NEED TO KNOW

AMERICANS FOR PROSPERITY FOUNDATION

WHY BOOM-BUST CYCLES OCCUR

Boom-bust cycles refer to periods of high economic growth followed by economic contraction, leading to either a recession or a depression. Many people assume that severe boom-bust cycles are a natural part of the free market. Inexplicably, the market may soar high one year and swing low the next as the spirits of the bull and the bear roam throughout Wall Street. However, these cycles are much more complex.

THE BOOM SIDE OF THE BUSINESS CYCLE

Economic booms begin with the expansion of credit in the money supply (2). This occurs because banks increase lending while lowering interest rates on loans. As a result, individuals and companies take out larger loans at lower rates in order to build up their capital resources, invest in bigger homes, hire more laborers, etc. The assumption is that profits will come when consumers spend their money on these projects.

As this credit works its way through the economy and consumers flock to the bigger projects, overall optimism soars. Investors, politicians, and journalists mistakenly presume that these investments are signals of real and sustainable economic growth, when they are really just mal-investments that are spurred by the overflow of easy credit and low interest rates.

It's important to note that this credit expansion can occur within a free market, but it cannot be sustained for very long, meaning that booms and busts would not be so catastrophic. What makes the boom last longer than it should is the existence of a central back and/or government regulations that artificially suppress interest rates, increase the money and credit supply, and distort bankers' practices (3). Without this support, banks would not be able to sustain such dangerous levels of lending for an extended period of time, meaning the market would self-correct the malinvestments more rapidly. Moreover, government policies that subsidize certain investments by diverting resources from one sector of the economy and funneling them into another (such as housing in the 2000s) will further incentivize mal-investments.

THE BUST SIDE OF THE BUSINESS CYCLE

Eventually, consumers reign back their spending on the increasingly expensive mal-investments. When this happens, those individuals, businesses, and banks that heavily invested in these projects come to the realization that their investments are rapidly declining in value. At this point, these investors make a rush for the exits, leading to either a substantial decline in the stock market, if not an all-out crash. This causes loan defaults and creditors are unable to make good on their promises.

It is at this point that many observers panic and proclaim that the economy is on unsound footing. However, in reality, the crisis was years in the making as the seeds of mal-investment were planted based on artificial credit expansion, reduced interest rates, and distortive government policies.

QUICK FACTS

- The United States economy has suffered through twelve recessions since World War II.
- The 2008 crash and subsequent recession is the worst boom-bust cycle that the United States has experienced since the Great Depression.

NOTABLE & QUOTABLE

"True, governments can reduce the rate of interest in the short run. They can issue additional paper money. They can open the way to credit expansion by the banks. They can thus create an artificial boom and the appearance of prosperity. But such a boom is bound to collapse sooner or later and to bring about a depression."

-**Ludwig von Mises** (1)

THE AFTERMATH

Two case studies demonstrate what the aftermath of a boom-bust cycle can look like: the 1920s depression illustrates what happens when government deregulates and steps back, while the 2008 recession illustrates what happens when government attempts to jumpstart the economy through Keynesian stimulus and money supply manipulation.

According to Thomas Woods, in 1920, only seven years after the creation of the Federal Reserve, the United States suffered a severe depression as unemployment rose from 4% to 12% and Gross National Product (GNP) fell by 17% (4). However, in response to this economic col- lapse, President Harding slashed spending, cut tax rates, and reduced the national debt by 33%. Meanwhile, the Federal Reserve practically did nothing to affect the money supply or interest.rate levels. Within two years, unemployment returned to 2.4%.

In contrast, in the aftermath of the 2008 crash, both Presidents Bush and Obama enacted interventionist policies that bailed out big banks and artificially stimulated further lending. Congress also passed oppressive financial regulations in the form of Dodd-Frank. Meanwhile, the Federal Reserve reduced the Federal Funds rate to practically 0% after 2009 and manipulated the money supply through a series of Quantitative Easing programs. And yet, the results of these efforts are dismal. The unemployment rate rose to 10.2% in October of 2009 and did not return below 8% until October 2012. GDP growth has been mediocre as well.

CONCLUSION

Without a proper understanding of why boom-bust cycles occur, it is impossible for political leaders to develop programs that will restore the economy to fundamental soundness. Keynesian stimulus proposals ultimately won't accomplish anything more than prolonged after effects of the initial boom-bust, while paving the way for yet even more disastrous future crashes. On the other hand, if government loosens its stranglehold on the economy in the aftermath of a boom-bust, then the free market will be able to provide recovery much more quickly.

Endnotes:

1. Ludwig von Mises, Omnipotent Government (Indianapolis: Liberty Fund, 2010), p. 251.
2. Roger Garrison, "The Austrian Theory: A Summary," in the Austrian Theory of the Trade Cycle and other Essays, comp. Richard Ebelling (Auburn: Ludwig von Mises Institute, 1996), 99.
3. Steven Horowitz and Peter Boettke, "The House that Uncle Sam Built," (New York: Foundation for Economic Education, 2009), 5.
4. Thomas Woods, "The Forgotten Depression of 1920," Ludwig von Mises Institute, November 27, 2009 http://mises.org/daily/3788/ (accessed August 20, 2012)