of view we need not deplore unduly the indeterminateness of expectations, for it is *intelligibility* and not *determinateness* that social science should strive to achieve (emphasis in the original).

However, as von Mises (1943) commented, the Austrian approach did not neglect the role of expectations, even though it was very difficult to be incorporated in their analysis. Hayek (1937, p. 34) explicitly states:

... in the treatment of the more "dynamic" questions of money and industrial fluctuations the assumptions to be made about foresight and "anticipations" play an equally central role, and that in particular the concepts which were taken over into these fields from pure equilibrium

analysis, like those of an equilibrium rate of interest, could be properly defined only in terms of assumptions concerning foresight.

The above analysis suggests that individual economic behaviour is influenced continuously by many factors that force a change in the individual plans which are based on knowledge, defined as information and judgement, which is idiosyncratic and not easily transferable. Now, if economic problems are created by individual economic actions, then these could not be anticipated[17].

Furthermore, these could not be controlled by social planning, i.e. by a conscious creation of institutions which will design a social order according to what some people perceive as society's welfare. Economic policy interventions are such attempts that eventually will create economic and even social disorder.

To summarise, individual economic behaviour is a process of continuous planning. Expectations, information and judgements play an important role and they have an important time dimension. This behaviour is very complex and each individual possesses unique knowledge concerning his environment.

Hayek's analysis of individual behaviour is correct and can be identified with the assumption of rational economic behaviour in the sense of purposeful actions. However, the fact that the stock of knowledge possessed by one individual is unique does not imply that it could not be affected by the flow of information. For example, the free supply of formal education can be considered as society's conscious attempt to affect the flow of information. Also, technological information is consciously produced by consciously formed institutions, i.e. research and development organizations. However, there is a difference between knowledge and information. Knowledge is the sum of information and individual judgements. Society can control the flow (stock) of information possessed by individuals but it cannot affect the interpretation (judgement) of this information at least in a systematic (predictable) way. This is the reason that Hayek considers impossible the prediction and therefore control of aggregate economic phenomena.

Economic policy: a disorder created by social planning

Central to Hayek's version of methodological individualism as this is applied to economic policy issues is the role of institutions[18]. According to Hayek (1944, p. 29), institutions are man-made but not in a conscious way:

But phenomena like language or the market, money or morals, are not real artifacts, products of deliberate creation. Not only have they not been designed by any mind, but they are also preserved by, and depend for their functioning on, the actions of people who are not guided by the desire to keep them in existence.

And a few pages below, Hayek (1944, p. 31) makes an even stronger statement:

Indeed, any social processes which deserve to be called "social" in distinction to the action of individuals are almost *ex definitione* not conscious.

Hayek (1944, p. 29) reaches the conclusion that institutions cannot be designed by social (state) control:

From the belief that nothing that has not been consciously designed can be useful or even essential to the achievement of human purposes, it is an easy transition to the belief that, since all "institutions" have been made by man, we must have complete power to refashion them in any way we desire. But, though this conclusion at first sounds like a self-evident commonplace, it is, in fact, a complete *non sequitur*, based on the equivocal use of the term "institution". It would be valid only if all the "purposive" formations were the result of design.

The above view is very strong and leads to the rejection of any attempt to intentionally change society[19]. Economic policy is a conscious attempt to change society's economic problems such as unemployment and inflation. Hayek in his recent studies, during the 1970s and the 1980s, both tackled economic problems and provided explanations. The problem of unemployment is examined here as an example in order to show the nature of Hayek's explanation of economic problems based on his methodological approach which emphasises subjectivism (the individualistic perspective).

According to Hayek, unemployment is the result of distortions in the relative prices and wages. These distortions are the results of the malfunctioning of the market system owing to trade union, monopoly (monopsony) power and previous and current government interventions[20]. The latter can explain the high levels of unemployment in the 1970s and the 1980s. Hayek (1975, p. 11) writes:

The present unemployment is the direct result of the short-sighted "full employment policies" we have been pursuing during the last 25 years.

Hayek questions the statistical (casual) relationship between aggregate demand and employment; even if there is a temporary positive relationship, it makes things even worse owing to misdirection of labour[21]. Two points should be made here. First, the recent developments in statistical theory, that of co-integration analysis, can verify Hayek's hypothesis that there is no stable long-run relationship between aggregate demand and unemployment, i.e. whether the two variables are co-integrated.

Second, macroeconomic policy measures to combat unemployment are not exhausted by aggregate demand policies. Unemployment may be due to deficient aggregate demand, something that Hayek himself acknowledges as a possible cause, or due to other structural problems such as the application of new technologies. In this case, economic policy can play an important and effective role with such policies as training or even welfare policies to mitigate the personal economic suffering, i.e. unemployment insurance. Hayek's explanation of unemployment is very simplistic and this is contrary to his methodological dualism that requires a different approach to social sciences mainly because social phenomena are more complex than the physical phenomena.

Hayek's theory of employment determination is monistic and very simplistic. In a nutshell what he says is that if the market is left free to operate then there will be no problem of unemployment. He blames past government policies, trade unions and monopoly powers. Government, trade unions, monopolies and even the market are institutions. How were these institutions formed? Were they

the results of the unconscious design of many individual actions? Can a monopoly firm or a trade union be the unconscious design of many individuals? Or does the market system lead to the creation of such institutions? Hayek offers no explanation. But the problem of unemployment, a complex social phenomenon indeed, cannot be explained by simply blaming these institutions. The analysis of unemployment requires the incorporation of social categories that Hayek's methodological individualism assumes to be non-existent[22].

What are Hayek's policy recommendations to fight unemployment? Stable money and a free labour market. If these policies are followed, then for a year unemployment will be very high but then will be decreased. The 1970s and 1980s show that unemployment persists and Hayek's naïve theory cannot explain this persistence[23].

Conclusion

Hayek's methodological individualism offers an acceptable explanation concerning the nature of atomistic economic behaviour. This behaviour is characterised by individual planning forming expectations about future events. In this process the individual knowledge plays an important role.

Contrary to atomistic planning, social planning is ineffective and leads to social disorder. Economic policy is a form of social planning and, if it is attempted, then economic disorder will be created. The problem of unemployment was used also by Hayek on many occasions to show that Hayek's explanation is very simple, which contradicts his version of methodological individualism, which takes social phenomena, contrary to natural phenomena, as being very synthetic requiring a very complex explanation.

Notes

1. Arrow (1994) chose methodological individualism as his theme for the Richard T. Ely Lecture. Hayek's (1976, 1990) argument for the denationalization of money is an example of a peculiar policy recommendation.
2. Hayek's Alfred Nobel Memorial Lecture, delivered on 11 December 1974 and published as Chapter 2 in Hayek (1975) with a title "The pretence of knowledge", links his methodological individualism to an economic policy problem (unemployment).
3. The recent search for microeconomic foundations of macroeconomics can benefit from Hayek's approach. Also, at the micro level, the search for a micro-micro theory (see Leibenstein (1979)), can also benefit from Hayek's approach.
4. Another important issue is that of welfare, which is not examined here; see the studies by Tomlinson (1990, pp. 80-87) and Shearmur (1990, pp. 207-11).
5. Negishi (1989, chapter 8) gives a concise exposition of the Austrian School's contributions to economic theory and methodology. Hayek himself wrote a biographical study for Carl Menger in 1934 and in 1973 an article on "The place of Menger's *Grundsätze* in the history of economic thought". Streissler and Weber (1973) wrote on the Menger tradition.
6. Tradition is considered more appropriate than a school because it is really very difficult to identify an Austrian school of thought. Actually, Hayek (1973, p. 13) himself argued "Though there is no longer a distinct Austrian School, I believe there is still a distinct Austrian tradition..."

7. Shearmur (1990) argued that there is a discontinuity between Menger and Hayek, particularly in the area of welfare and human nature.
8. A series of three articles in *Economica* (February, May and August 1941) entitled "The counter-revolution of science" contain some elements of Hayek's position on philosophical issues relative to the great tradition of the eighteenth and nineteenth centuries. All these were reprinted in Hayek (2nd edition 1979, originally 1952). See also Hayek (1939).
9. Methodological dualism can be considered as a reaction to the natural sciences penetration into economics. Recently, Rima (1994, p. 197) has stated that "...a still closer interpenetration of the natural sciences into economics is less promising for progress in acquiring economic knowledge than would be a greater affinity with the other social sciences".
10. Lachmann (1969) also acknowledges these two contributions as the great achievements of subjectivism but not without serious challenges.
11. This is the reason that New Classical Economics that uses very formal and abstract models can still relate to Hayek's approach as this is recognized by Lucas (1977).
12. As Werner Tschiderer (1995) has stated, Hayek's critical thoughts were less against Keynes than "...against *certain* trials to synthesize the further development of the Keynesian analysis and econometrics" (emphasis added).
13. See the book by McCormick (1992) and the review article by O'Driscoll (1994) for some thoughts on Hayek and the Keynesian dominance in the economics profession.
14. Hayek's arguments against aggregate relationships are very weak but are of no consequence to his theoretical and policy arguments.
15. Hayek (1943, p. 63).
16. See Blaug (1980, p. 92) and also the comment by von Mises (1943).
17. Relative to this discussion is the issue of predictions in economics. According to Hayek (1984, p. 27), predictions are impossible in economics because all economic problems are caused by unforeseen events. This point is further discussed and linked to econometrics by Paque (1990).
18. The issue of economic policy is directly linked to Hayek's views on the political process and the role of social (distribution) policy. On this issue see Leube (1989).
19. This view contrasts with that of Menger who accepts that some social changes can be the result of conscious actions. Arrow (1994, p. 3) points out this difference. He writes "In Burke and Hayek, [methodological individualism] leads to a principled rejection of deliberate changes in society, for the existing actions, having arisen by so many individual choices, embody the wisdom of the ages. Menger is more reserved; he considers that some social changes occur consciously and for pragmatic reasons, while others are indeed the unintended outcomes of individual actions". See also the studies by Garrouste (1994) and Shearmur (1990).
20. See Hayek's monographs published first in 1975, 1976, and 1980.
21. Hayek (1975, p. 37) writes "...the very measure which the dominant 'macro-economic' theory has recommended as a remedy for unemployment, namely the increase of aggregate demand, has become a cause of a very extensive misallocation of resources which is likely to make later large-scale unemployment inevitable".
22. This is the criticism raised by Arrow's 1994 article.
23. A recent survey for the European Unemployment experience is given by Bean (1994).

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