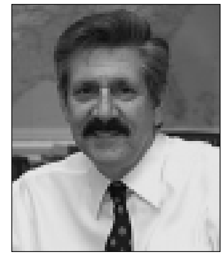
The Current Economic Crisis and the Austrian Theory of the Business Cycle



BY RICHARD M. EBELING

The current financial crisis emerged out of an economic boom that began in 2003 and saw rising stock values, increasing home prices, and high levels of employment and production. The upturn followed a downturn that hit in 2001 after the dazzling prosperity during the second half of the 1990s.

In other words, over slightly more than one decade, the economy has gone through two swings of the business cycle, with still no certainty about how long and severe the recession phase of the present cycle will turn out to be.

Many mainstream economists are baffled about these events. The Keynesians certainly cannot claim there has been any shortfall in "aggregate demand." Both in America and around the world, the demand for raw materials and consumer goods has been riding high for a long time.

Ludwig von Mises and F. A. Hayek
FEE Archives

On the other hand, the monetarists believe monetary policy has not been excessive; price inflation has remained pretty much in check, with consumer prices only rising at 2 to 3 percent a year for a long time.

So what has caused these economic crises? The answer can be found in the ideas of another group of economists, those of the Austrian School. Though this school of thought developed in Austria in the late nineteenth century and the first half of the twentieth century, most "Austrian" economists are Americans living in the United States.

The two leading figures of the school in the twentieth century (and who were originally from Austria) were Ludwig von Mises and F. A. Hayek, who won the Nobel Prize in economics in 1974 partly for his work on business cycles.

For many Austrian economists the past two business cycles have been, in the words of Yogi Berra, "like déjà vu, all over again." Mises and Hayek had first developed their theory of the business cycle in the 1920s, when the American economy experienced numerous technological innovations that lowered manufacturing costs, raised labor productivity, and thus resulted in an expanding supply of consumer goods, along with a rising stock market and a massive real estate boom. And all the while the general level of prices was rising at no more than 2 percent a year.

There was much talk of a "new economic era" and the "death" of the business cycle. One of America's most renowned economists, Yale professor Irving Fisher, publicly declared in the spring and summer of 1929 that the stock market had reached a plateau from which it could only go higher. That was just months before the great stock-market crash in October.

The Austrians argued, both before and after 1929, that the cause of the boom and the inevitable depression was Federal Reserve monetary policy. Under the influence of a variety of economists, including Fisher, the Federal Reserve had sought to stabilize the general price level on the rationale that both inflation (rising prices) and deflation (falling prices) were harmful.

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Given the expansion of the supply of goods and services during the 1920s, prices throughout the economy would have been expected to fall slowly, and this likely would have happened if not for the Fed's policy.

Viewing any decline in the price level as a sign of "bad" deflation, the monetary authorities pumped additional quantities of money and credit into the banking system to prevent prices from falling. The banks could lend this newly created money only by lowering interest rates below what the Austrians call their "natural," or equilibrium, level, where the amount of money demanded by borrowers would equal the amount saved by income earners. Thus there were insufficient savings to complete and maintain many of the investment projects that were undertaken.

Because monetary expansion prevented prices from falling, no harmful price inflation appeared. Thus the magnitude of the *monetary* inflation was hidden by the stable price level. Nevertheless, the investment distortions and imbalance between savings and investment were real.

In late 1928 and early 1929, the Fed became concerned that its expansionary monetary policy was finally threatening a significant rise in the price level. The bank put on the monetary brakes, and in late 1929 and 1930 the stock-market, investment, and real-estate house of cards came tumbling down.

The severity and the duration of what soon became labeled the Great Depression were caused by the interventionist policies of first the Hoover and then the Roosevelt administrations. Rather than allow the market to adjust to the new noninflationary environment—which would have required timely downward adjustments in prices, wages, and shifts in production and employment—the government used various pressures and controls to prevent these changes. The American economy for a long time was caught in "disequilibrium" relationships between costs and prices, supply and demand, and production and consumption—not because of any "failure of capitalism" but because the heavy hand of government prevented the market from reestablishing "full employment."

How similar this is to the events of the last decade! Technological innovations, cost efficiencies, greater output and new goods on the market, along with booming stock prices and real-estate values—all occurring mostly with an annual price inflation of around 1 or 2 percent.

But throughout the second half of the 1990s and then again after 2003, the Fed undertook expansionary monetary policies, with the money supply sometimes increasing annually at double-digit rates. Interest rates were pushed to 1 to 2 percent and were even at times negative, when adjusted for price inflation. Money for investment and other purposes was being given away virtually for free.

Is it any wonder that financial markets boomed, that standards of creditworthiness for investment and mortgage loans almost disappeared, that real-estate prices went up and up? Both in 2000 and in 2007, when the Fed became concerned that its policy was creating an unstable and unsustainable inflationary environment did it put on the brakes. And both times the Fed-created house of cards came tumbling down.

Every historical episode has its own unique features. History never mechanically repeats itself. But like causes do bring about like effects. The concentration of monetary control in a central bank means that those who manage monetary policy are in effect central planners. Like all forms of central planning, monetary planning is heavy-handed, clumsy, and pervasive in its effects throughout the economy.

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We will see the same inevitable sequence again and again for as long as money is in the hands of a monopoly central bank and the central bankers believe they are sufficiently knowledgeable, wise, and able to manage the society's economic affairs.