

EE460- Friedrich Hayek and Austrian Business Cycle Theory

Friedrich Hayek is the famous Austrian economist born in 1899. He is known for his liberal perspective and the defense against free-market capitalism. His liberal view was presented in the the book 'The Road to Serfdom' written from the stance against any power centric political system from the basis of imperfect information of a governor. Since information only be held by market, government cannot make the perfect decision. Rather, each individual is the true information holder. Hence, their decisions together form the best decision. Hayek supports free-market and is a big opponent against socialism.

Accordingly, this stance becomes the basis of his famous 'Austrian Business Cycle Theory' (ABCT), a work in collaboration with Ludwig von Mises. According to the site Wikipedia.com, Austrian Business Cycle Theory can be briefly described as following, "The theory views business cycles as the consequence of excessive growth in bank credit, due to artificially low interest rates set by a central bank or fractional reserve banks." To illustrate further, IMF working paper (Oppers, 2002) provides a good explanation of Austrian theory:

Interference by the monetary authorities leads to an artificial boom that creates malinvestment, or mismatch between investment and future consumption plans. That mismatch is the cause for the subsequent bust. This bust is inevitable, and the economy will not recover until the structure of production is readjusted to match the intertemporal spending plans of consumers.

Important points that should be taken here are:

1) Malinvestment: badly allocated business investment, i.e. excessive investment in

one sector while shortage of investment in other sectors 2) Inevitable (and desirable) bust: Since the government intervention has distracted market from its organic mechanism, busting is the process for economy to adjust towards equilibrium. 3) Should government intervene? Will the intervention ease or deepen the crisis?

However, this theory was marginalized among scholars after its early publication and became completely rejected in 1967 at "The Great Keynesian Consensus", the opposing theory which government intervention was proved to be useful in coping with recession. Nevertheless, after 2007 GFC, ABCT has gained significant recognition as a rival of Keynes's theory in explaining 2007 global financial crisis.

ABCT and Thailand 1997 Financial Crisis

Framing Thailand 1997 Financial Crisis into this theory, can ABCT really explain Thailand financial collapse in the 90s? First, we have to look at the root of the crisis whether the crisis boom stemmed from the artificially low interest rate set by the central bank or not. According to Bhanupong (2013) on Economic Crisis in Thailand, the economic bust was rather the result of premature liberalisation than the artificial low interest rate. Thailand did not have the prudential regulation ready before it opened to global capital. The paradoxical coexistence of unrealistic fixed exchange rate, controlled interest rate and liberalised financial market leads to the arbitrage opportunity, malinvestment and in turn the unavoidable bust. In this sense, Thailand was not a liberlised market at the first place. The liberalisation decision was made by Thai government along with market and international organisation's pressure. Hence, this crisis is more or less Thailand's monetary authority false. **To sum up, ABCT does**

not perfectly explain 1997 economic crisis. However, from the pro-market point of view, if the government had not involved in anything at the first place, the result would be better than this. Or, from the Keynesian stance, the government should have had a profound regulation and prevented this bust.

Weakness of ABCT

Opper states that there are two major weaknesses of his framework: (1) what should the government roles be in order to prevent economic bust, and (2) why exactly does the artificial boom terminate in a recession, and not just a return to potential output.

Furthermore, this theory lacks of theoretical and numerical supports. Most of the evidences produced by his supporters are descriptive and limited in a small scope. In explanation, they describe the economic trends to manifest the theory. For example, during economic expansionary featuring robust growth, low inflation, and strong growth in particular sectors, hence imbalance investment between sectors may happen; in other word, there is misallocation of resource which is expected to become a bubble and eventually bust the economy; and the study of effectiveness of different kinds of economic policies in recession.

Although this theory was completely rejected during the 20th century, it had gained attention lately as a plausible explanation of the dot-com bubble and the United State Housing Bubble, especially when US economy was hardly pick up after the severe financial crisis; BBC published the article “Keynes v Hayek: Two economic giants go head to head” in August, 2011.

In conclusion, there is no overarching economic theory that can explain every economic cycle. Even though this Hayek’s theory is still controversial, there are some truth of it that should not be disregarded.

References

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