Austrian Business Cycle Theory and the Current Economic Crisis

I believe I am correct in saying that there is no best-selling economics principles textbook on the market today (including my own) that discusses the Austrian School of Economics or, in particular, the Austrian Business Cycle Theory (ABCT). Lately, though, the ABCT has been discussed in a few economics blogs and in the press. If you check out these blogs, much is being said about Austrian economists having predicted the current financial and economic crises. Here are three of the blogs:


Now is a good time to remind students what a business cycle is (see *Arnold Economics 9e*, page 150 and *Arnold Macroeconomics 9e*, page 150). It is also important to remind students that some economists view the economy as self regulating (see *Arnold Economics 9e*, Chapter 8 and *Arnold Macroeconomics 9e*, Chapter 8) while other economists view the economy as inherently unstable (see *Arnold Economics 9e*, Chapter 9 and *Arnold Macroeconomics 9e*, Chapter 9).

Austrian economists fall into the self-regulating camp, and this is perhaps nowhere more evident than in their ABCT. Briefly, that theory explains the business cycle and the current economic crisis this way:  

- During the period of about mid-2002 through the third quarter of 2006, the Fed implemented a ridiculously low interest rate policy. The low interest rates (brought on by the Fed) and not by a rise in savings (which would have been different indeed) sent out the wrong signal to the economy. The signal read: “Households are saving more” -- when in fact households weren’t saving more.

- Low interest rates tend to favor consumer durables (like automobiles and houses) and capital projects because present values are increased. (See *Arnold Economics 9e*, pages 628-629 and *Arnold Microeconomics 9e*, pages 366-367 on present value.)

- Resources now move into consumer durable goods and capital projects.

- When interest rates rise, things begin to unravel. Specifically, homeowners who thought low interest rates would continue indefinitely learn that they cannot pay off their loans. Resources that were earlier directed to capital projects turn out to be misdirected.

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1 The source for the Austrian business cycle explanation is *The Misdirection of Resources and the Current Recession* by Mario Rizzo, *Mises Daily Article*, February 19, 2009.
According to Austrian economists, this “unraveling” is an economy’s way of correcting for past mistakes, specifically past Fed mistakes.

- A policy position falls out of the ABCT, namely: The best thing to do is let the economy correct for past mistakes. Let it reallocate the previously misdirected resources. Simply put, the bailouts and stimulus package are the “wrong medicine” to be giving the economic patient.

If you would like to read a more detailed explanation of the Austrian business cycle, I recommend the following:

- Chapter 1 of *America’s Great Depression* by Murray N. Rothbard
- *The Austrian Theory of the Business Cycle* by Roger Garrison at [http://www.auburn.edu/~garriro/a1abc.htm](http://www.auburn.edu/~garriro/a1abc.htm)
- Chapter 20 of *Human Action* by Ludwig von Mises