

## Perspective

by Steve Hanke



# Booms and busts

**B**EFORE THE GREAT DEPRESSION GOT UNDERWAY, MEMBERS of the Austrian school of economics developed a theory of business cycles. For the Austrians, things go wrong when a central bank sets short-term interest rates at artificially low levels. Such rates fuel credit booms.

In consequence, businesses overestimate the value of long-lived investments and an investment-led boom ensues – where a plethora of investment dollars is locked up into excessively long-

lived and capital-intensive projects.

Investment-led booms sow the seeds of their own destruction. The booms end in busts. These are punctuated by bankruptcies and a landscape littered with malinvestments made during the credit booms. Many of these malinvestments never see the light of day.

The accompanying chart depicts how, given the length of a project's life, a decline in the discount rate pumps up the present value of a capital project.

SXC/HU



An artificially low interest rate alters the evaluation of projects – with longer-term, more capital-intensive projects becoming more attractive relative to shorter-term, less capital-intensive ones.

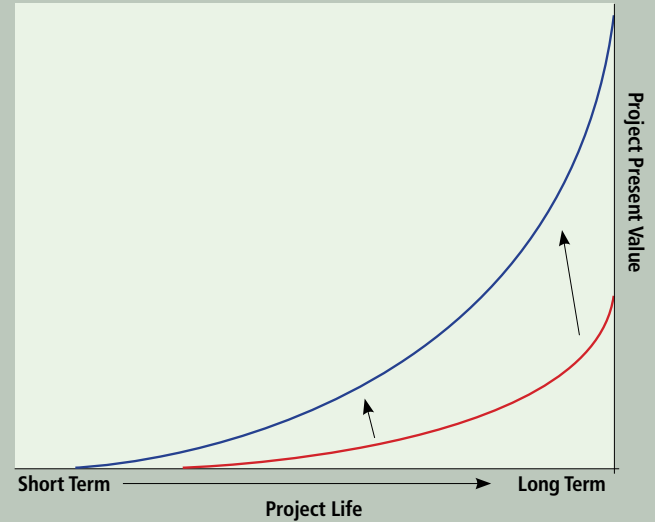
Austrian theory played out to perfection during the most recent boom-bust cycle. By July 2003, the Federal Reserve had pushed the federal funds interest rate down to what was then a record low of 1%, where it stayed for a full year.

During that period, the natural (or neutral) rate of interest was in the 3-4% range. With the fed funds rate well below the natural rate, a credit boom was off and running. And as night follows day, a bust was just around the corner.

The bust has manifested itself in various forms – the most recent one being the crisis in Dubai. From an Austrian perspective, the Dubai bust is not surprising. Indeed, the credit boom flowed into the Gulf emirate with a vengeance.

It's hard to imagine such a small piece of real estate with such a concentration of long-lived, capital-intensive projects. The cheap credit boom literally pushed many Dubai projects skyward. Skyscrapers are relatively capital-intensive buildings.

### Effects of a Decline in the Rate of Discount



Source: Sechrest, Larry J. "Explaining Malinvestment and Overinvestment." *The Quarterly Journal of Austrian Economics* Vol. 9, No 4 (2006): 27-38.

### World's Tallest Buildings\*

Year Completed	Building Name	City	Height (ft.)	Stories	Economic Crisis
1908	Singer Building	New York	612	47	Panic of 1907
1909	Metropolitan Life Tower	New York	700	50	Panic of 1907
1913	Woolworth Building	New York	792	57	U.S. Recession**
1930	The Trump Building (40 Wall Street)	New York	927	71	Great Depression
1930	Chrysler Building	New York	1046	77	Great Depression
1931	Empire State Building	New York	1250	102	Great Depression
1972-73	World Trade Center	New York	1368	110	Oil Crisis, U.S. Recession and Stock Market Crash
1974	Sears (Willis) Tower	Chicago	1451	108	Stock Market Crash
1998	Petronas Towers	Kuala Lumpur	1483	88	Asian and Russian Financial Crises and collapse of LTCM
2004	Taipei 101	Taipei	1667	101	–
2010 (projected)	Burj Dubai	Dubai	2600+	160+	2009 Dubai Crisis
2020 (projected)	Nakheel Tower	Dubai	3281+	200+	?

\*Only includes buildings that have been completed or are under construction. Proposed skyscrapers are not included. At the time of completion, each listed skyscraper was the tallest in the world, until displaced by the next building on the list.

\*\*The Federal Reserve Act was enacted on December 23, 1913.

Sources: Council on Tall Buildings and Urban Habitat and the National Bureau of Economic Research.

## Quarterly Growth Implications of Spread Widening or Narrowing

spreads expressed in basis points, from 1949

Quarterly change in Baa/Aaa spread	Quarterly real GDP growth (annual rate)			
	in same quarter	One quarter later	Two quarters later	Three quarters later
Averages for:				
4 quarters in which it widened more than 40 b.p. (averaging 88 b.p.)	-5.0%	-4.6%	3.1%	4.4%
16 quarters in which it widened between 20 b.p. and 40 b.p. (averaging 28 b.p.)	2.8	1.2	2.9	2.9
208 quarters in which it changed less than 20 b.p. (averaging -1 b.p.)	3.6	3.6	3.4	3.4
8 quarters in which it narrowed between 20 b.p. and 40 b.p. (averaging -26 b.p.)	3.8	3.5	2.7	4.4
4 quarters in which it narrowed more than 40 b.p. (averaging -51 b.p.)	4.0	7.3	7.0	4.7

Data: Quarterly averages of daily yields on Baa and Aaa corporate bonds (Moody's/Federal Reserve Board); and quarterly totals of real gross domestic product (Bureau of Economic Analysis).

Source: *Economy Watch*, H.C. Wainwright & Co. Economics, Inc., November 18, 2009.

Not surprisingly, artificially low interest (or discount) rates make skyscrapers look attractive relative to shorter buildings. In consequence, skyscraper construction follows the rhythm of Austrian cycles: during a credit boom, skyscrapers are built and their completion typically coincides with a bust (see accompanying table). The Burj Dubai, which is near completion, fits neatly into this pattern.

The busts have usually spelled long periods of trouble for the world record-setting skyscrapers. There is no better account of skyscraper troubles than James Grant's classic of 40 Wall Street's woes (see table).

In *The Trouble with Prosperity*, Grant wrote: "Forty Wall Street was a losing proposition (as, indeed, were most boom-era skyscrapers) even after the Bank of Manhattan helpfully stepped forward to take up enough extra space to bump up its annual rent bill to \$1 million from \$690,000.

The trouble lay with the world at large. Incomes were shrinking, but the skyscraper's debt-heavy capital structure was unyielding; debts assumed in good times were due and payable in bad times, too. At \$6 a square foot, 40 Wall would have generated revenues of \$4.7 million a year when fully occupied.

It needed \$3.9 million a year just to break even. It is testament to the height of the boom and the depth of the bust that \$3.9 million of revenues were first earned in 1952."

As Grant recounts, prior to the 1952 break-even date, bankruptcy visited 40 Wall Street. "Rents, of course, were gravity-prone

in the extreme.

Not so the funds due to the city in property taxes, to the fee holders in ground rent, and to the bondholders in interest, and the corporation proceeded to default on each of these obligations in the spring of 1939.

Formal bankruptcy proceedings were completed in the next year." And in 1940, the value of the building was little more than half its 1930 cost.

If 40 Wall Street and other record-setting skyscrapers are a guide, Dubai could be in for a Hayekian hangover. This condition – after the Nobelist Friedrich Hayek, a leading architect of Austrian cycle theory – follows a boom-bust cycle, and most painfully visits the most capital-intensive projects built during booms.

Moving from Dubai to the United States, the spread between Baa and Aaa corporate bond yields has dropped from its peak of 350 basis points at the end of 2008 to under 120 basis points. The narrowing of this spread is the largest since the 1930s.

As the accompanying table signals, the United States should have entered a boom. Indeed, if the annualized real growth rates in the next two quarters (Q4 2009 and Q1 2010) don't hit 7%, we will know that the Obama administration's interventionist policies have been a bust. GA

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