SA19001

An Explanation of the "Great Recession" Based on Austrian Business Cycle Theory

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Abstract

I use Austrian business cycle theory (ABCT), as developed by Ludwig von Mises, Friedrich Hayek and George Reisman, to explain the recession of 2008-9—the Great Recession. I first provide a brief description of ABCT. This theory says that, today, the business cycle results from the manipulation of the supply of money and credit through government monetary policy. This manipulation results in an expansion when monetary policy keeps interest rates artificially low and the rate of profit in the economy artificially high. These manipulations lead to mal-investment in the economy. This manifests itself primarily in the expansion of industries that are farther removed from final consumption (such as capital goods industries) or that are more interest rate sensitive (such as housing) relative to industries closer to final consumption or that are less interest rate sensitive. The contraction results when monetary policy slows the growth of the supply of money and credit and causes interest rates to rise and the rate of profit to fall.

I then apply ABCT to the Great Recession to show the causes and effects of the Great Recession. I use output (such as GDP and Gross National Revenue, the latter being a more comprehensive measure of output than GDP), the money supply, interest rates, industrial production, the rate of profit (i.e., the return on equity), and the velocity of circulation of money to show the causes and effects of the recession. I also show how other government policies contributed to the Great Recession in a significant way, such as the Community Reinvestment Act of 1977 and mortgage lending engaged in by Fannie Mae and Freddie Mac.