



# Economic Cycles

**From the beginning of the widespread use of money in China, circa the year 1000, to the trade and budget deficits of the twenty-first century, economic cycles have plagued most of the world. Economists have argued endlessly and inconclusively about exactly what caused these booms and busts, and which governmental policies might counteract their troubling effect on human lives.**

**I**n recent centuries, economic cycles—years of boom leading up to a sudden bust followed by a period of hard times—began to prevail in most of the world. Why that irregular rhythm exists remains a matter of debate among economists and politicians. In the deeper past other disasters—crop failure, epidemics, and the ravages of war—often afflicted our ancestors, and years of plenty and years of hunger affected almost everybody in course of a lifetime. But the modern pattern of boom and bust arose only when the use of money became widespread and introduced a powerful new variable into human behavior.

## **From Crops to Coins**

The widespread use of money first occurred in China about the year 1000, after the government decided to collect taxes from peasants in coin instead of demanding a share of the harvest, as they had before. Paying in coin required millions of ordinary persons to find something to sell, and the effect at first was to launch a sustained boom since buying and selling among scores of millions and across hundreds of miles along China's two principal rivers rewarded efficiency and increased specialization of production.

Wealth multiplied accordingly, and Chinese officials soon resorted to printing paper money to supplement coinage and make large-scale payments easy. Surviving records do not show whether anything like modern patterns of boom and bust developed in China, but we do know that when Mongol conquerors invaded and eventually founded the Yuan dynasty (1279–1368), paper currency ceased to circulate, since prolonged warfare provoked reckless printing of paper money and made it worthless. That bought on so big a bust that the Chinese relied entirely on coins for centuries thereafter.

As far as historians can tell, ancient Greece and Rome never experienced modern forms of boom and bust, though when Alexander of Macedon (Alexander the Great, 356–323 BCE) captured the Persian treasury and began to spend its contents lavishly, he provoked a boom of sorts. It was prolonged by his Greek and Macedonian soldiers who founded scores of cities throughout the empire and put a vastly increased amount of money into circulation. During the early Roman Empire (30 BCE to 180 CE) money payments sustained the circulation of wine, olive oil, and grain throughout the empire, but neither boom nor bust can be clearly detected before epidemics and invasion impoverished everyone. Thereafter, widespread return to local self-sufficiency made money marginal in most of Europe again during the early Middle Ages.

After about 1000, however, long-distance trade began to flourish anew in Europe and money again financed it. That provoked a long-term boom as warm weather brought improved harvests, population grew, and extensive new fields were carved from the forests. Money circulated more and more freely, and the first unmistakable bust came in 1343–1344, when Florentine banks went bankrupt



after King Edward III of England repudiated his debts, and bank-financed export of raw wool from England to Flanders and Italy suffered interruption. Sheep farmers in England, spinners and weavers in Flanders and Italy, and the merchants who distributed woolen cloth throughout Europe and the Mediterranean coastlands all suffered severe losses of income.

## Plague and Tulip Mania

Before full recovery, a far greater disaster came in 1346 when the Black Death (almost surely bubonic plague) arrived in the Crimea and in the next three years spread almost everywhere across Europe, killing about one third of the entire population. The enormity of that disaster was never forgotten and made the financial crisis that had temporarily paralyzed the wool trade seem trivial. In spite of efforts at quarantine, plague continued to break out in Europe at irregular intervals for the next few centuries, and population continued to decline until about 1450. Whenever plague raged all ordinary business was suspended and recovery often came slowly. But alternating boom and bust, if it existed apart from epidemics and warfare, was not conspicuous until the seventeenth century, by which time private financial deals had attained a greater scale than before.

The so-called tulip mania in Holland was an unusually bizarre example. Tulips reached Europe from Turkey only in 1550, and their vivid and varied colors attracted much attention from the start. Prices for rare varieties began to rise in northwestern Europe. The boom reached its climax in Holland between 1633 and 1637 when thousands of persons invested in bulbs, hoping to sell them almost immediately at a higher price. Sometimes an especially precious bulb remained safely in the ground and was sold and resold at higher and higher prices until the bubble broke early in 1637. Many Dutch families suffered financial disaster because they had tried to get rich quickly by mortgaging homes and other valuables to enter the tulip market. Consequently the bust affected the whole

economy. Foreigners had also rushed to buy, so the bust extended more faintly to other parts of Europe.

The tulip mania differed from earlier boom and bust cycles by depending on widespread hope and the expectation of making a fortune almost overnight by speculating on the rising price of tulip bulbs—an object no one needed for anything but luxury display. Initial instances of attaining sudden wealth provoked a crowd reaction as thousands rushed into the market to get their share of the bonanza, pushing prices to ridiculous and unsustainable extremes. At the time, the Dutch were busy building an empire in the Indian Ocean, the Caribbean, and Brazil; Dutch trade flourished and the country's general prosperity may have been what allowed so many to invest so foolishly in tulips.

But this was not the only time that similar crowd behavior, seeking sudden monetary wealth, provoked comparable booms and busts. One of the most notable of these centered in France when a Scottish economic theorist and adventurer named John Law persuaded the government in 1716 to allow him to found a bank that would sell its stock to the public, have the right to issue paper money, and use its resources to develop the potential wealth of the territory of Louisiana in the Mississippi valley of North America. Law's bank prospered for a while when a rush to invest raised the price of its stock, as well as stock in several subordinated companies, very high. One of them took over tax collection in France itself and promised to pay off the entire royal debt. But there were doubters from the start, and when enough investors lost faith in Law's "system" for making money, the whole scheme suddenly collapsed in 1720. Law fled to Venice, leaving a host of angry and impoverished private investors, together with burdensome and disordered government debts, behind.

In 1718 a similar but less massive boom got underway in England when the South Sea Company, chartered to sell African slaves to the Spanish Empire in America, took a leaf from Law's book and persuaded Parliament to let it take over the national debt. For the next two years the two booms ran parallel. The price of South Sea Company shares multiplied almost

800 percent in the first months of 1720; in France shares in Law's companies rose by twice as much, and then both collapsed in just a few days. Subsequent investigation in England showed that government ministers had been bribed. They and the company's directors were disgraced, but the company itself survived until 1853, long after Great Britain had abolished the slave trade. Unlike the situation in France, government debt, managed by the Bank of England since 1694, was not much disturbed.

## Industrial Revolution—Wars and Peace

Gains and losses from short-lived, get-rich schemes like these remained comparatively superficial as long as most of the population remained on the land, where they prospered or suffered from variations in the harvest but were little affected by financial shenanigans in the cities. Wars and the expansion of industry in parts of Europe changed, so that by 1815 a crisis of confidence among bankers, whose loans were needed to keep both factories and governments in operation, became capable of diminishing a whole nation's welfare.

This vulnerability started with the so-called Industrial Revolution in Great Britain. It was achieved between 1750 and 1815 very largely through a series of booms and busts driven by government borrowing for war expenditures in the periods from 1754 to 1763, 1776 to 1783, and 1792 to 1815. Borrowed money equipped the country's army and navy with vast quantities of cloth, guns, cannon, and other supplies. Accordingly, factories, forges, and mines rapidly expanded their capacity to supply the necessary materials, and faced hard times whenever government orders were suddenly cut back in peacetime. But the net effect of these long wars was to expand industrial production and employment, as first water power and then steam engines put new machines into motion, inaugurating cheap mass production of cloth and other commodities.

Warfare diminished after 1815, and peacetime rhythms of boom and bust began to manifest themselves

more insistently. Government expenditures ceased to dominate the business cycle; instead privately financed new technologies—railroads above all—took primacy. In 1825, the first steam-powered railroad demonstrated how dramatically even rickety rails and a tiny steam engine could lower overland transport costs. Almost at once private companies and then governments began to build railroads around the world. Initial costs for shaping a smooth and stable road bed were high and required large loans. Moreover, in the United States and Canada transcontinental railroad construction soon outstripped frontiers of settlement. This in turn provoked intensive land speculation wherever people thought a new town might arise along the track.

As a result, some profited and others lost from speculative investments, and alternating booms and busts became frequent. They often spread from country to country wherever railroading, land speculation, and related new technologies—steamships, telegraphs, Bessemer steel furnaces, and literally thousands of other novelties—kept on altering everyday lives.

In the 1850s a Frenchman named Clement Juglar was the first to suggest that a business cycle of eight to ten years had become normal. An unusually severe depression occurred in 1873, followed by another in 1893, and World War I (1914–1918) suddenly transformed peacetime economic behavior more drastically than ever before. In the light of this experience, in the 1920s a Russian economist, Nikolai Kondratieff, proposed a fifty-year cycle of expansion and contraction behind and underlying the shorter, more superficial ups and downs of market prices.

Since then economists have argued endlessly and inconclusively about exactly what caused booms and busts, and which governmental policies might counteract their troubling effect on human lives. After World War I, booms and busts became more damaging than before as farming ceased to employ the majority of the total population in more and more countries, and variations in harvest yields lost most of their former importance.

In most of the world, World War I was followed by a short depression, then a boom that lasted

until 1929; then came what is often called the Great Depression of 1929 to 1938. But Communists who had come to power in Russia in 1917 experienced a different cycle—destructive civil war, a brief return to small-scale private buying and selling, then forcible collectivization of agriculture and ambitious five-year plans for industrial construction. Resulting industrial expansion coincided with the Great Depression and seemed to show that Communists had solved the problem of boom and bust by resorting to official command and deliberate planning.

The onset of World War II (1939–1945) abruptly ended the Great Depression, and brought something resembling Communist-style command economies to all the principal belligerents. But in non-Communist countries, postwar return to free markets worked better than ever when efforts by central bankers to move interest rates up and down seemed for a while to have softened the impact of boom and bust, while the Russians and a new Communist regime in China struggled to repair wartime damages. Until about 1970, the Cold War between Communist countries and the self-styled “free world” was in stalemate by a balance of atomic terror. But by the 1990s a long-sustained economic boom, punctuated only by slender and short-lived busts in America and western Europe, began to outstrip the Russia’s achievements, where wasteful use of manpower and other resources hampered the command economy.

Chinese Communists forestalled comparable difficulties in 1981 by relaxing state controls and inviting peasants and other entrepreneurs to seek private profit by relying on market prices for whatever they produced. Thereupon, China launched itself on a sustained boom and soon far outstripped the rate of growth in the rest of the world. Russian Communists tried to follow suit in 1987 and 1988, but, unlike the Chinese, they provoked widespread impoverishment as inefficient factories shut down and political discontents boiled to the surface. The upshot was a surprisingly peaceable disruption of the Soviet Union in 1991. A diminished Russian republic emerged, which is still in pursuit of a satisfactory balance

between political and private management of economic affairs.

## An Uncertain Future

A strange partnership spanned the Pacific as the Chinese boom became manifest. Americans started to buy cheap Chinese goods and outsourced manufacture to China on an unprecedented scale, while the Chinese government bought billions of dollars of U.S. bonds to keep their boom, and American prosperity, going. American national prosperity itself began to take on a feverish quality. Government expenses for war in Iraq and Afghanistan increased while tax rates for the wealthy were reduced, so budget deficits ballooned at the same time that cheap goods from China increased the trade deficit while also restraining some prices. But not all prices. When American bankers began to sell mortgages to marginal borrowers and then bundled thousands of them into a new kind of security called “collateralized mortgage obligations,” the price of housing rose even faster than the stock market. Irresponsible boom set in when more and more home buyers signed mortgages hoping to get rich quick by selling again at a higher price, just like those who had bought tulip bulbs in Holland 375 years before.

Thus the American and the global financial system headed for another bust. It arrived in August 2007, and has yet to be resolved in 2009. Initial efforts by the U.S. government to save banks and insurance companies from bankruptcy by loaning them billions of dollars have not forestalled rapidly mounting unemployment, and the world’s economic future remains profoundly uncertain. Even the Chinese feel threatened. Moreover, behind the financial bust loom problems of diminishing oil supplies, mounting environmental pollution, global warming, and other foreseeable difficulties. Most urgent of all, no one knows how, when, or even if, financial recovery will come.

William H. McNEILL

*University of Chicago, Emeritus*

*See also* Currency; Famine

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