

## **Business Cycle Theory - An Explanation of Cyclical Recessions and Depressions**

*Tuesday, June 22, 2010 by Jason Riddle*

*What causes the economic boom and bust periods? Is this just an inconvenient defect of an otherwise efficient free market system? Are rapid periods of rising prices followed by crashing recoveries simply a result of unbridled greed?*

### **The Boom & Bust Business Cycle - As Simple as ABC(T)**

Economists characterize the business cycle as period of boom caused by artificial expansion of credit followed by an inevitable bust as market forces work to correct the misallocation of scarce resources. It is precisely the introduction of artificial credit that misrepresents the availability of resources in the economy causing widespread malinvestment that drives up prices during the boom. There is nothing in the inherent nature of a market or price system that would lead to rapid increases or decreases in aggregate prices. Nor is there any characteristic of an unhampered market that would cause or encourage individuals to widely misallocate resources. The business cycle is fueled by artificially cheap credit. The engine is the central bank, and interventionist public policy is the ignition.

This article builds on the [Fundamental Economic Concepts](#) of scarcity, value, time preference, and capital structure.

### **Intervention in the Market – The Central Bank Floods the Market with Cheap Credit**

For various political reasons (including creating the perception that a benevolent government is giving the public something for free), the central bank intervenes in the credit market by increasing the money supply. This artificial increase in the money supply (or expansion of credit beyond market levels) tends to lower the interest rate below the level that would occur naturally in the market. This sets the boom / bust cycle in motion.

*Note:* The fraudulent expansion of the money supply by the central bank can be accomplished today electronically - counterfeiting money is no longer limited to the mere confines of a printing press. The artificial expansion of the money supply causes many economic problems including the risk of severe inflation as discussed in [Legalized Theft – The Expropriation of Americans' Wealth](#). However, here we will only focus on one problem resulting from intervention: The damage caused during a boom / bust business cycle.

### **Faulty Signals – Artificial Credit Expansion Tends to Lower Interest Rates**

Because we live in a world where we are limited by the scarce resources of time, materials, and labor, we must choose how we want to allocate our scarce resources to best satisfy our needs. Investing in capital goods may increase future output, but in order to invest in the future we have to either decrease current consumption or consume real savings during our period of investment.

The market interest rate indicates the amount of resources that may be devoted to the production of capital goods without impacting current consumption based on available savings. Because capital investment requires the postponement of current consumption, it signals to entrepreneurs the availability of real savings accumulated to undertake capital investment projects. The interest rate is essentially a measure of the market's preference of present goods in relation to future goods.

An artificially low interest rate distorts this vital signal to consumers, producers, and investors. Entrepreneurs are led to believe investments in the production of capital goods can be undertaken without frustrating current consumption. Investors commence capital projects under the assumption that sufficient resources are currently

available to complete the projects and that consumer demand will exist in the future to support their investment decisions.

As a result, scarce resources are diverted away from useful projects that would have otherwise satisfied consumers' true time preference. The recent housing boom is a perfect illustration. Artificially cheap credit sent the false signal to entrepreneurs that the market had sufficient savings necessary to undertake substantial real estate investments. Digital bank account balances and paper currency do not equate to real savings. The misinformation created by the Federal Reserve has left us with \$1 million+ half-built homes all over the country.

### **Boom Time! - A Period of Pervasive Economic Damage**

Things are good during the boom, right? Prices are rising. People think that real wealth is being created at an accelerated rate. Society is living a lifestyle fueled by artificially generated 'economic progress'. People always seem that things will be different this time. This time the boom will go on forever. Unfortunately for the naïve seeking the benefits of an effect without a cause, reality teaches the harsh lesson that nothing is free. It is not possible to create wealth out of nothing.  $A = A$ .

It is true that as a result of increased capital investment, the prices of capital goods are bid up by investors competing for the use of these scarce resources. Prices of capital goods do rise during the boom. However, this only fuels the malinvestment as entrepreneurs perceive the continued investment of capital will pay off. Scarce resources are taken from productive uses and employed in projects that the market is not ready to undertake.

It is actually during the period of boom (a period that lends the perception of wealth creation) that the real damage to wealth occurs. The faulty assumption that capital can be created by artificially increasing the supply of paper money only gives the illusion the savings available for investment is real. Of course, real savings must exist before capital projects can be completed, and the notion that capital can be created out of nothing is false. Increasing the money supply may temporarily increase consumption, fueling the good times during the boom, but only at the expense of consumed capital. As scarce resources are devoted to new investment projects, valuable capital is consumed in order to meet the current consumption demand levels.

To sustain our current lifestyle we are actually eating into the savings of past generations. The existence of real savings and investment in capital is *THE* reason that America became an economic powerhouse. Over the last half a century, we have actually been consuming our savings and saved capital at an alarming rate to sustain our desired levels of consumption. **We are no longer a production economy. We are a consumption economy. We are damaging our capital structure. This is not sustainable.** Our standard of living seems to be high, but our destruction of capital and savings is actually making Americans relatively poorer each year.

To fully appreciate the extent of the damage caused during the boom period, it must be understood that all capital goods are not identical in nature. Although mainstream economists like to treat all capital investment as homogeneous items to be input into complex economic models, capital goods exist as individual pieces of an intricate system of individual plans. The structure of production is such that capital production can only exist to the extent by which the factors of production are available for use. It is important to understand that not only is there massive over investment during the boom period, but entrepreneurs are investing in the *wrong* areas. We are damaging the capital structure of our economy.

Valuable capital is diverted to unsustainable projects during the boom in pervasive malinvestment. Valuable capital is consumed to sustain desired consumption levels. It is during the boom time that real wealth is destroyed.

## **The Bust – A Painful But Necessary Healing Process**

The illusion that real savings exists can only go on for a finite period of time. Once it is determined that production expansion cannot be completed with the available resources, a correction must occur. The severity of the correction required to liquidate malinvestments and appropriately reallocate resources is determined by the duration and intensity of the central bank's interference. The solution is not as simple as switching from the malinvestment back to previous levels of capital production. Production requires capital. The boom period damaged our capital structure. Real savings must be reestablished before there can be investment in new production.

If the mistakes caused by central bank interference in the market can be identified early on and stopped, the damage caused during the boom period can be fixed by the market relatively quickly during a brief period of recession. The medicine is painful: Consumption is deferred and real saving occurs.

If the central bank continues to fuel the market with cheap credit, as is the [case today](#), the consequences may be dire. As Thomas Taylor describes in the [Introduction to Austrian Economics](#): *"To continue easy-money policy in order to avoid the otherwise inevitable depression must bring about an even harsher fate: the collapse of the monetary system and the market economy..."*

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*The above explanation is an interpretation of the **Austrian Business Cycle Theory (ABCT)** developed by Ludwig von Mises, F.A. Hayek, and other brilliant economist from the Austrian school of economic thought.*

### **Additional Suggested Readings:**

- [Thomas Taylor – An Introduction to Austrian Economics](#)
- [Ludwig von Mises – The Theory of Money and Credit](#)
- [F.A. Hayek - The Austrian Theory of the Trade Cycle and Other Essays](#)