

The Austrian Theory of the Trade Cycle

Ludwig von Mises

Compiled by Richard M. Ebeling

Nowadays it is usual in economics to talk about the Austrian theory of the trade cycle. This description is extremely flattering for us Austrian economists, and we greatly appreciate the honor thereby given us. Like all other scientific contributions, however, the modern theory of economic crises is not the work of one nation. As with the other elements of our present economic knowledge, this approach is the result of the mutual collaboration of the economists of all countries.

The monetary explanation of the trade cycle is not entirely new. The English "Currency School" has already tried to explain the boom by the extension of credit resulting from the issue of bank notes without metallic backing. Nevertheless, this school did not see that bank accounts which could be drawn upon at any time by means of checks, that is to say, current accounts, play exactly the same role in the extension of credit as bank notes. Consequently the expansion of credit can result not only from the excessive issue of bank notes but also from the opening of excessive current accounts. It is because it misunderstood this truth that the Currency School believed that it would suffice, in order to prevent the recurrence of economic crises, to enact legislation restricting the issue of bank notes without metallic backing, while leaving the expansion of credit by means of current accounts unregulated. Peel's Bank Act of 1844, and similar laws in other countries, did not accomplish their intended effect. From this it was wrongly concluded that the English School's attempt to explain the trade cycle in monetary terms had been refuted by the facts.

The Currency School's second defect is that its analysis of the credit expansion mechanism and the resulting crisis was restricted to the case where credit is expanded in only one country while the banking policy of all the others remains conservative. The reaction which is produced in this case results from foreign trade effects. The internal rise in prices encourages imports and paralyzes exports. Metallic money drains away to foreign countries. As a result the banks face increased demands for repayment of the instruments they have put into circulation (such as unbacked notes and current accounts), until such time as they find they have to restrict credit.

Ultimately the outflow of specie checks the rise in prices. The Currency School analyzed only this particular case; it did not consider credit expansion on an international scale by all the capitalist countries simultaneously.

In the second half of the 19th century, this theory of the trade cycle fell into discredit, and the notion that the trade cycle had nothing to do with money and credit gained acceptance. The attempt of Wicksell (1898) [\[1\]](#) to rehabilitate the Currency School was short-lived.

The founders of the Austrian School of Economics—Carl Menger, Böhm-Bawerk, and Wieser—were not interested in the problem of the trade cycle. The analysis of this problem was to be the task of the second generation of Austrian economists. [\[2\]](#)

In issuing fiduciary media, by which I mean bank notes without gold backing or current accounts which are not entirely backed by gold reserves, the banks are in a position to expand credit considerably. The creation of these additional fiduciary media permits them to extend credit well beyond the limit set by their own assets and by the funds entrusted to them by their clients. They intervene on the market in this case as "suppliers" of additional credit, created by themselves, and they thus produce a lowering of the rate of interest, which falls below the level at which it would have been without their intervention. The lowering of the rate of interest stimulates economic activity. Projects which would not have been thought "profitable" if the rate of interest had not been influenced by the manipulations of the banks, and which, therefore, would not have been undertaken, are nevertheless found "profitable" and can be initiated. The more active state of business leads to increased demand for production materials and for labor. The prices of the means of production and the wages of labor rise, and the increase in wages leads, in turn, to an increase in prices of consumption goods. If the banks were to refrain from any further extension of credit and limited themselves to what they had already done, the boom would rapidly halt. But the banks do not deflect from their course of action; they continue to expand credit on a larger and larger scale, and prices and wages correspondingly continue to rise.

This upward movement could not, however, continue indefinitely. The material means of production and the labor available have not increased; all

that has increased is the quantity of the fiduciary media which can play the same role as money in the circulation of goods. The means of production and labor which have been diverted to the new enterprises have had to be taken away from other enterprises. Society is not sufficiently rich to permit the creation of new enterprises without taking anything away from other enterprises. As long as the expansion of credit is continued this will not be noticed, but this extension cannot be pushed indefinitely. For if an attempt were made to prevent the sudden halt of the upward movement (and the collapse of prices which would result) by creating more and more credit, a continuous and even more rapid increase of prices would result. But the inflation and the boom can continue smoothly only as long as the public thinks that the upward movement of prices will stop in the near future. As soon as public opinion becomes aware that there is no reason to expect an end to the inflation, and that prices will continue to rise, panic sets in. No one wants to keep his money, because its possession implies greater and greater losses from one day to the next; everyone rushes to exchange money for goods, people buy things they have no considerable use for without even considering the price, just in order to get rid of the money. Such is the phenomenon that occurred in Germany and in other countries that followed a policy of prolonged inflation and that was known as the "flight into real values." Commodity prices rise enormously as do foreign exchange rates, while the price of the domestic money falls almost to zero. The value of the currency collapses, as was the case in Germany in 1923.

If, on the contrary, the banks decided to halt the expansion of credit in time to prevent the collapse of the currency and if a brake is thus put on the boom, it will quickly be seen that the false impression of "profitability" created by the credit expansion has led to unjustified investments. Many enterprises or business endeavors which had been launched thanks to the artificial lowering of the interest rate, and which had been sustained thanks to the equally artificial increase of prices, no longer appear profitable. Some enterprises cut back their scale of operation, others close down or fail. Prices collapse; crisis and depression follow the boom. The crisis and the ensuing period of depression are the culmination of the period of unjustified investment brought about by the extension of credit. The projects which owe their existence to the fact that they once appeared "profitable" in the artificial conditions created on the market by the extension of credit and the increase in prices which resulted from it, have ceased to be "profitable." The

capital invested in these enterprises is lost to the extent that it is locked in. The economy must adapt itself to these losses and to the situation that they bring about. In this case the thing to do, first of all, is to curtail consumption and, by economizing, to build up new capital funds in order to make the productive apparatus conform to the actual wants and not to artificial wants which could never be manifested and considered as real except as a consequence of the false calculation of "profitability" based on the extension of credit.

The artificial "boom" had been brought on by the extension of credit and by lowering of the rate of interest consequent on the intervention of the banks. During the period of credit extension, it is true that the banks progressively raised the rate of interest; from a purely arithmetical point of view it ends up higher than it had been at the beginning of the boom. This raising of the rate of interest is nevertheless insufficient to reestablish equilibrium on the market and put a stop to the unhealthy boom. For in a market where the prices are rising continually, gross interest must include in addition to interest on capital in the strict sense—i.e., the net rate of interest—still another element representing a compensation for the rise in prices arising during the period of the loan. If the prices rise in a continuous manner and if the borrower as a result gains a supplementary profit from the sale of the merchandise which he bought with the borrowed money, he will be disposed to pay a higher rate of interest than he would have paid in a period of stable prices; the capitalist, on the other hand, will not be disposed to lend under these conditions, unless the interest includes a compensation for the losses which the diminution in the purchasing power of money entails for creditors. If the banks do not take account of these conditions in setting the gross interest rate they demand, their rate ought to be considered as being maintained artificially at too low a level, even if from a purely arithmetical point of view it appears much higher than that which prevailed under "normal" conditions. Thus in Germany an interest rate of several hundred per cent could be considered too low in the autumn of 1923 because of the accelerated depreciation of the mark.

Once the reversal of the trade cycle sets in following the change in banking policy, it becomes very difficult to obtain loans because of the general restriction of credit. The rate of interest consequently rises very rapidly as a result of a sudden panic. Presently, it will fall again. It is a well-known

phenomenon, indeed, that in a period of depressions a very low rate of interest—considered from the arithmetical point of view—does not succeed in stimulating economic activity. The cash reserves of individuals and of banks grow, liquid funds accumulate, yet the depression continues. In the present [1936] crisis, the accumulation of these "inactive" gold reserves has for a particular reason, taken on inordinate proportions. As is natural, capitalists wish to avoid the risk of losses from the devaluations contemplated by various governments. Given that the considerable monetary risks which the possession of bonds or of other interest-bearing securities entail are not compensated by a corresponding increase of the rate of interest, capitalists prefer to hold their funds in a form that permits them, in such a case, to protect their money from the losses inherent in an eventual devaluation by a rapid conversion to a currency not immediately menaced by the prospect of devaluation. This is the very simple reason why capitalists today are reluctant to tie themselves, through permanent investments, to a particular currency. This is why they allow their bank accounts to grow even though they return only very little interest, and hoard gold, which not only pays no interest, but also involves storage expenses.

Another factor which is helping to prolong the present period of depression is the rigidity of wages. Wages increase in periods of expansion. In periods of contraction they ought to fall, not only in money terms, but in real terms as well. By successfully preventing the lowering of wages during a period of depression, the policy of the trade unions makes unemployment a massive and persistent phenomenon. Moreover, this policy postpones the recovery indefinitely. A normal situation cannot return until prices and wages adapt themselves to the quantity of money in circulation.

Public opinion is perfectly right to see the end of the boom and the crisis as a consequence of the policy of the banks. The banks could undoubtedly have delayed the unfavorable developments for some further time. They could have continued their policy of credit expansion for a while. But—as we have already seen—they could not have persisted in it indefinitely without risking the complete collapse of the monetary system. The boom brought about by the banks' policy of extending credit must necessarily end sooner or later. Unless they are willing to let their policy completely destroy the monetary and credit system, the banks themselves must cut it short before the catastrophe occurs. The longer the period of credit expansion and the longer

the banks delay in changing their policy, the worse will be the consequences of the malinvestments and of the inordinate speculation characterizing the boom; and as a result the longer will be the period of depression and the more uncertain the date of recovery and return to normal economic activity.

It has often been suggested to "stimulate" economic activity and to "prime the pump" by recourse to a new extension of credit which would allow the depression to be ended and bring about a recovery or at least a return to normal conditions; the advocates of this method forget, however, that even though it might overcome the difficulties of the moment, it will certainly produce a worse situation in a not too distant future.

Finally, it will be necessary to understand that the attempts to artificially lower the rate of interest which arises on the market, through an expansion of credit, can only produce temporary results, and that the initial recovery will be followed by a deeper decline which will manifest itself as a complete stagnation of commercial and industrial activity. The economy will not be able to develop harmoniously and smoothly unless all artificial measures that interfere with the level of prices, wages, and interest rates, as determined by the free play of economic forces, are renounced once and for all.

It is not the task of the banks to remedy the consequences of the scarcity of capital or the effects of wrong economic policy by extension of credit. It is certainly unfortunate that the return to a normal economic situation today is delayed by the pernicious policy of shackling commerce, by armaments and by the only too justified fear of war, not to mention the rigidity of wages. But it is not by banking measures and credit expansion that this situation will be corrected.

In the preceding pages I have given only a brief and necessarily insufficient sketch of the monetary theory of economic crises. It is unfortunately impossible for me in the limits set by this article to enter into greater detail; those who are interested in the subject will be able to find more in the various publications I have mentioned.

This essay was originally published as "La Theorie dite Autrichienne de Cycle Économique," in the *Bulletin* of the Société Belge d'Etudes et d'Expansion

(1936): 459-64. It was translated from the French by David O'Mahoney and J. Huston McCulloch.

[1] Knut Wicksell, *Interest and Prices*, R.F. Kahn, trans. (New York: Augustus M. Kelley, 1965)—Tr.

[2] The principal Austrian works concerning the theory of the economic cycle [as of 1936] are: Mises, *The Theory of Money and Credit* (New York: Foundation for Economic Education, 1971; translation of the 2nd German edition, 1924; originally published in 1912); Mises, *Monetary Stabilization and Cyclical Policy* (1928) reprinted in *On the Manipulation of Money and Credit*, Percy L. Greaves, ed., Bettina Bien Greaves, trans. (Dobbs Ferry, N.Y.: Free Market Books, 1978; originally published as a monograph in German); Friedrich A. von Hayek, *Monetary Theory and the Trade Cycle* (New York: Augustus M. Kelley, 1966; reprint of 1933 English edition, originally published in German in 1929); Hayek, *Prices and Production* (New York: Augustus M. Kelley, 1967; reprint of 1935 2nd revised edition, originally published in 1931); Fritz Machlup, *Führer durch die Krisenpolitik* (1934); Richard von Strigl, *Capital and Production*, Margaret Rudelich Hoppe and Hans-Hermann Hoppe, trans. (Auburn, AL: Ludwig von Mises Institute, 1995; translation of the 1934 edition); the best analysis of the actual crisis was made by Sir Lionel Robbins, *The Great Depression* (Freeport, R.I.: Books for Libraries Press, 1971; reprint of 1934 edition).—Note: citations have been updated in this new edition.]

See also Ludwig von Mises, [Human Action: A Treatise on Economics](#). (Chicago: Henry Regnery Company) Chapter XX. Interest, Credit Expansion, and the Trade Cycle pp. 538.