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MENDING THE MELTDOWN: Fending off the Interventions and Resurrecting the Market

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Introduction

The emerging economic crisis in USA and the global economy presents a phenomenon which started to appear frequently in different economies around the world during late 18th century with the advent of central banking in England. In the science of economics[1], this phenomenon is called, The Business Cycle. It is important that when we are trying to recover from the present economic crisis, we must first understand the whole phenomenon of the business cycle. After that, we must understand the causes of the business

cycle which are presented by a proper theory of business cycle. In this short paper my goal is two-fold. First to make the business cycle phenomenon clear to the readers and present the economic theory of business cycle which discusses its main cause. After having a full grasp of the theory of business cycle, I will then present the solution of the crisis. The discussion follows in three different sections. Section 2, will present the understanding of and the proper theory of business cycle. In section 3, I will argue against the efforts of various governments and their central banks to solve the present economic crisis. Using the business cycle theory developed in the preceding section, I will demonstrate why the present efforts of various governments and central banks won't work and in fact will prove to be counter productive and even more disastrous. Section 4, will then discuss what we need to do for a quick recovery from the present meltdown and what we need to do in the long run to stop the problem of the business cycle from recurring[2] .

The Cause of the Crisis

For finding the solution of any problem requires one to first have a clear understanding of the problem and its causes[3]. Here, I first discuss the distinction between the business cycle and business fluctuations. Once we understand the business cycle then I present its causes.

Business Cycle and Business Fluctuation

Both the phenomenon of the business cycle and day to day business fluctuations are vastly different from each other. The distinction between them must be made clear to understand what causes day to day business fluctuation and what causes the business cycle. Business fluctuations are part of routine life where prices of individual goods or services fall or rise on daily basis. The rise and fall is due to changes in the market forces of demand and scarcity of the goods or service in question. As analyzed by the Austrian economist, price is determined primarily by the subjective valuations of all consumers. Other factors affecting price are the given circumstances under which the consumer finds himself while choosing the marginal unit and the relative scarcity of the goods or service. For example, during a natural disaster such as a flood, the price of milk rises rapidly because the given circumstances of flood make milk scarcer. Similarly prices of individual products rise and fall on a daily basis with the change in underlying economic data. It must be emphasized here that, this rise and fall in individual product prices or even prices in some sector of the economy, like automobile industry or agriculture products etc., can not be considered as a cycle. These are individual events happening in one or the other sector of the economy. These fluctuations are corrected automatically by the market if left alone to work. For example, during flood, if we let the price of milk rise for sometime then it will automatically induce producers from other areas to start producing more milk because now milk industry is more profitable during flood time. Once this new supply enters the flood hit place it will increase the supply of milk and will remove the scarcity of milk. This removal of scarcity itself will lower the prices of milk in few days time. Market will automatically resolve the milk problem. So we don't need any special attention for such daily events. Market easily sorts out gluts and scarcities. Like the rise and fall of prices of individual products in the market, everyday many individual businesses silently cease its operation when they make losses. Individual business closures are very normal in Market. Profit and loss is the market mechanism through which inefficient and unproductive businesses are weeded out while efficient and productive business remains and continues their activity to serve the consumers most effectively[4] .

> Rise and fall in individual product prices or even prices in some sectors can not be considered as a cycle

But the phenomenon of business cycle is very different. It requires special attention because the causes of business cycle are not in built in the market process [5]. Let's first understand what business cycle is.

Business cycle is a general boom and bust phenomenon which occurs at the economy wide level. It is a macroeconomic phenomenon having crucial microeconomic roots. The phases of an economic cycle are typical [6]. It starts with a mild boom in economic activity (when everything seems very rosy), then the boom expands rapidly and that starts to result into inflation and then a final slowdown of the economy, the recession . What is very peculiar of the business cycle is the phase of recession[7]. During the recession, we see economy

wide mass business failures, like the present one where the housing market, majority of banks and auto industries are collapsing one by one. What seem to be so profitable industries in the boom period suddenly become unprofitable. Due to these business closures large scale unemployment results. The capital structure of the economy changes where resources starts to flow from unprofitable industries to other sound industries. During the boom period also the economic activity seems very unusual where most of the goods and services' prices tend to push up dramatically [8]. Inflation slowly emerges in the economy and it spreads from one sector to another sector[9] . This is what is the character of the general boom and bust cycles. It is very different from the daily business fluctuations.

After understanding what business cycle is, it is important to understand its causes. Any good business cycle theory should explain all the phases of cycle within the framework of general theory of economics. It must explain why during the recession period mass business failures results, why the capital structure starts to change (many projects fails and resources flows from this projects to other more viable projects), why unemployment results and why during the boom period economic activity increases dramatically, money supply is continually increasing and in the end it all ends with an inflation and subsequent recession. There are many theories of business cycle in mainstream economics but they all either don't fit into the general framework of economic theory or fail to explain the business cycle properly. The only theory which successfully integrates itself into economic theory and simultaneously explains the boom bust cycle fully is The Austrian Business Cycle Theory (ABCT) as developed first by Ludwig von Mises (Mises1953) and subsequently by Friedrich Hayek (Hayek1967) and Murray Rothbard (Rothbard2000) [10].

Austrian Business Cycle Theory is the only theory which successfully integrates itself into economic theory

The Austrian Business Cycle Theory: The ABCT

The Austrian Business Cycle theory is based on many crucial insights of Austrian economics like the capital structure of the economy, the different stages of production, the nature of money, bank credit expansion through the system of fractional reserve banking, time preference of consumers etc. Here, I will directly use all these concepts without going into details, again because of the space constraints.

As we have said, ABCT explains the business cycle completely starting from the artificial boom to its ultimate bust in form of recession. I will discuss all phases one by one.

The artificial boom starts to take place when the central bank of the country (RBI in case of India) starts to increase the money supply by printing more money and then commercial banks starts to lend this money to the business people and general public at a lower interest rate. The increased money supply, which is result of printing of money and the credit expansion activity of banks through fractional reserve banking, lowers the interest rate below its natural market level [11]. During this phase, due to artificially lowered interest rate many projects appear profitable to an individual entrepreneur which would not have appeared profitable previously. What is important to understand here is how the market interest rate is lowered. There are two ways in which interest rate can get lowered. One is when people's time preference becomes low and they look to consume more goods in the future and thus in the present they increase their savings. This increased savings lowers the market interest rate. This low interest rate sends a signal to the entrepreneurs that consumers are asking for more goods and services in the future. In order to fulfill those future demands at a future date entrepreneurs starts new long term capital projects in present time which will enable them to produce more in future and thus meet the future demand of consumers. When the investment in new projects is backed by this type of real savings, it results in no boom and bust.

The problem starts to take place when the market interest rate is lowered by the central banks by printing more money out of thin air and by credit expansion by commercial banks through fractional reserve banking. This artificially lowered interest rate sends a wrong signal to entrepreneurs about the future demand of consumers. Here, consumers' time preferences have not changed and thus they are not asking for more goods and services in future. Working under the illusion created by the central bank, businesses starts to expand their activities. They start many new long term projects. Resources start to flow into these new ventures. As

resources are employed in these new projects they are less available for producing other consumer items which are required for present consumption. As the newly created money starts to enter market it increases the purchasing power of those in whose hands it goes first. On one side consumers acquire new income and on other side their time preference haven't changed and thus they start to spend their money in market for present consumption. On the other side production of consumer goods is not taking place because resources are flowing in long term production processes. This slowly starts to result in inflation[12] . Price rise slowly spreads from one sector of the economy to the other sector with the flow of money from one sector to another. Once the money spreads fully it results into inflation.

Now as Inflation emerges in the economy, suddenly government becomes concerned about it. To combat this inflationary situation, central bank starts increasing the interest rate by using tight monetary policy. With this increase in interest rate, the entrepreneurs realize that the new projects which they started during the boom period are not backed by real saving and are thus not profitable and sustainable. Mass business failure takes place. Murray Rothbard called this phenomenon of mass business closure, a cluster of errors, where many businesses suddenly discover many errors in their past decisions. The artificial boom inevitably results into a recession. People employed in those projects now become unemployed until they find work in activities suited to consumers' preferences.

What is important here to understand is that, recession is a necessary outcome of the artificially created boom by the central bank. The recession is the process through which market starts to correct the capital structure of the economy. Through that whatever mal-investment has taken place during the boom period now starts to liquidate and those resources slowly starts to flow in correct industries to fulfill consumers' immediate demand.

The recession is the process through which market starts to correct the capital structure of the economy

But, if during this period government again starts to intervene in the market adjustment then the mild recessions can result in a deep depression such as the Great Depression of 1929. The present economic crisis could result in a big depression because governments around the world are meddling heavily in market adjustment process of recession. I now discuss how the recession becomes a depression and why the present efforts of governments around the world are unnecessary and in fact counter productive.

Why the Present Meddling with the Market Won't Work?

The action of government during the recession period is typically to prevent the recession at any cost. They fail to

understand that recession is necessary to liquidate the mal-investment of the boom period. It is necessary for realignment of capital structure and the production process according to consumer time preferences. The typical response of government and their central banks is to pump more money into the market during the recession period[13]. These Keynesian policies are based on flawed economic reasoning that a recession takes place because consumers suddenly start spending less[14]. What actually results due to this pumping of money is more distortions of market interest rate[15] and further distortions in the adjustment process. More distortions in market will require a longer time for readjustment and thus recessions becomes depressions[16]. Governments and their central banks fail to understand that the process which was started by creating money out of thin air can never be corrected by the same process of creating more money out of thin air.

Without real savings, economy will never grow. Artificially created wealth gets wiped out one day. Fiat money can only result into booms and busts. By printing more money one can not make poor people rich or a poor nation rich. Living beyond one's means is not possible in the long run [17].

Doing nothing sometimes is a more beneficial action than doing everything and deteriorating the situation further

The Ultimate Remedy

After getting the full grip of the theory of business cycle it is clear what we need to do in the short run for a recovery and more importantly what we need to do in the long run to prevent the business cycle from ever occurring.

In short run, we should need to do nothing. Doing nothing sometimes is a more beneficial action than doing everything and deteriorating the situation further. We need to let the market do its work. The market in a very short period of time will reallocate all the resources in right channels of production and will adjust the capital structure of economy in line with consumers' time preferences. Through recession the market will liquidate all mal-investments. In the short run all the unnecessary projects will shutdown and we should allow this business closures instead of bailing them out one by one, as they are doing right now. People will increase their savings in the recession period and that is good. We should not meddle with consumer's desire to save more during recession. In fact this saving is necessary in recession because this

increased saving can, to some extent, help some of the businesses to survive in recession period. Consumers by making this actual savings available to some of the businesses can help them in avoiding bankruptcies and also preventing them from laying off their workers. It can also prevent the loss to the equity holders. Once the recession period is over, economic activity will return to normal. People will find employment in more viable activities again. Prices will come down to their normal market level which will increase the standard of living of people slowly.

Money is too important subject to be handed over to government who is always eager to exploit it

And in the long run, if we wish to prevent the business cycle from ever happening then the key lies in taking the control of money back from government and restoring it again to market. We need to adopt three crucial steps:

1. Money essentially is a commodity and it should be produced in the market itself like any other commodity. For restoring the money in the market place and to take back the control of money supply from the government, we need to adopt the market based commodity money[18]. Commodity money can either be gold or silver or both gold and silver, as existed in historical periods. This is what is needed for stopping government from printing money out of thin air. Public mints should give its way to the private coinage.
2. Secondly, we need to abolish the central banks. This means abolishing the RBI from India. Central banks are the root cause of this whole problem. A central bank is just like any other central plan authority which worked under communist/socialist/market socialist countries. Theory and history both shows that central planners and their plans never work. They can only create problems for people. Central banks' monetary policy and its fixing of interest rate is the prime cause of boom and bust cycle. If we want to stop the booms and busts then we need to abolish all the central banks around the world [19].
3. Even in the absence of central banks, private banks (through the process of credit expansion under a fractional reserve banking system) can distort the market interest rate creating a boom and bust. The whole system of fractional reserve banking is unethical and thus we need to stop it too. All banks must operate on a 100 per cent reserve banking norm. If banks have 100 customers with 100 rupees worth of reserves then that bank must, all the time, keep 100 rupees reserves with it. In short the money creation process of banks should be stopped. Stock and bond markets are good places for the businessman for getting people's savings for their business investments. Banks-of-credit (as oppose to the banks-of-deposit) will also perform the function of providing consumer's savings to the businesses. In short, 100 percent free banking system should replace our present day fractional reserve banking system [20].

These three steps are necessary for stopping booms and busts from ever occurring. We must let free market work in the very crucial sphere of money. Money is too important subject to be handed over to government who is always eager to exploit it. IER

Endnotes

1 Economics is a study of human action, also known as Praxeology.

2 At the very outset of this paper I make it clear that it will be impossible for me to discuss all the issues which will arise in reader's mind after reading my paper. Because of space constraints I will be very brief. But I will give detailed references so that one can go and find answers of their queries by reading those references.

3 Studying this cause and effect relationship is the backbone of any scientific inquiry as made clear by famous Austrian economist Carl Menger, in the first sentence of his seminal work The Principles of Economics (Menger2007, p.51.) Menger started his magnum opus with the following statement: All things are subject to the law of cause and effect.

4 To understand the mechanism of profit and loss thoroughly please refer to, (Mises2008).

5 Many people, including many renowned economist blame the free market for causing the business cycle e.g., J.M. Keynes developed whole new economics (The Keynesian economics) by refuting Say's Law of Market. Later on in this article I will show, why all those people who blame the market are mistaken in their views or present flawed reasoning on their part to refute workings of the market.

And those who blame the market for today's crisis, fails to see the fact that we simply don't have any free market working anywhere. What we actually have is the hampered market, raft with government interventions and regulations.

[6] Although not regular and thus not predictable.

[7] In the following section we will see why the mild recessions sometimes can take a form of a deep depression e.g., the great depression of 1929 in America. It is highly likely that the way government across the world is reacting towards the present crisis, this recession can also turn into big depression like 1929 or even worst than that.

[8] Price rise is just the effect of the process of inflation. It's not the cause of Inflation. We will see in subsequent section the main cause of Inflation. There I will define Inflation from an Austrian point of view.

[9] This is called the Cantillon Effect.

[10] For a short introduction to the Austrian Business Cycle theory, please refer to (Ebeling1996).

[11] This is called the easy money policy of the central bank.

[12] Austrian economists define inflation differently. I quote Henry Hazlitt for the definition, Inflation is an increase in the quantity of money and credit. Its chief consequence is soaring prices. Therefore inflation - if we misuse the term to mean the rising prices themselves — is caused solely by printing more money. For this the government's monetary policies are entirely responsible (Hazlitt2004).

[13] To resolve the so called liquidity problem.

[14] Because of many constraints again it is difficult for me to discuss the fallacies of Keynesian economics. For a thorough reading on this please refer to (Hazlitt1959) and (Hazlitt1995).

[15] For example, central banks around the world have now lowered the market interest rate to combat the recession. RBI is also pushing huge amount of paper money in the market.

[16] Thus, as against the mainstream view of market responsible for depressions, it is the government and central banks who are responsible for big depressions, with the business cycles.

[17] We certainly die in long run as Lord Keynes said, but we live long enough to suffer from the government policies. And we also leave a wrecked economy for our future generation as a legacy of our present follies.

[18] For a discussion of the market based commodity money please refer to, (Rothbard1974).

[19] The campaign for ending the US Federal Reserve Bank has already started in USA and it is backed by the leading proponent of sound money, Ron Paul. Their website is here - http://www.endthefed.us/.

[20] For a discussion of the flaws and unethical practice of fractional reserve banking system (FRB) please refer to, (Soto2006).

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