Journal of Economics and Sustainable Development
ISSN 2222-1700 (Paper) ISSN 2222-2855 (Online)
Vol.6, No.12, 2015

The Austrian and Keynesian business cycle theory and its effectiveness to combat recession-A case study in construction industry in United Kingdom

Mina Md. Rabiqul Hasan [1*] Tahsan Rahman Khan[2*] Tonmoy Toufic Choudhury[3] Ashique Mahmood Adnan[4] Md. Rashidul Islam [5]
1. London Southbank University,UK.
2. Senior Lecturer, School of Business, BRAC University, Bangladesh.
3. Lecturer, School of Business, BRAC University, Bangladesh.
4. Lecturer, School of Business, University of Liberal Arts, Bangladesh.
5. Senior Lecturer, Dept of Business Administration, East West University,Bangladesh.

Abstract
Business cycles are the "ups and downs" in economic activity, defined in terms of periods of expansion or recession. This paper attempted to find out empirical evidence of effectiveness of Austrian and Keynesian theory of business cycle when a country is in recession and how to combat the recession. The study investigates UK economic data from 2003-2013 derived from Trading Economics Website and office of the National Statics UK. This study concludes that in the boom period Keynesian theory is effective as interest rate was low and government spending was high to stimulate demand. In recessionary period it is found that government money supply was very high but production of capital goods was very poor which means Keynesian theory has not been applied. But the recent booming period evidenced that interest rate is low and govt spending high.

1. Introduction

Business cycles are the "ups and downs" in economic activity, defined in terms of periods of expansion or recession. While in expansions the economy grows, in recessions, it contracts in terms of production, sales, and employment (Kaya and Engkuchik, 2013). It is very important to understanding and forecast of business cycle for investor to make their decision on investment.

The report aims the review of Austrian and Keynesian business cycle theory for evaluation of causes of business cycle with verification of relevant economic data, its impact on construction industry is also evaluated. Finally in conclusion, recommendation is made to government about the necessary action to recover from recession.

2.1 Review of Business Cycle

2.1.1 Keynesian theory of business cycle

Keynesianism stems from the work of British economist John Maynard Keynes (1883-1946) who published the book ' The General Theory of Employment, Interest and Money' in 1936. Almost universally by his contemporaries accepted the General Theory as first such theory of recession and unemployment. The Keynesian theory of recession is based on demand deficiency and that demand deficiency is a cause of recession, so demand stimulation is a necessary counterweight to the forces of contraction. After the General Theory, a number of analytical model were developed such as Hick's IS-LM apparatus that also showed that, it was variation in demand which lead to variation in economic activity. During the demand deficiency, there must need to increase the level of demand by increasing public spending. Keynesian theory state that multiplier effect on investment spending stimulates demand through increase of production that leads to increase of employment but there is probability of overproduction that might cause recession, so need policy at that stage to reach in equilibrium. In this situation, Keynesian theory stated to implement accelerator principle that is at some point investment need to make to produce capital goods such as plant, machinery or building instead of consumer goods production to overcome the recession due to overproduction (Kates, 2002).

In Keynesian theories, the interest rate is allowed to differ from the return on low-risk capital, but if that really happened, people could take advantage of it on massive scale. Another feature that is hard to accept is the notion that people can be unemployed because wages stubbornly refuse to fall when they should (Black, 1981).

During 1970, when the United States suffered from both unemployment and high inflation, challenged the Keynesian approach as it was not coherent with the empirically proven natural trade-off between the two (Abel and Bernanke, 1992).

During the last decade, due to monopolistic competition the researcher developed a more explicit treatment of monetary policy within real business cycle models known as New Keynesian economics, also referred to as a 'New Neoclassical Synthesis' is that the output gap should be defined by reference to the level of output that would have been produced under fully flexible wages and prices rather than, as traditionally done in the past (Cukierman, 2005).

2.1.2 Austrian theory of business cycle

The Austrian business cycle theory (ABCT) originally presented by Mises (1966, 1971) and Hayek (1967), and it suggests that a monetary shock disturbs relative prices. The monetary explanation of the business cycle is the first main feature of the ABCT and it state that artificial boom occurs by the extension of credit, lowering the rate of interest and intervention of the banks. Mises (1912) reported that the crisis and ensuing period of depression are the culmination of the period of unjustified investment brought about the extension of credit (Bismans and Mougeot, 2009).

The excess supply of money due to monetary shocks depress the market rate below the natural rate and leads the investors to invest in such project which would not have been thought profitable, in other word called malinvestment which is unsustainable and collapse inevitably as entrepreneurs start to realise that their plan can not be completed, so expansion phase of the cycle creates the condition for recession phase. To generate economic expansions, Hayek suggested to encourage entrepreneurs activity and the productivity of new technology for changes in aggregate economic activity. Equilibrium in the credit market requires the balance of real flows of funds from saving and the demand for loans for investment, including changes in money supply and demand (Keeler, 2001).

The Austrian theory allows for the possibility that during malinvestment, capital is being liquidated and reabsorbed elsewhere in the economy's inter-temporal capital structure, unemployment can increase dramatically with reduced incomes and reduced spending feed upon one another. The self-aggravating contraction of economic activity was designated as a 'secondary depression' by the Austrians to distinguish it from the structural maladjustment that, in their view is the primary problem. The Austrian recommended to avoid credit induced boom and decentralisation of banking (Mises *et al.,*1983).

'Where is the evidence?' is one of the prime quarries from critics of ABCT, Critics often suggest that the lack of empirical analysis reflects the lack of explanatory power for this theory. The ABCT is of historical explanation rather than formal modelling (Bismans and Mougeot, 2009).

2.1.3 Summary of business cycle theory

The table 1, shows the summery of Keynesian and Austrian business cycle theory which is author's own work, based on the above discussion about the theory.

Table 1: Summery of Keynesian and Austrian business cycle.

Factors	Keynesian	Austrian
Demand	Demand shortage is probable cause of recession and unemployment, demand stimulation in necessary to recover recession.	Demand is not cause of recession, it is entrepreneurs and innovation activities that effects towards employment, living standard, supply and demand to create boom or bust.
Supply	Supply depends on demand, stimulation of demand lead to increase of supply of production.	Supply increases with increase of profit seeking business that leads to increase of employment.
Government	Government intervention require stimulate demand.	Government intervention is limited as it kills entrepreneurial spirit.
Money	Money supply needs to increase to stimulate demand and unemployment..	Money supply suggested to be strict as it can't create prosperity and wealth, but raising living standard can achieve it.
Interest Rate	Set by government according the situation, so it is controlled.	It is set by the market and not by the government.
Wage	Wages refuse to fall when they should, so creates unemployment and leads to recession.	Wages are flexible and depends of company's productivity.
Employment	Employment increase with stimulation of demand.	Employment increases with increase of businesses and innovation.
Growth	Government intervention lead the growth of market.	Entrepreneurs and innovation drive the growth of market.

3.1 Data Analysis

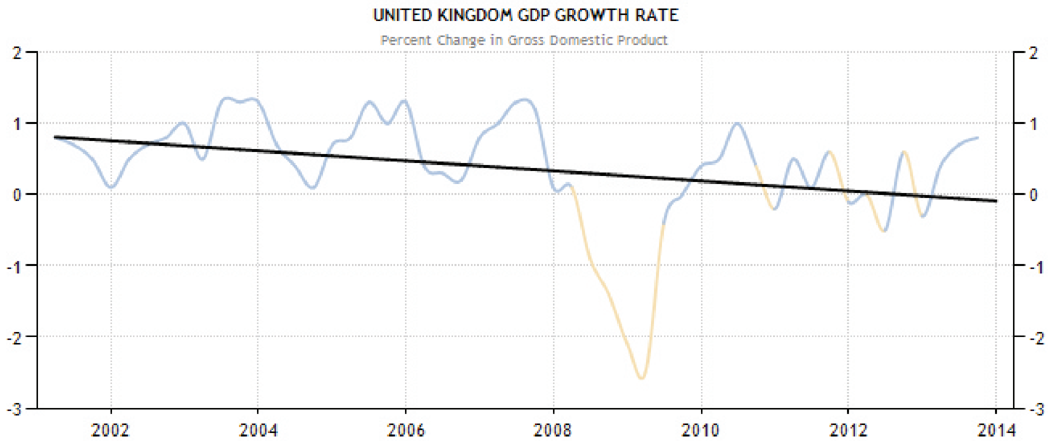


Figure 1: United Kingdom GDP growth rate (Source: Trading economics, ONS)

The following 'Table 2' is prepared on basis of the UK's economic data, collected from 'Trading Economics' web site as graphical format (Appendix A) and the web site mentioned that all the data are accurate and collected from 'Office for National Statistics'. The findings is following:

2003 to 2004: The economy was rising (figure 1) and the data shows that government spending was high and interest rate was low, means it follows the Keynesian concept to stimulate demand by reducing employment. The rate of unemployment found low with sticky wages and high production both consumer goods and capital goods. So, Keynesian theory proved successful for the economy.

2008 to 2009: Figure 1 shows that, there was a recession and according the data government spending and money supply was high but production of capital goods very low, that means Keynesian's accelerator principle was not followed to counterweight the contraction.

2012 to 2013: It found that recession is recovering by using the concept of Keynesian theory by government spending and keeping the interest rate low.

Table 2: Summery of economic data of the United Kingdom. (Author's own work based on data from appendix A)

Year	Money supply	Interest rate	Inflation	Govt. Spending	Unemployment	Wage	Industrial prod- uction	Manufactural product-ion	Supply/ productivity	Foreign Investment	Construction out put	Economy	Theory
2003 to 2004	Low	Low	Low	High	Low	Sticky	High	High	High	Low	High	Rising (Boom)	Keynesian (Successful)
2008 to 2009	High	High	High	High	High	sticky	Low	Low	Low	Low	Low	Bust (Recession)	None properly used
2012 to 2013	Low	Low	Low	High	Low	Not sticky	High	High	Low	High	High	Recovery	Keynesian (Successful)

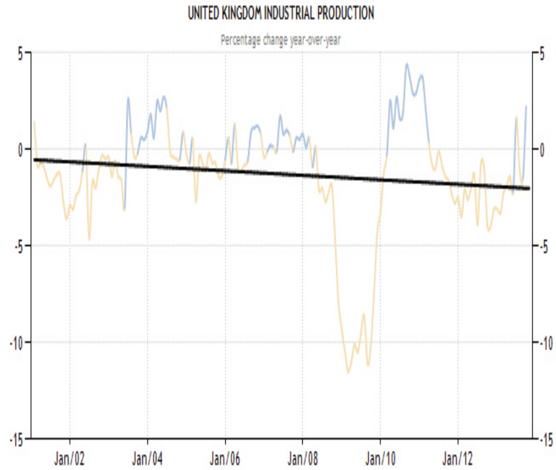
4.1 Impact on construction industry

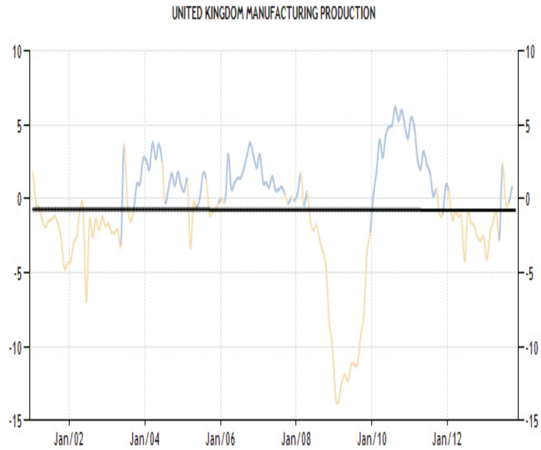
Construction is a capital goods industry. According to Bratt (1937), it is about hundred years observation that during recession, there needs to speed up capital goods production for economic recovery. On the other hand, Keynesian's multiplier principle state that there is possibility of overproduction and at certain stage need to implement accelerator principle that is increase of investment in capital goods product instead of consumer goods to counter weight the contraction. In this sense, the construction as a capital goods industry plays important role in economy for both recovery from recession and prevention from contraction.

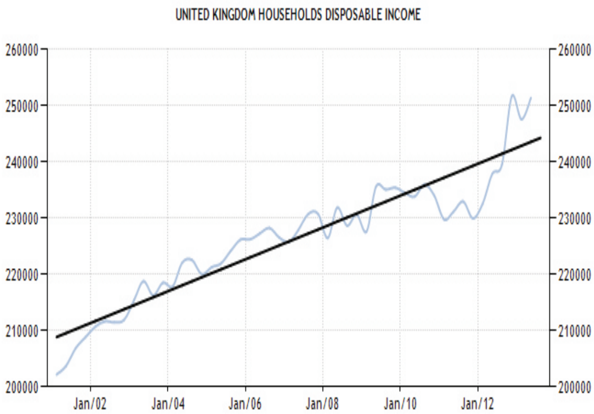
5.1 Conclusion

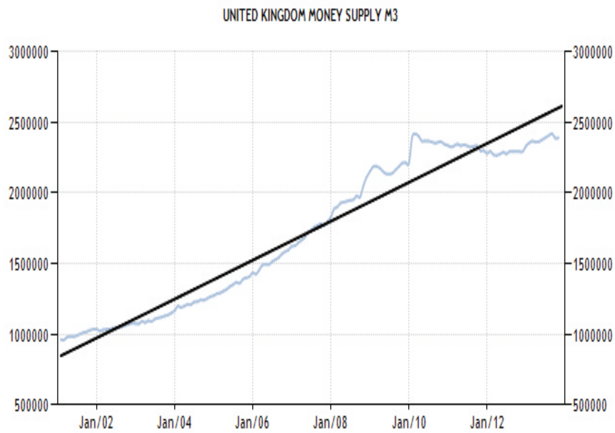
Business cycle is the representation of economic activity, the data analysis represent the high acceptability of the Keynesian business cycle theory. To keep country's wealthy economy, the recommendations to the government is base on Keynesian business cycle theory which are: constant forecasting of business cycle trend so that at certain stage of economic growth, the initiative is able to increase the production of capital goods to protect from over production of consumer goods. During recession the suggestion is to increase of government spending and lower the interest rate to attract business investment to create employment.

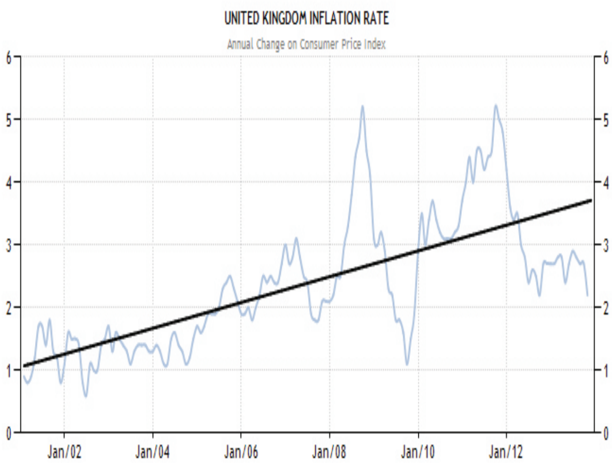
Appendix A: Economic data of the UK from 2002-2013.
(Source: http://www.tradingeconomics.com)

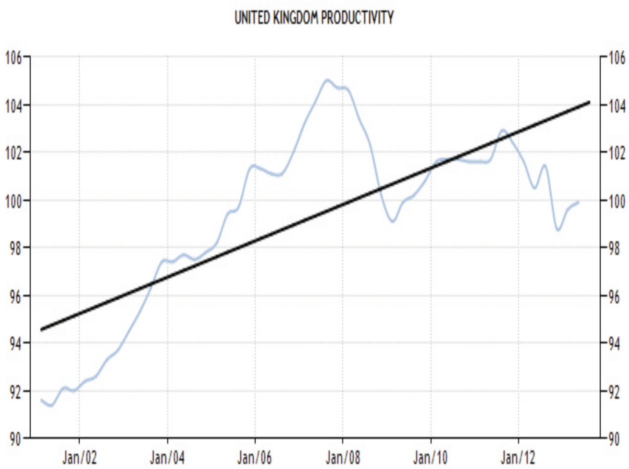




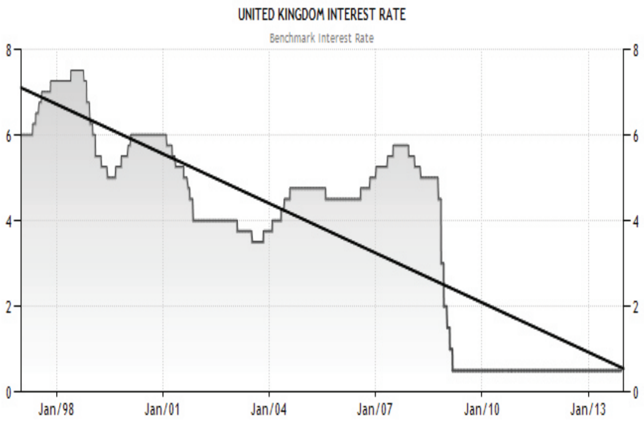


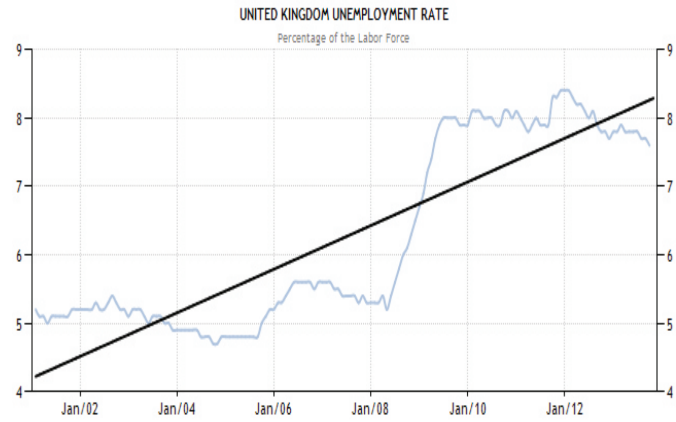


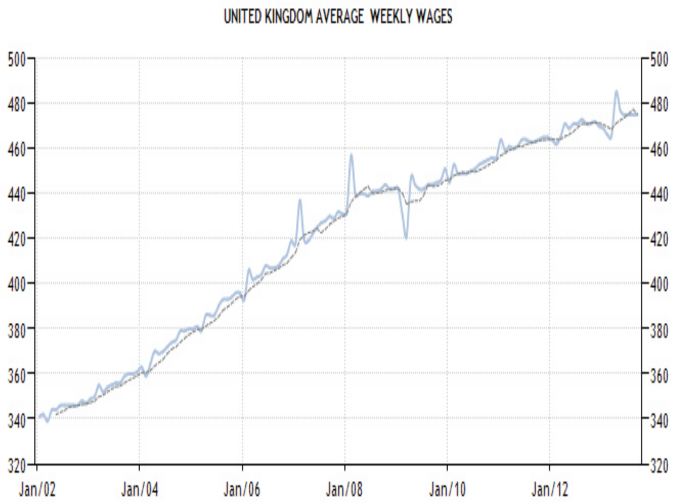


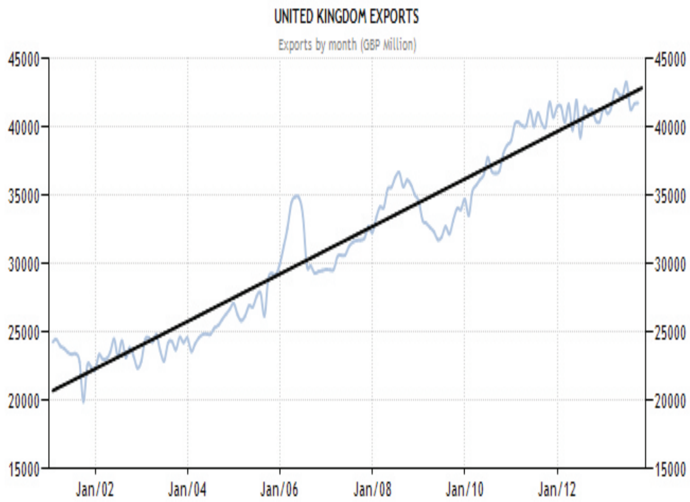


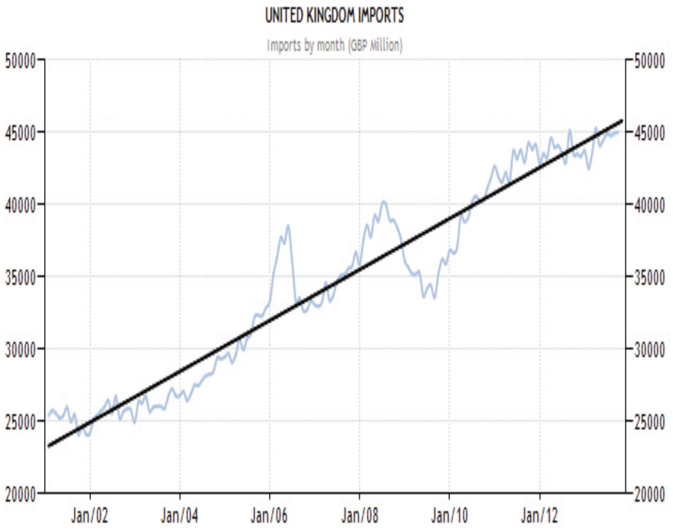
(Appendix A Cont.)

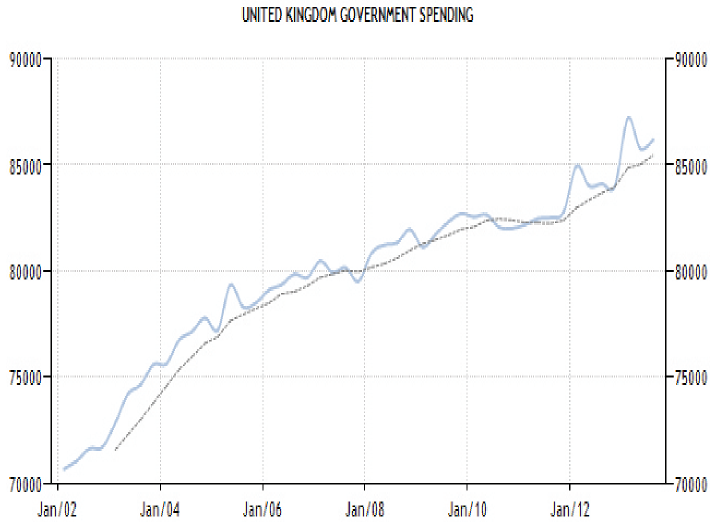












Reference:

Abel, A. B. and Berrnanke, B. S. (2001) Macroeconomics, 4th edition, London : Addison-Wesley.
Barras, R. (1994) Property and the economic cycle: Building cycles revisited, *Journal of Property Research*, 11 (3), pp.183-197.
Bisman, F. And Mougeot C., (2009) Austrian business theory: Empirical evidence, The *Review of Austrian Economics*, 22, pp.241-257.
Black, Fisher (1981) The ABCs of Business Cycles, *Financial Analysts Journal*, 37 (6), pp.75-81.
Bratt, E. C. (1937) The Timing of Capital Production and the Need For Forecasting, *Harvard Business Review*, 15(4), pp. 429-437.
Cukierman, A. (2005) Keynesian Economics, Monetary Policy and the Business Cycle – New and Old, *CESifo Economic Studies*, 51 (4), pp.697-728.
Garrison, R. W. (1989) The Austrian theory of the business cycle in the light of modern macroeconomics, *The Review of Austrian Economics*, 3 (1), pp.3-29.
Hayek, F. A. (1975b), Monetary Theory and the Trade Cycle. New York: Augustus M. Kelley.
Kates, Steven (2002) Economic Management and the Keynesian Revolution: The Policy Consequences of the Disappearance Of Say's Law, *International Journal of Applied Economics & Econometrics*, 10 (3), pp.463.
Kaya, H. and Engkuchik, E. N., (2013) The Effect of the Business Cycle on Stock Market Analysts' Purchase Recommendations, *International Journal of Management*, 30 (3), pp.186-200.
Keeler, P. J. (2001) *Empirical Evidence on the Austrian Business Cycle Theory*, The Review of Austrian Economics, 14 (4), pp. 331–351.
Lester R. B and Wolff J. S. (2013) The empirical relevance of the Mises-Hayek theory of the trade cycle, Springer: The Review of Austrian Economics, 26, pp.433-461.
Lucas, Robert E. (1981) Studies in Business-Cycle Theory, 1st edition, London: MIT, Cambridge Mass.
Mises, L. (1953). *The Theory of Money and Credit*. New Haven: Yale University Press. [1912].
Mises, L. V., Haberler, G., Rothbard, M. N., and Hayek, F. A., (1983) *The Austrian Theory of the Trade Cycle and Other Essays.* Ludwiq von Mises Institute, Auburn, Alabama.
Mullineux *et al.*, (1993) Business Cycle: Theory and Evidence, 1st edition, Oxford, Blackwell Publishers.
Parkin, M., Powell, M., Matthews, K., (1997) Economics, 3rd edition, Addison-Wesley.

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:
http://www.iiste.org

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: http://www.iiste.org/journals/ All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: http://www.iiste.org/book/

Academic conference: http://www.iiste.org/conference/upcoming-conferences-call-for-paper/

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digtial Library , NewJour, Google Scholar