Anatomy of the Fed

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Lecture 3: The Austrian Theory of the Business Cycle

The Mises-Hayek
Business Cycle Theory

Ludwig von Mises (1881 – 1973)

Dean of the “Austrian” School

The Theory of Money and Credit (1912)

Friedrich A. Hayek (1899 – 1992)

Nobel Prize in Economics (1974)

Prices and Production (1931)

Savings-Supported Economic Growth

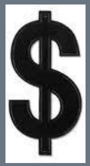
"Before we can even ask how things might go wrong, we must first explain how they could ever go right." – F.A. Hayek

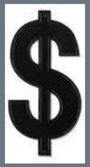
For Austrians,
Prices Act as *Signals*

Interest Rates Are Special Prices That Coordinate *Through Time*

Interest Rate =

10%

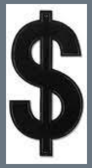




SUPPOSE FAMILY SAVES MORE

Interest Rate =

10%

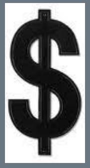


INTEREST RATE FALLS

Interest Rate =

~~10%~~

5%



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FACTORY BORROWS MORE

Interest Rate =

~~10%~~

5%

$ $ $

$ $ $

Not Just About Dollars—
Physical Resources Rearranged

Year 1:

Not Just About Dollars—
Physical Resources Rearranged

Year 1:

Year 2:

Not Just About Dollars—
Physical Resources Rearranged

Year 1:

Year 2:

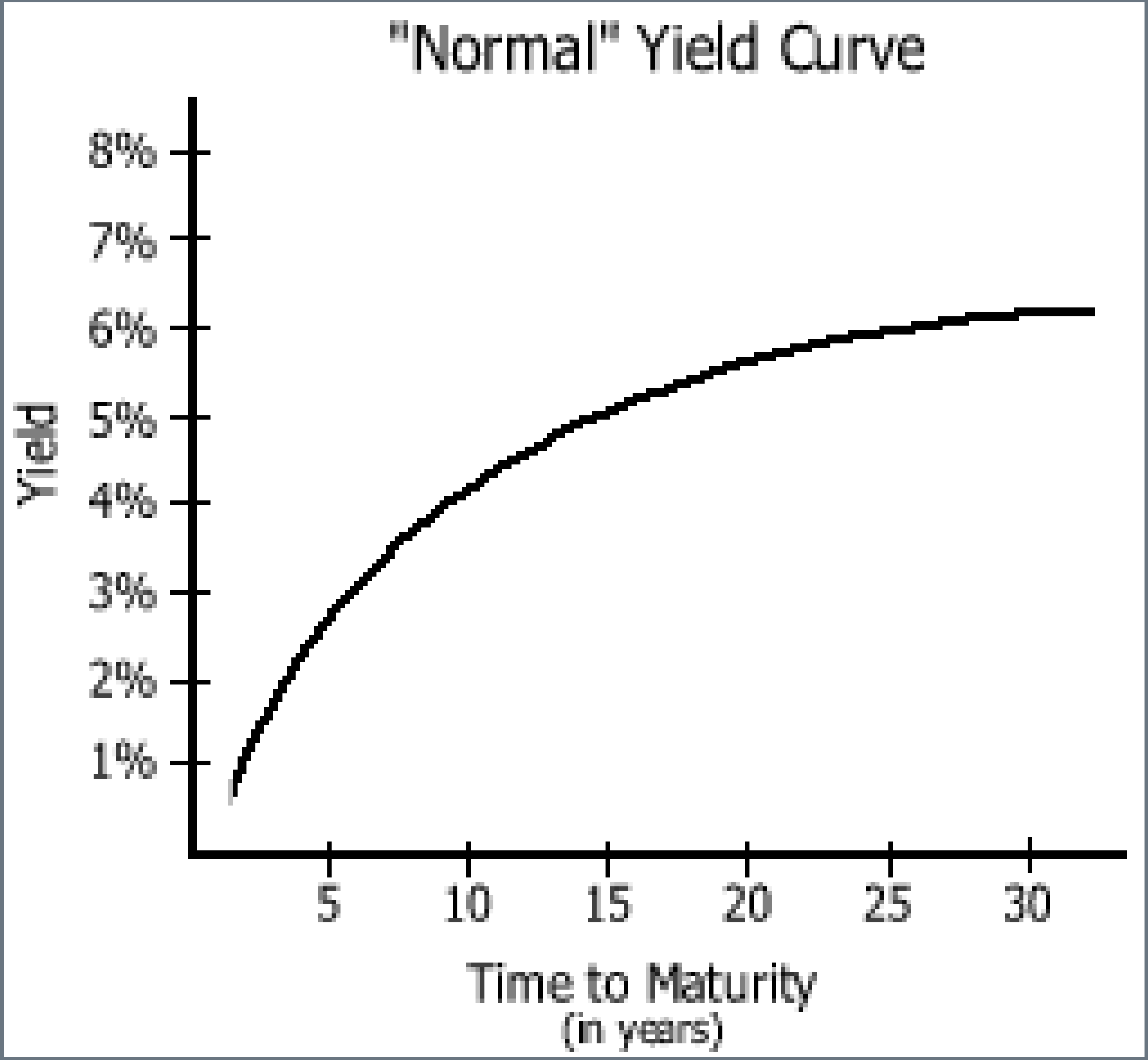
Year 3:

Interest Rates Are Special Prices That Coordinate *Through Time*

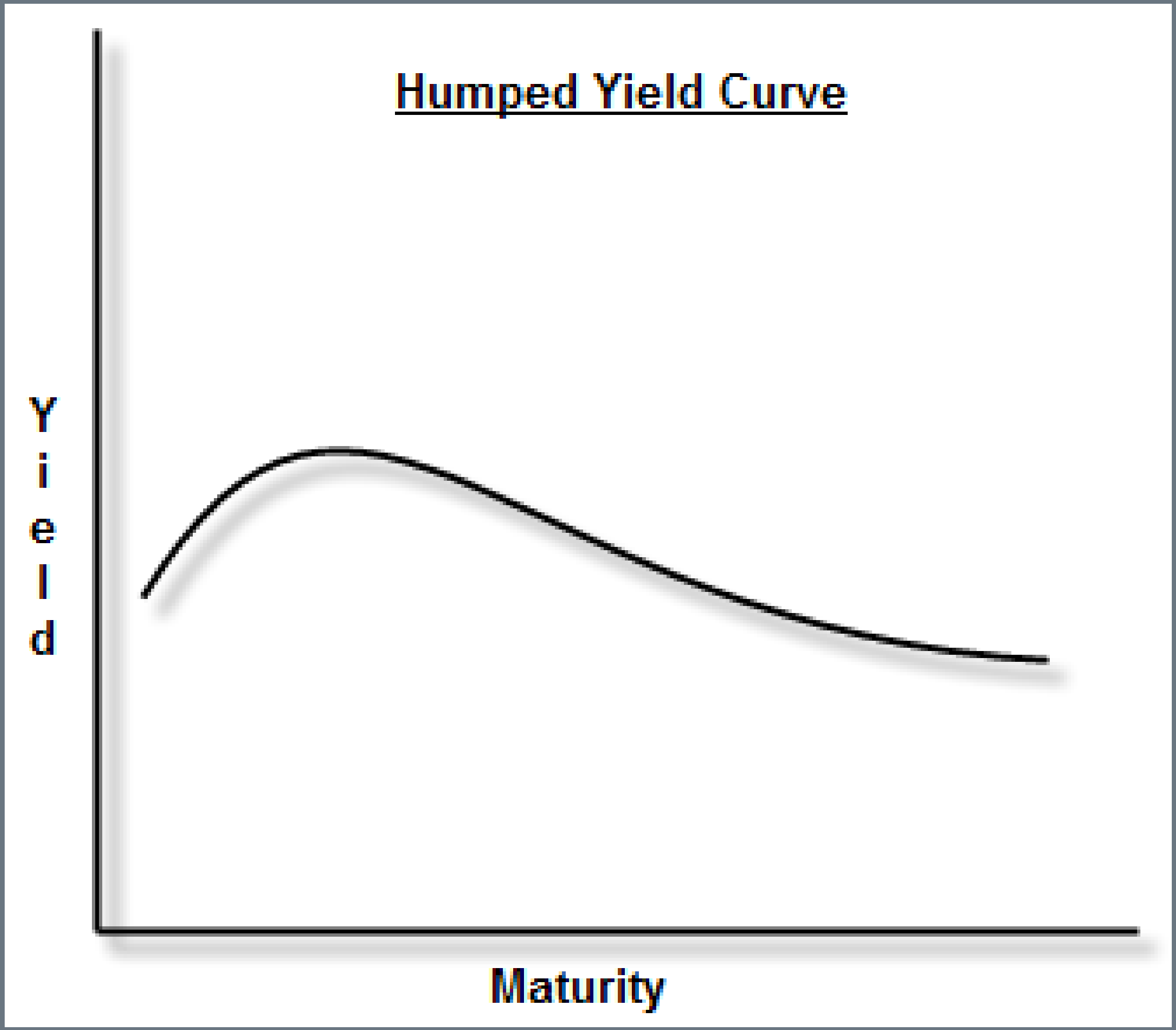
But what if factory borrows more because of FRACTIONAL RESERVE BANKING…?



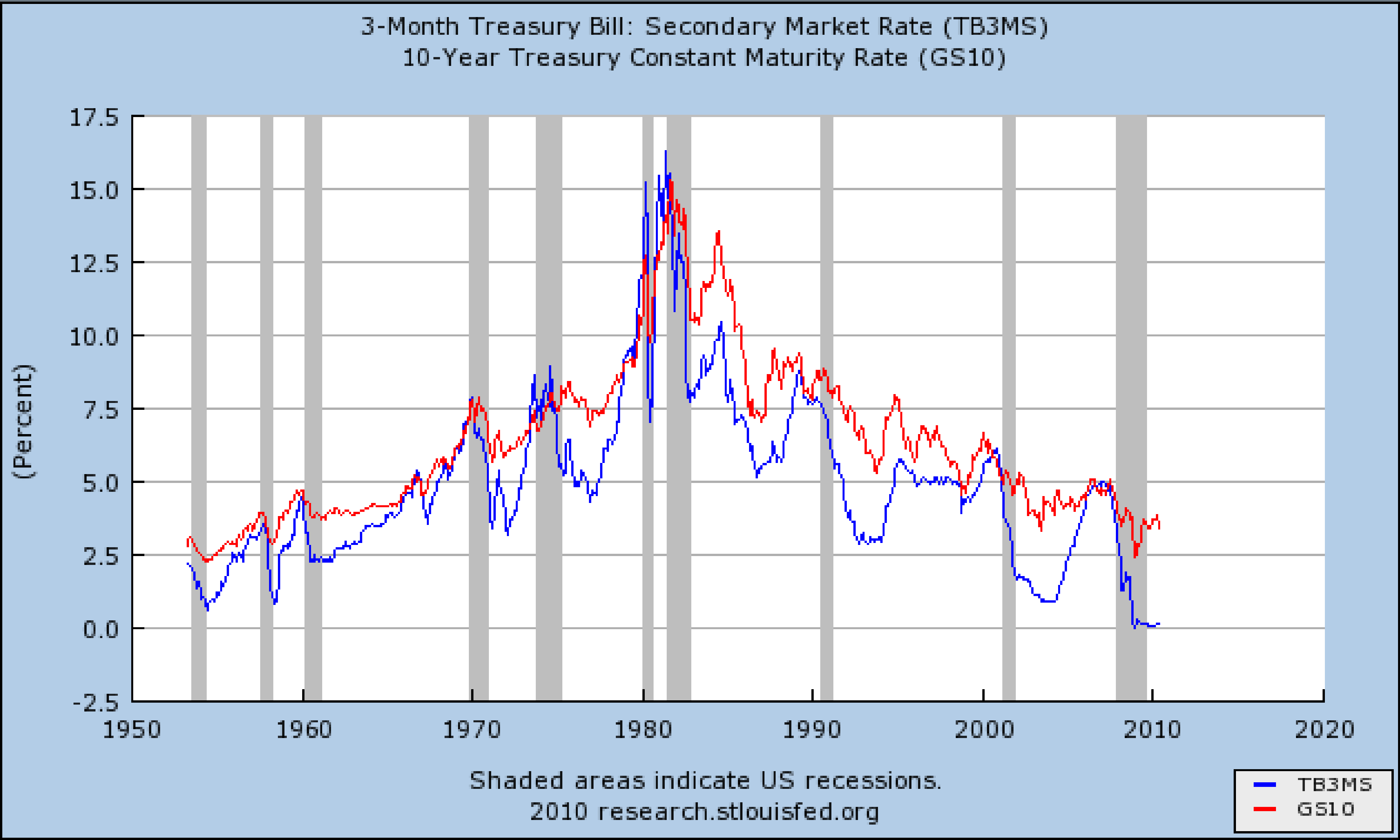

The Yield Curve Predicts Recessions


"Normal" Yield Curve
Yield
8%
7%
6%
5%
4%
3%
2%
1%
5
10
15
20
25
30
Time to Maturity
(in years)

Abnormal, Inverted Yield Curve



Austrians Can Explain



Predicting the Housing Bust

“Higher interest rates should trigger a reversal in the housing market and expose the fallacies of the new paradigm….[T]his exposure will hurt homeowners and the larger problem could hit the American taxpayer, who could be forced to bailout the banks and government-sponsored mortgage guarantors.”

Austrian Economist
Mark Thornton

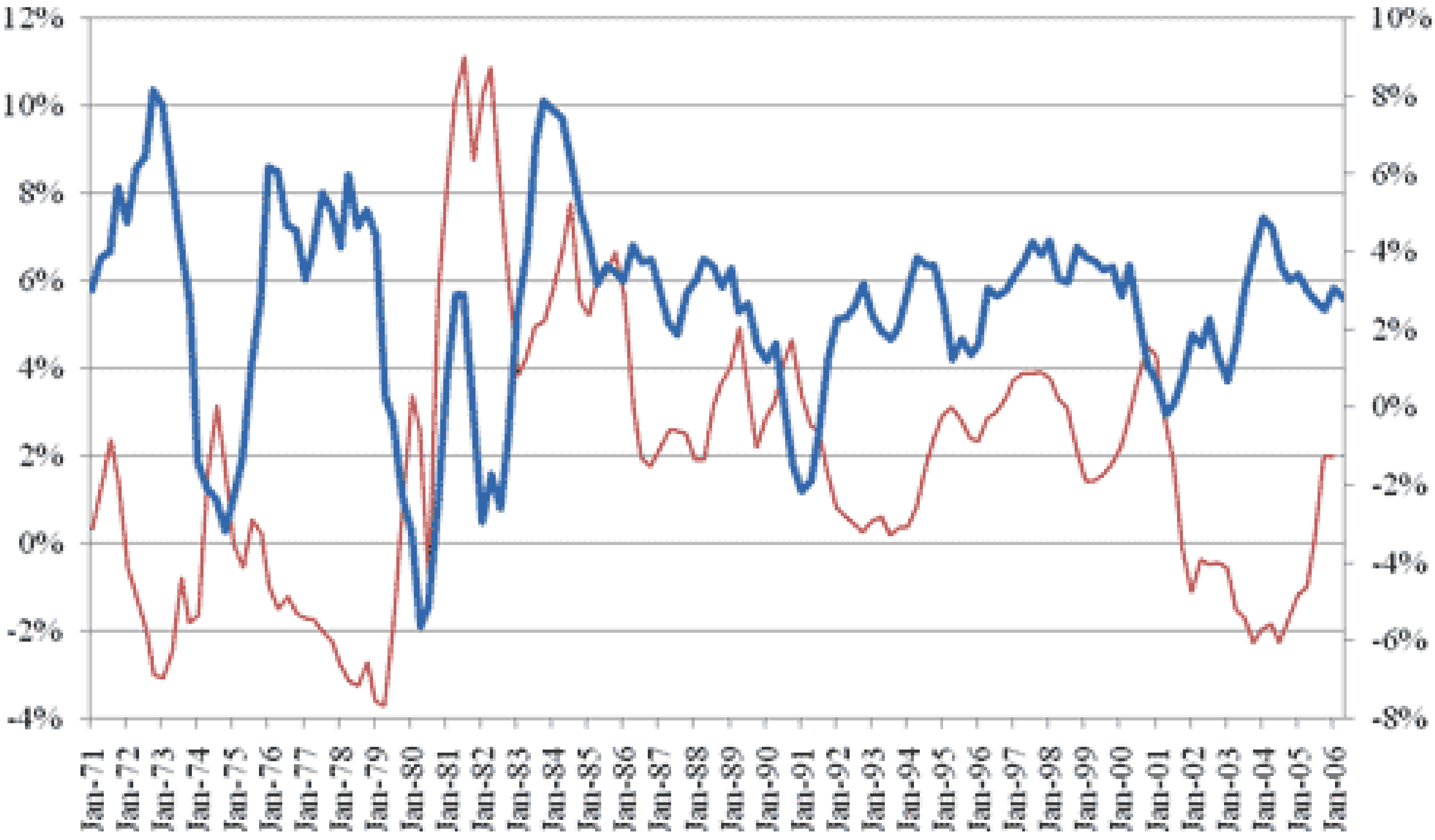
June 2004!!

“[Greenspan’s] artificial monetary stimulus….has sown the seeds of a contraction that will hit by 2Q 2008. The concerns of an asset bubble in real estate and (to a lesser extent) the stock market are entirely justified.”

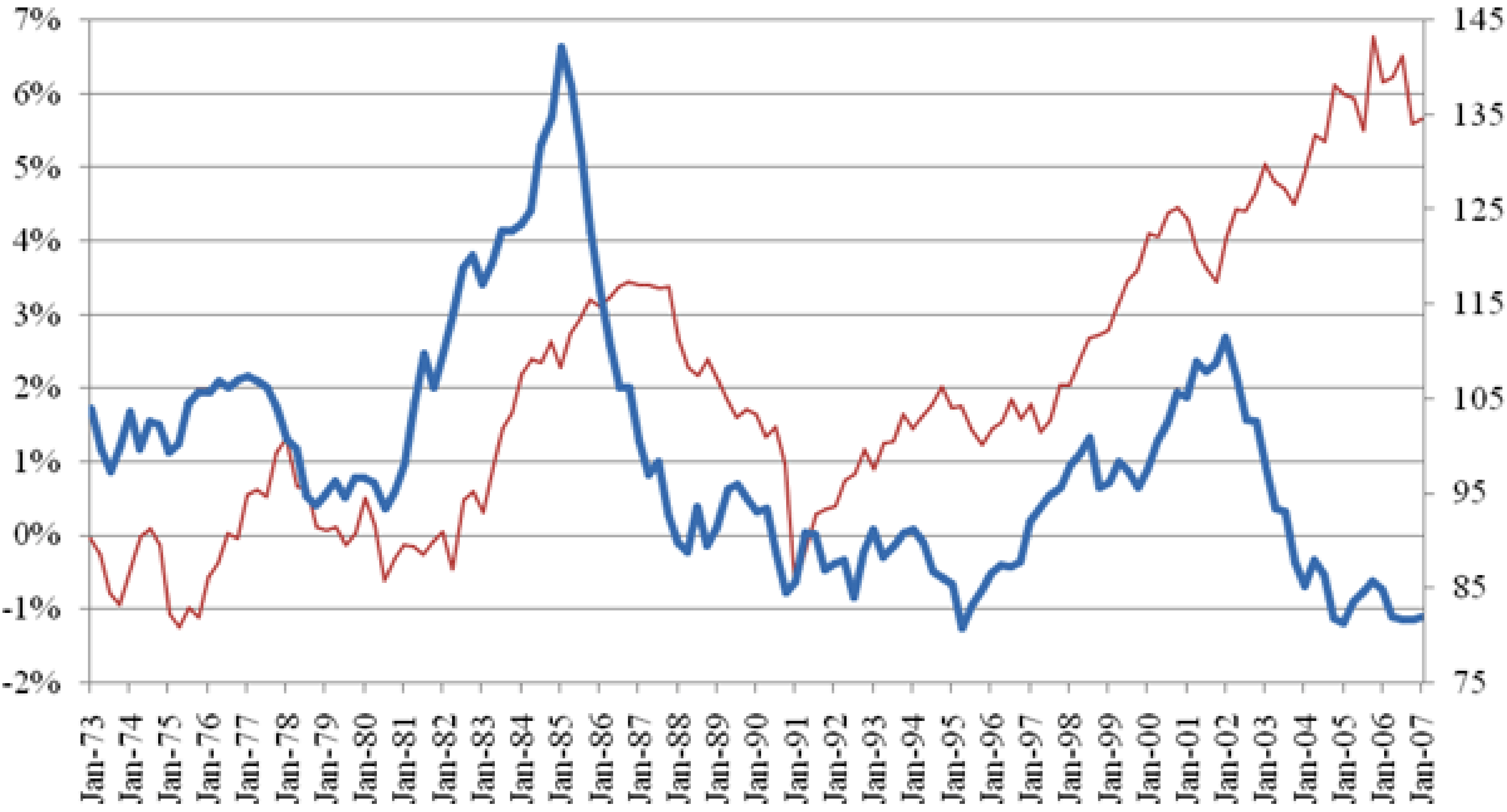
Robert Murphy (*moi*) in forecast for bank

July 2007

Real Fed Funds Rate (Red, Left)
Real Yr/Yr GDP Growth (Blue, Right)

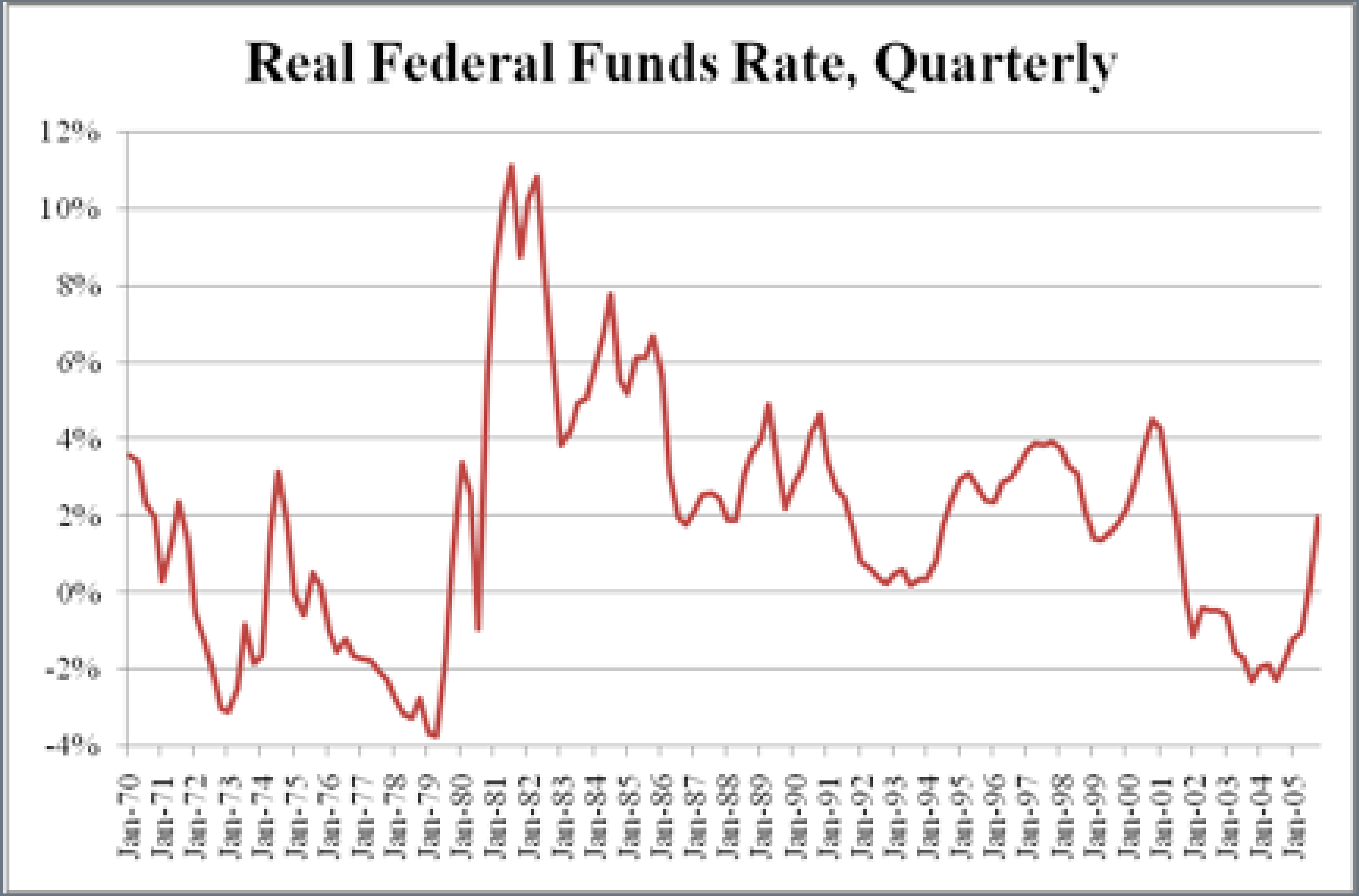


US Current Account Deficit (Red, Left)
Dollar Strength (Blue, Right)

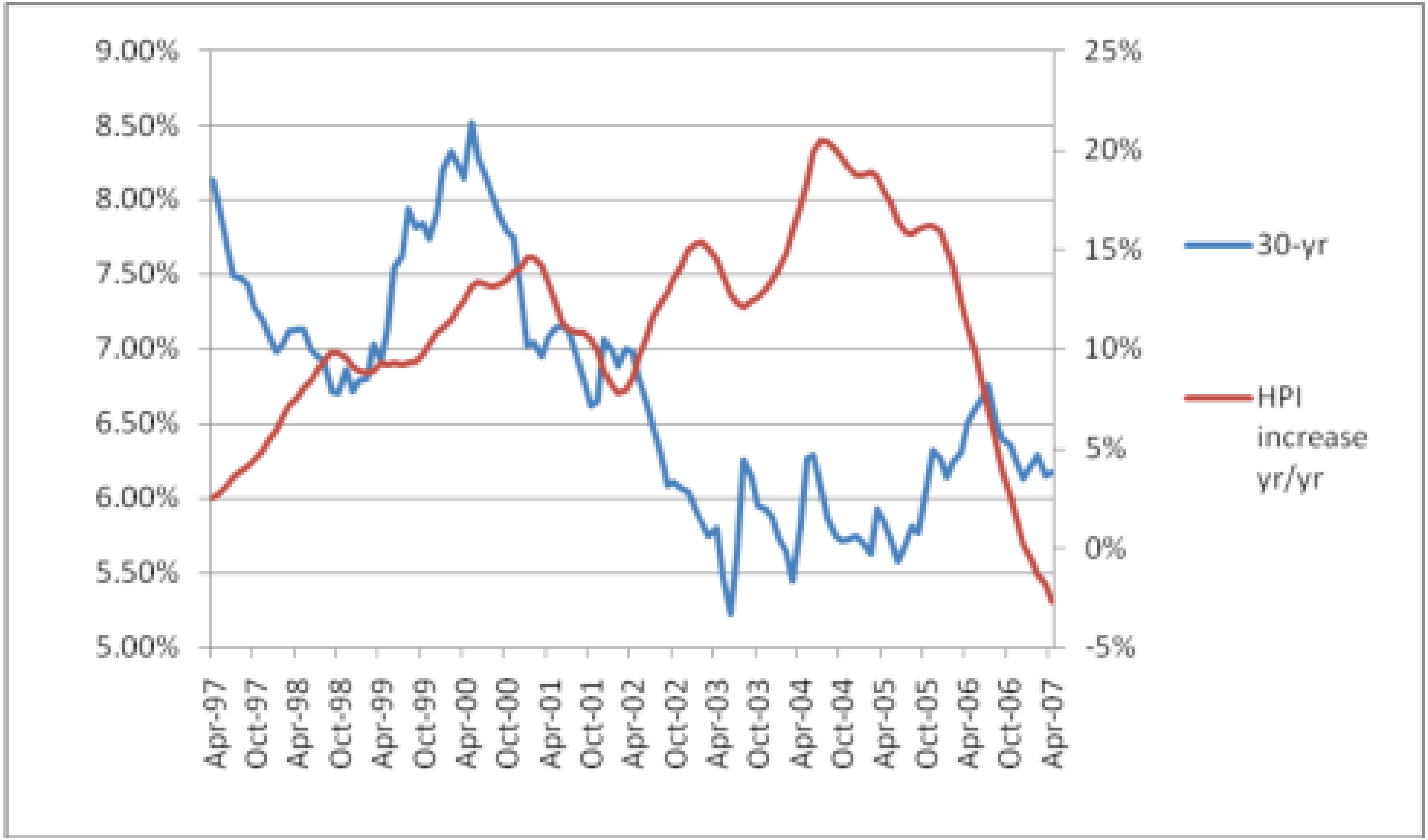


Fed Prints Money to Cut Interest Rates

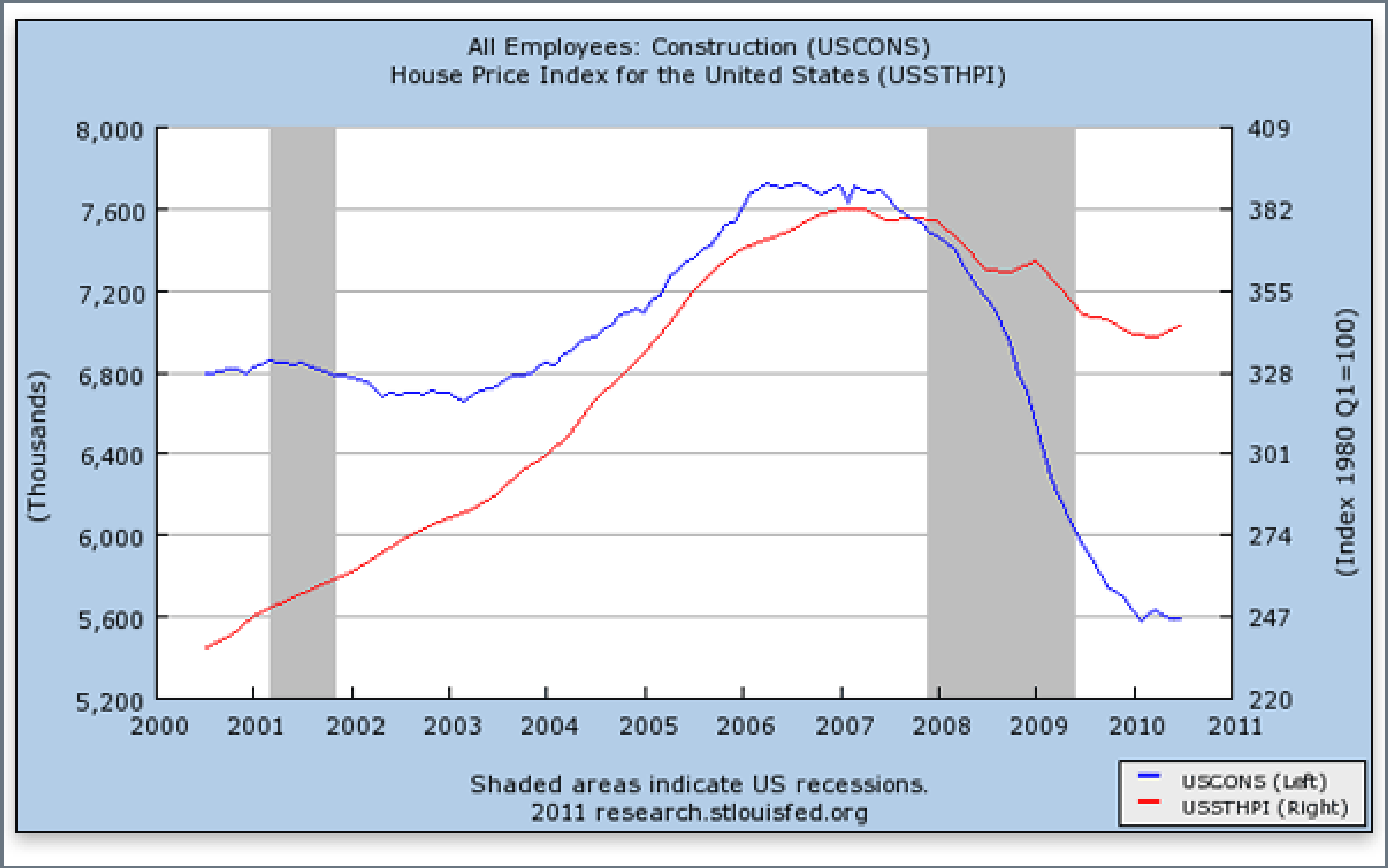
Greenspan Cut (Inflation-Adjusted) Rates to Lows Not Seen Since 1970s



Mortgage Rates and House Prices Move In Opposite Directions



Housing Boom/Bust Sucks Workers Into/Out of Construction Sector



Construction Sector Movements Mirror National Unemployment Rate