
Special report:
The world economy

Of shocks and horrors

The causes of booms and busts

Sep 26th 2002 | From the print edition

IN THE bible, Joseph tells the pharaoh to expect seven years of plenty followed by seven lean years. That was, perhaps, the first documented business cycle—and the first (and probably last) example of an accurate economic forecast. Recorded data on business cycles go back to the early 19th century, but economists still cannot agree about what causes contractions and expansions in economic activity.

Economists have come up with all sorts of explanations, from the effect of sunspot activity on climate to the alignment of planets and their magnetic forces. The current preference is to look for more down-to-earth causes, which come in two main varieties: those that explain the business cycle as a self-perpetuating process, and those that blame recessions on shocks or policy mistakes. The main theories are:

- **Exogenous shocks.** Recessions, it is argued, are caused by unexpected events, such as the rise in oil prices in the mid-1970s or, as some (incorrectly) tried to argue, the terrorist attacks on September 11th last year. If so, recessions are, by definition, totally unpredictable. They cannot be prevented, but once they have arrived governments can use fiscal and monetary policies to cushion demand.
- **Keynesian theory.** John Maynard Keynes blamed recessions on the inherent instability of investment caused by “animal spirits”: swings in the mood of producers, from optimism to pessimism. As investment slumps, jobs and household incomes fall, amplifying the initial drop in demand. Unemployment rises because workers will not accept the pay cuts required to price the jobless back into work. So, to bring the economy back to full employment, the government needs to pursue expansionary policies.
- **Real business-cycle theory.** This theory, which emerged in the early 1980s, sees productivity shocks as the cause of economic fluctuations. For example, if productivity falls, current returns decline, says the theory, so workers and firms choose to work less and take more

leisure. Rather than explaining the cycle in terms of market failure, as Keynes did, real business-cycle theory views a recession as the optimal response by households and firms to a shift in productivity. If so, there is no point in governments stimulating the economy. But most economists find this theory hard to swallow. Mike Mussa, a former chief economist at the IMF, and now at the Institute for International Economics, describes it as “the theory according to which the 1930s should be known not as the Great Depression, but the Great Vacation.”

- **Policy mistakes.** The late Rudi Dornbusch, an economist at the Massachusetts Institute of Technology, once remarked: “None of the postwar expansions died of old age, they were all murdered by the Fed.” Almost every recession since 1945, with the exception of last year's, was preceded by a sharp rise in inflation that forced central banks to raise interest rates. The first mistake was to allow economies to overheat; the second to slam on the brakes too hard. This theory gave rise to the popular belief that recessions could be avoided so long as governments pursued prudent monetary policies to keep inflation low and stable. Yet the recessions in Japan after the 1980s bubble and America more recently suggest that price stability does not prevent booms and busts.

- **Austrian business-cycle theory.** This is the oldest, developed by Austrian economists such as Ludwig von Mises and Friedrich Hayek in the early 20th century. Unlike Keynes, who thought recessions were caused by insufficient demand, these economists put them down to excess supply brought about by overinvestment. As a result of mutually reinforcing movements in credit, investment and profits, each boom contains the seeds of the subsequent recession and each recession the seeds of the subsequent boom.

According to Hayek, output fluctuates because the short-term interest rate for loans diverges from the “natural” or equilibrium interest rate—the rate at which the supply of saving from households equals the demand for investment funds by firms. If central banks hold interest rates below this rate, credit and investment will rise too rapidly, and consumers will not save enough. This creates a mismatch between future output (which will increase as a result of higher investment) and future spending (which will fall as a result of lower saving today). Cheap credit and inflated profit expectations cause both overinvestment and “malinvestment” in the wrong kind of capital. The mismatch between saving and investment will eventually push up interest rates, making some previous investments unprofitable. Too much capacity will also reduce profits. Investment collapses, ushering in a recession. As excess capacity is cut, profits rise and investment eventually recovers.

According to this theory, central banks would not be able to avoid a downturn by heading off a rise in interest rates. The only way to prevent the cycle from turning is to inject ever more credit, which becomes unsustainable. A recession is inevitable, and indeed necessary to correct the imbalance between saving and investment.

A tour of the Austrian Alps

In the second half of the 20th century, self-perpetuating theories of the business cycle were almost completely ignored in favour of theories that stressed shocks or policy mistakes. Most recessions were caused largely by economies overheating, forcing central banks to raise interest rates. Now, however, the fall in inflation has brought the inherently cyclical behaviour of credit, investment and profits to the fore.

In the late 1990s inflation rose only slightly, leading most economists to believe that growth would continue in America. Only a few economists, such as John Makin, at the American Enterprise Institute, and Stephen King, at HSBC, recognised that this cycle was different: that it was an investment-led boom that carried the seeds of its own destruction.

The recent business cycles in both America and Japan displayed many “Austrian” features. Hayek argued that the natural rate of interest could rise if faster productivity growth increased expectations about profits and hence investment opportunities. This is what happened in Japan in the 1980s and in America in the 1990s. If such a shift in investment occurs, central banks need to raise interest rates. But because inflation was low (and because Austrian economics had long gone out of fashion), the Fed and the Bank of Japan failed to do so. The cost of capital therefore fell below its expected return, fuelling a surge in credit, equity prices and investment.

Investment normally accounts for about one-sixth of America's GDP, but during the three years to 2000 the investment boom pushed up its share of GDP growth to one-third. Overinvestment caused the return on capital to decline. Anybody who looked at the profits of corporate America in 2000, as reported in the national accounts (which allow for the true cost of stock options) rather than by the companies themselves, should have seen trouble coming. Profits had been falling since 1998, as before every previous recession (see chart 2).

Investment will not rebound until excess capacity has been cleared and profits have improved.

Strict Austrian-school disciples would argue that because the current downturn is due to overinvestment, the Fed's repeated easing of interest rates is wrong; it delays the correction of past excesses. The present economic and financial disruption is needed to bring saving and investment back into balance. But most economists today would accept that in the face of a severe recession central banks need to act. Even the Austrian economists recognised that a collapse in confidence could push the economy into a much deeper recession than necessary. Monetary and fiscal policy therefore still has a role—not to avoid recession, but to head off a downward economic spiral.



Many economists still do not accept that this recession has been quite different from all previous post-war cycles, and that the shape of the recovery will therefore also be different. Investment-led downturns tend to last longer because it takes much more time to eliminate financial excesses than to tame inflation. High debts and excess capacity will restrain growth.

The complete rejection of Austrian-school ideas over the past half-century partly reflected a desire by economists to develop a framework that could explain all business cycles. The truth is that there is no single cause of cycles. Sometimes an oil-price shock or a policy mistake may trigger a recession, but the endogenous movements in credit, investment and profits are also always at play. Indeed, the Austrian cycle may become more common again if, as this survey will argue, financial liberalisation has made bubbles in credit and investment more likely.

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