Causes of Boom

Loose Monetary Policy

If monetary policy is too loose, it means real interest rates are too low given the state of the economy, e.g. UK economy in late 1980s. Loose monetary policy reduces the cost of borrowing and mortgage payments (increasing disposable income). This will cause a rise in investment and consumer spending. This rise in aggregate demand can cause excessive growth in the money supply and cause economic growth to be above the long run trend rate.

If economic growth is substantially above the long run trend rate, we will tend to see:

- Rising inflation. Demand grows faster than supply. Therefore firms put up prices.
- Wage inflation. Due to high demand for labour, there will be labour shortages leading to wage inflation.

As inflation rises, the Central Bank/government may seek to reduce inflation by putting up interest rates, and this can turn the growth into an economic downturn.

Loose Fiscal Policy

Excessive economic growth could be caused by a loosening of fiscal policy, at an inappropriate time. For example, if economic growth is already 2.5%, a cut in income tax would cause higher consumer spending leading to an economic boom. A loosening of fiscal policy would also cause a rise in government borrowing. This could be inflationary if financed by an accommodation of monetary policy (allowing the money supply to rise). Also, to increase government borrowing in a boom, means the government will have fewer resources to pursue expansionary fiscal policy when the economy contracts.

Boom and Bust in Asset Prices

A rise in assets such as house prices causes an increase in household wealth and also encourages bank lending. With rising house prices we tend to see a growth in equity withdrawal, a lower saving ratio and an increase in bank lending. This would cause higher consumer spending and a rise in economic growth. Rising house prices cause higher growth; however, if prices start to fall, the process starts to work in reverse. Households see a fall in wealth, reducing confidence. This will lead to a fall in consumer spending – especially if households experience negative equity. Falling house prices also will make banks more reluctant to lend.

Bank Lending

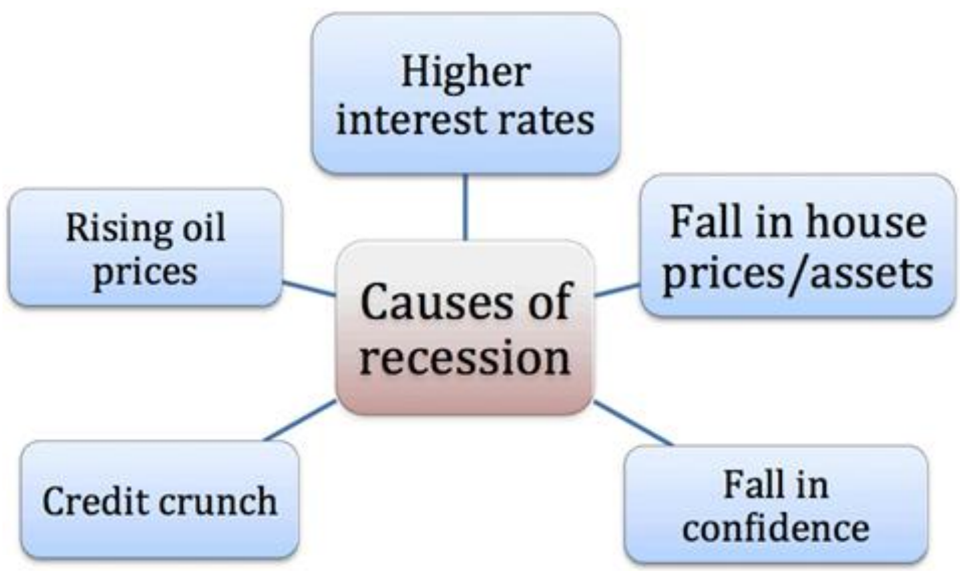
There had been a rapid expansion in bank lending which was often based on the ability to borrow from other banks, e.g. credit default swaps. Therefore, there was a reliance on money markets to finance longer-term lending. This boom in bank lending helped sustain economic growth, but, when there was a credit crunch, bank lending fell rapidly leading to lower economic growth. Firms couldn't get access to finance, so they had to stop investment projects.

Multiplier/accelerator effect

There are factors which can magnify growth, but also magnify the opposite. The accelerator theory states that investment depends on the rate of change of economic growth. A small improvement in growth can cause a bigger percentage increase in investment.

The multiplier effect states that a rise in investment can have knock-on effects causing a bigger final increase in GDP than initial injection. But, if spending falls, it causes a rise in unemployment and further falls in unemployment.

Causes of Recessions



Recessions (a fall in real GDP) are primarily caused by a fall in aggregate demand (AD). A demand-side shock could occur due to several factors, such as

- **A financial crisis**. If banks have a shortage of liquidity, they reduce lending and this reduces investment.
- **A rise in interest rates** – increases the cost of borrowing and reduces demand.

- **Fall in asset prices** – negative wealth effect leads to less spending.
- **Fall in real wages** – e.g. inflation exceeds nominal wage increases.
- **Fall in consumer/business confidence** also exacerbated by the negative multiplier effect.
- **Appreciation in exchange rate** – exports less competitive.
- **Fiscal austerity** – when government cuts spending.
- **Trade war** – Global economic downturn.
- **Supply-side shock**, e.g. rise in oil prices cause inflation and lower spending power. (e.g. in 1970s)
- **Black swan event** – this is an unexpected event that is very hard to predict. For example, Covid-19 flu pandemic which disrupts travel, supply chains and normal business activity. A pandemic affects both supply and demand.