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Financial Cycles, Business Activity, and the Stock Market

ABSTRACT

The monetary theory of the business cycle in the tradition of Austrian economics holds that trade cycles result from excessive growth of circulating credit, which affects the real economy leading to unsustainable investment projects that get corrected in a recession when credit contraction occurs. Government and monetary authorities that systematically practice a policy of stabilizing financial assets and business activities by a policy of easy money and bailouts expose individual economic agents to a learning process of diminishing risk perception. Moral hazard as its consequence brings forth more credit growth. While, in the short run at least, these policies may stimulate economic activity, they put the economy on a path to more malinvestment in the long run. With governments and monetary authorities providing tight safety nets, a hideous form of central planning is being installed causing the spread of soft budgets constraints and the misallocation of capital. Unhampered credit growth as the result of such measures puts the economy on a path towards overextension of investment and consumption patterns that get out of line with individual time preferences and the availability of specific resources. If it were only aggregate demand and supply gaps, the application of expansive and restrictive measures might cure the problem when the disequilibria become more manifest. But it was under the expectation of ample availability of funds that investors and consumers have pursued a pattern of demand that has become incompatible with sustainable

funding in real terms. Economic booms based on credit expansion appear as a period in which for some time the law of scarcity seems nonexistent and economic agents tend to pursue projects, for which the economy is not yet rich enough. In this view, the onset of a recession signals the need of structural adaptation at the micro-level and not the mere re-adjustment of aggregates.

In this paper, the prime concepts are based on the Mises-Hayek-theory of the business cycle. Using this model as the general framework for analysis, additions and modifications are introduced reflecting theoretical advances and current problems.

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