

Handling the Crisis: A Keynesian vs. Austrian Analysis of the “Great Recession”

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Abstract

This paper explores the differences between the mainstream economic interventionist view associated with John Maynard Keynes and the heterodox, non-interventionist Austrian School perspective associated with Friedrich Hayek on the Great Recession of 2007-2009. The literature review compares and contrasts articles explaining each view as they attempt to solve the problem of ending the recession. The heterodox Austrian School/Hayekian view is that central banks should take a hands-off approach to recessions, whereas the mainstream neo-Keynesian view is that central banks should take a more active role through monetary easing in an attempt to end the Great Recession. These two approaches are at odds with each other, but through this thorough and robust analysis, we will understand the similarities (if any) as well as substantial differences and what they can tell us for the next recession. Also included is a section on Methodology to highlight the differences in how economists of both camps conduct their research and present their findings to argue their case. The paper uses an analytical framework to show how the Austrian/Hayekian and Keynesian approaches differ both in content and methodology. The Keynesian perspective makes use of graphs and empirical data in the primary sources referenced to prove that the federal government and the Federal Reserve should have acted more quickly to implement an interventionist economic recovery. On the other hand, the Hayekian/Austrian approach makes use of methodological individualism and praxeology as the lens with which to examine the Great Recession and to show that such economic interventionism had the opposite of the intended effect; intervention, according to the Austrians, made the crisis worse. Not only are their conclusions different, but the means by which they examine the crisis are different as well. Finally, the paper examines some areas for future research on both sides to make each case stronger. Special emphasis is placed on how to develop the arguments of these two views further with regard to future recessions, particularly of the magnitude of the 2007-8 financial crisis.

Keywords: Great Recession, Keynes, Hayek, central banks, Austrian Business Cycle Theory, monetary policy.

JEL Classification: B5, B4, E14, O4.

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1. Introduction

This literature review will cover the 2007-9 so-called “Great Recession” and how the U.S. Federal Reserve responded. What led to the recession? How is it different than recessions from the past? Was it inevitable? How did the experience in the United States differ from that of other countries? These are some of the questions that will be considered. To do so, we will compare and contrast the work of Rognlie et al., (2018), Munoz and Ortiz (2016), Horwitz (2011), Cochran (2010), Murphy (2015), Young (2012), Snowden (2015), Congdon (2015), Koppl and Luther (2012), and Bean (2020). Common themes central bank monetary policy and intervention in the 2008 financial crisis are the underlying structure in this literature review. The

literature can be broken down into two broad categories: the heterodox, Austrian School approach and the mainstream, neo-Keynesian approach. Horwitz (2011), Murphy (2015), and Young (2012) will provide solutions to the recession from the Hayekian perspective. Similarly, Rognlie et al. (2018), Munoz and Ortiz (2016), Cochran (2010), Congdon (2015), Koppl and Luther (2012), and Bean (2020) will provide solutions to the recession from the Keynesian perspective. The two different approaches were chosen to demonstrate two opposing views of how the Great Recession should have been handled. Through the analysis of these works we will discern what led to the Great Recession, how it should have been resolved, and we will also take a look at what the future of free banking will look like going forward. By conducting such an analysis, we hope to lay the groundwork for how recessions in the future, particularly of this magnitude, can be better handled.

The remainder of the paper is organized as follows: Part 1 will be Introduction, Part 2 – Methodology, Part 3 – Literature Review, Part 4 will discuss areas for future research, and Part 5 will be a Conclusion, summarizing the results. Finally, attached are works cited.

2. Methodology

The goal of the research presented in this paper is to expand scientific understanding of the current literature on this topic. Therefore, the type of research conducted here is “basic,” as opposed to “applied.” In addition, the research is “explanatory” in nature, as opposed to “exploratory.” That is, the paper seeks to identify and analyze causes of the Great Recession from two opposing points of view to arrive at clarity of what caused and what may have prolonged or worsened the financial crisis of 2007-8. Because each side (Keynesian vs. Austrian) claims that the other had the wrong approach and remedy for the problem, we will explore why each side believes they are in the right and their opponent in the wrong. The paper does this by taking a neutral or objective approach to each camp’s arguments and providing, hopefully, a balanced overview of the points made so that the reader can decide for him- or herself which might be right, or at least, have a better understanding of the two views and what they contribute to the literature on this important topic. Finally, the paper utilizes “inductive research”, as opposed to “deductive research.” That is, the paper takes already established theories and uses them to compare and contrast with other other, opposing established theories to shine light on the different approaches to a worldwide problem that affects everyone; namely, the Great Recession, but also how to combat future global recessions of a similar magnitude going forward.

3. Literature review

The first paper that we will consider is “Investment Hangover and the Great Recession” by Matthew Rognlie, Andrei Shleifer, and Alp Simsek (2018). In this paper, the authors show us that the market had overheated and that investors were reeling in from their losses using Hayekian and Keynesian analysis. The Hayekian analysis refers to the conventional thinking prior to the Great Recession. The Keynesian analysis refers to the shift in macroeconomic thinking and policy after the Great Recession with the use of governmental bailouts of banks deemed “too big to fail” which had a multiplier effect in other industries. This is useful because it demonstrates how the overbuilding of the housing market coupled with so-called “predatory lending” has a deadly result when unchecked for too long. The authors explain that there was a housing bubble that when popped, led to a crisis in the financial sector. They identify two main channels explaining the Great Recession: First, “financial institutions that suffered losses related to the housing market cut back their lending to firms and households (Brunnermeier, 2009, Ivashina and Scharfstein, 2010).” Second, “homeowners who had borrowed against rising collateral values during the boom faced tighter borrowing constraints and had to reduce their outstanding leverage (Eggertsson and Krugman, 2012, Mian and Sufi, 2014b, Guerrieri and Lorenzoni, 2017).” The authors state that the two preceding channels are wrong and that a third channel is at work, “Our key hypothesis is that there was also an *investment boom* in the housing market in addition to the price boom, which led to an overbuilding of housing capital by 2005.” In this case, “investment hangover” refers to the abrupt decline in home and lightweight automobile sales in from 2007 to 2009 that resulted from over-investing and over-building in the housing market. In their paper, Rognlie et al. (2018) construct a macroeconomic model to demonstrate why new-home sales slumped against existing

home sales with similar effects in other industries during this time period. As we will see, this agrees with other papers (Horwitz, 2011, Snowden, 2015, Koppl and Luther, 2012) in this literature review in that it compares two competing narratives of how to respond to the Great Recession: that of Keynes vs. Hayek.

The second paper that we will consider is “Heterodox Monetary Policies in the Context of the Great Recession: A Comparison between the System of the Federal Reserve and the European Central Bank” by Gerardo Garcia Munoz and Rodolfo Baeza Ortiz (2016). In this paper, the authors demonstrate that the U.S. Federal Reserve (Fed) and the European Central Bank (ECB) used two different approaches to handling monetary policy during the Great Recession. On the one hand, the Fed took a heterodox Keynesian approach and implemented Quantitative Easing (QE). On the other hand, the ECB took a different approach. This is important it helps us understand how important monetary policy is and what the different effects of different policies can be. Munoz and Ortiz (2016) assert that the Great Recession started at the center of the capitalist world, the United States, and through globalization affected every country of the world, particularly the developing countries who used every macroeconomic policy to resist it, especially monetary policy. Both the Fed and ECB suppressed interest rates from 5% to between 0 to 1% in an attempt to revive the economy. The Great Recession has sparked renewed debate on what the role of a central bank is and what its goals should be. In an unprecedented move, the Fed intervened in the housing market like never before and began buying up Mortgage-Backed Securities (MBS) during QE 3 of 2009; this would ensure that people could stay in their homes. In particular, the authors compare the U.S. and Germany at the start of the 2008 financial crisis. As goes the U.S., so goes the world. The authors call for the gradual normalization of the Fed’s monetary policy in order to diminish the risk of volatility and financial instability that then cripples developing countries.

The third paper that we will consider is “Theory, History, and the Great Recession” by Steven Horwitz (2011). In this paper, Horwitz explores the effect the Austrian Business Cycle Theory has had on theory and practice by the Federal Reserve and monetary policy. This paper is a response to Don Lavoie’s (2011) “The Interpretive Dimension of Economics” in which Lavoie uses Austrian School methodology to study economic history and how that might be useful in explaining and analysing the Great Recession. Horwitz begins by explaining there is a rift among Austrian economists between theory and history. Menger (1931) asserts that economists needed theory in order to make sense of history, particularly economic history. This is a diversion from the German Historical School which held that economics history could be understood without complex economic theory to provide a narrative. Lavoie cites Menger (1931) and Mises (1957) as contending that all historians use theory when choosing which facts to present in their narrative since it is not possible to include all the facts in the world. Theory is needed, Menger and Mises argue, to distinguish which facts are relevant and which are not in the underlying narrative. What Lavoie (2011) added that was not being discussed among Austrians was the idea that history impacts economic theory, not the other way around, which was the reverse of the common understanding. What does this have to do with the Great Recession? Horwitz (2011) contends that the 2007-9 financial crisis forces Austrian economists to re-examine the role that history plays in re/formulating economic theory. Horwitz (2011) asserts that the traditional Austrian Business Cycle Theory (ABCT) is not sufficient in explaining the 2007-9 recession. He makes a distinction between the “canonical Austrians” (Menger, Mises, Hayek) and the modern Austrians (Lavoie, Garrison, Woods). Horwitz (2011) contends that the core of the ABCT remains unchanged, however it needs to be updated to include how problems with interest rates come about and what effect they have on consumption-production decisions.

The fourth paper that we will consider is “Capital in Disequilibrium: Understanding the ‘Great Recession’ and the Potential for Recovery” by John P. Cochran (2010). In this paper, Cochran asserts that interventions during a recession only prolong the suffering, particularly during “regime uncertainty”, and that capital structure based macroeconomics is better than policy to foster economic recovery. Founded by Mises and Hayek, the Austrian Business Cycle Theory (ABCT) holds that within the natural boom and bust cycle, interest rates kept artificially low by central banks or fractional reserve banks prolongs the recession. Cochran uses the ABCT to explain the Fed artificially kept interest rates too low which led to economic distortions.

He explains that the Great Recession is the third major revival in the ABCT, after the Great Depression of the early 1930s and the stagflation period of the the 1970s. Cochran argues that the ABCT must be used to promote economic recovery through sound monetary policy, the rule of law (and not of men), and competitive resource markets. This is not the approach taken by the Fed; in fact, the Fed did the opposite through Quantitative Easing (QE) which, Cochran asserts, only worsened the Great Recession. Cochran illustrates that it is difficult to distinguish between a boom and long term growth and that busts are caused by overinvestment, malinvestment, and overconsumption. The ABCT falls short, says Cochran, because it is a theory of unsustainable boom, not of recession, which needs to be updated to better explain the Great Recession of 2007-9.

The fifth paper that we will consider is “The Plucking Model, the Great Recession, and Austrian Business Cycle Theory” by Ryan H. Murphy (2015). In this paper, Murphy shows us that Milton Friedman’s “plucking model” did not hold true during the Great Recession. Much like Cochran (2010), Murphy also asserts that the ABCT needs to be updated in light of the financial crises. However, Murphy states that the Great Recession caused many mainstream macroeconomists to take another look at the ABCT, although few would put it to serious consideration. The Great Recession happened exactly as the ABCT said it would, but the “plucking” of output downward as Friedman described it was incorrect in that that was not how the Great Recession occurred. Murphy differs from Garrison (1996) in that he asserts that booms do not “pluck” inward which suggests that busts need better explaining, not booms. When unemployment fell in 2014, Real Gross Domestic Product (RGDP) did not recover as Friedman predicted; this, additionally, was one reason Friedman said the ABCT was not accurate. Yet, the Great Recession proved the ABCT to be correct and Friedman to be incorrect. In the years following the 2007-9 financial crisis, RGDP did not rebound like Friedman predicted. The U.S. did not reach its productive potential as the plucking model suggested. This is important because as mainstream economists re-examine the ABCT, they will see that it lines up accurately with what happened in the late 2000s. Murphy contends that the Great Recession is the closest crisis to match the predictions of the ABCT.

The sixth paper that we will consider is “The Time Structure of Production in the US, 2002-2009” by Andrew T. Young (2012). In this paper, Young’s analysis agrees with Murphy (2015) that the Great Recession followed the ABCT quite closely. However, Young takes a different approach to monitoring the U.S. time structure of production during the business cycle of 2002-2009. Young uses industry level input-output data to measure an industry’s “roundaboutness,” that is, its ebbs and flows. In addition, he uses Total Industry Output Requirement (TIOR) as a suggested metric for roundaboutness. Using the ABCT assertion that the time structure of production and prices of higher- and lower-order goods move together in the business cycle, Young constructs Hayekian triangles to prove his point. He contends that this approach facilitates the evaluation of predictions of the ABCT. Young shows that his findings are consistent with ABCT. This is important because, as with Murphy (2015), mainstream economists are starting to rediscover the ABCT.

The seventh paper that we will consider is “What Really Caused the Great Recession? Rhyme and Repetition in a Theme from the 1930s” by Nicholas Snowden (2015). In this paper, Snowden shows that the 2008 financial crisis brought a revival of real sector development that had not been seen since the 1930s. Using an Austrian School approach, he shows that financial sector excess was a contributing factor but not the sole cause of the Great Recession. Snowden shows that while the Fed enacted monetary easing and the buying back of mortgage-backed securities (MBS), the consumers benefited while the corporate sector diverted funds from “higher stage” to “lower stage” investment. Snowden notes “monetary policy would best support full employment by diverting credit to investment expenditures elsewhere” than the corporate sector. Overstimulation of consumption spending is a key concern of the easy monetary policy enacted by the Fed that promotes an unsustainable amount of credit growth and allocation.

The eighth paper that we will consider is “Did Increased Inequality Cause the Great Recession?” by Tim Congdon (2015). This paper takes the complete opposite approach of the previous papers. Congdon takes Thomas Piketty’s *Capital in the Twenty-First Century* (2014) to task and implements some tests to see if Piketty’s premise, that greater inequality caused the Great Recession, holds true. Piketty uses data to make a

strong argument that in the U.S. the top 1% has amassed greater wealth while the bottom 99% has stagnated or declined. While wages for most workers have stagnated, their level of indebtedness has increased which over decades can become problematic. Through statistical analysis, Congdon shows that wealth inequality actually played a negligent factor in the slump of demand, output, and employment in the 2007-9 period. He uses the six quarters of GDP data leading to Q2 2009 both as a unit of comparison to neighboring periods (“outside-period comparison”) and the first quarter compared to the sixth quarter (“inside-period comparison”). What he finds is that demand did change between the two periods, but not on the scale Piketty describes. Congdon identifies another significant error in Piketty’s work: Piketty is comparing wealth inequality among individuals in the personal sphere, whereas most business cycles study expenditures by corporations, specifically investments, as opposed to personal expenditures. To say that wealth inequality is the primary cause of the Great Recession does not line up with modern business cycle theory, nor does Congdon’s statistical analysis support Piketty’s claim. Even if Piketty were right, Congdon argues, that massive inequality was on the rise in the decades leading to the Great Recession, that still does not explain the slump in aggregate demand. Rather, Congdon asserts that corporate demand is the culprit of the demand slump, which is in line with business cycle theory. Piketty argues that the stagnating or falling income of the lower and middle class coupled with a higher proportion of debt than the upper class created a slump in consumer demand resulting in lower consumption and a contraction across all sectors. Furthermore, Piketty maintains that housing starts and the inequality with the rising salaries of top managers are correlated- Congdon points out that a reinterpretation of the data shows that is false.

The ninth paper that we will consider is “Hayek, Keynes, and Modern Macroeconomics” by Roger Koppl and William J. Luther (2012). In this paper, Koppl and Luther show that since the financial crisis of 2008, there has been a resurgence of research interest in “animal spirits,” complexity, cognition, and radical uncertainty. This resurgence has mostly been from a Keynesian perspective. However, Koppl and Luther assert that the same research interest can be done from a Hayekian perspective as well. In addition, the authors have reason to think that the Austrian School approach might find more interest than in decades past, if Austrian economists are willing to engage in debate with the mainstream. The authors maintain that the resurgence of Keynesianism is a return to the lackluster interventionist policies of the past in which a crisis occurs and the government needs to fix it, but that need not be the case and in many cases only makes the situation worse. One of the reasons that Austrians have not been as successful in winning the macroeconomic debate in the past is that noted champions of free markets and non-intervention such as former Fed chair Alan Greenspan and former U.S. Circuit Judge Richard Posner retreating in favor of some intervention. As disappointing as this has been for Austrians, the authors admit that there is honor in “experts” saying they were wrong. Koppl and Luther conclude by saying the “The Age of Friedman” is over, but Keynesianism may not win the day- “The Age of Hayek” is also possible if Austrian economists rise to the challenge.

The tenth paper that we will consider is “Central Banking After the Great Recession” by Sir Charlie Bean (2020), former Deputy Governor of the Bank of England. In this paper, Bean describes how the Federal Reserve and other central banks reacted to the financial crisis of 2007-8 in the United States and how its macroeconomic policy has changed. In particular, he shows that because the debt of consumers and businesses was so high, the Fed might be tempted to raise inflation. Central banks around the world also inflated the supply of credit to boost aggregate demand. With interest rates kept artificially low, the result was a increase in consumer and business saving coupled with a decrease in investment. Bean shows that global savings and investing dipped during the Great Recession but bounced back afterward as a result of central bank intervention. These findings are important because they show that central banks had a key role in stimulating the economy. This is the opposite conclusion reached by the Austrian economists who assert that no central bank is necessary, and further, only make matters worse by creating more distortions in the economy.

Some other findings include: Hasan et al. (2015) study the effect of the Great Recession on the construction industry in the United Kingdom from the lens of the Austrian School. Hammond (2012) compares the diverse approaches of Ron Paul, former U.S. Congressman, the intellectual grandfather of the U.S. Tea Party

movement, and political proponent of the Austrian School, and Paul Krugman, noted New York Times columnist and Keynesian economist, to the financial crisis of 2008. Fillieule (2016) continues a critique of the handling of the crisis from an Austrian lens. Kates (2010) explores whether an entirely new framework is needed to explain the causes and prolonged suffering experienced during the Great Recession. Bragues (2016) compares and contrasts the experience of the U.S. and Canada during the 2007-9 financial crisis from both a Keynesian and Austrian perspective. Machovec (2014) and Wayne (2015) re-examine what most macro-economists take for granted in their quest to explain the Great Recession and proposes a new, scientific way to approach old methods, building on Keynesian analysis. Whalen (2010) explores what full employment, a Keynesian concept, would like in a society run by Austrian School principles, off the coattails of the Great Recession. Usenmez and Duman (2016) utilize a Hayek versus Polanyi analysis to re-examine what a free market means in the context of greater regulations and anti-capitalist sentiment arising from the financial crisis (and the Occupy Wall Street movement). Finally, Troncoso (2019) provides a reinterpretation of the causes of the 2008 global financial crisis from a neo-Keynesian perspective on the use of derivatives markets.

4. Future research

This section will cover areas of future research in the field of the 2007-8 Great Recession. We will identify any holes in the current literature and what what knowledge will be useful going forward. Particular emphasis is placed on the fundamental differences between the Austrian School and the Keynesian mainstream approach to monetary policy in handling the financial crisis.

In regard to Rognlie et al. (2018), future research could be done to verify whether it was really an investment boom in the housing market that led to the Great Recession. Testing can be done on Rognlie et al.'s (2018) hypothesis that consumers were foregoing lightweight automobile sales and other "higher order" goods, the so-called "hangover," was really a variable in making the recession worse by the loss of confidence in all sectors, not only the financial sector.

In regard to Munoz and Ortiz (2016), future research could be done on the comparison between how the Fed and ECB reacted to the Great Recession as opposed how they reacted to the global economic downturn brought by governments' response to the Covid-19 pandemic.

In regard to Horwitz (2011), future research could be done by "modern" Austrian School economists, as opposed to the "canonical" Austrians such as Mises and Hayek, to unite the split between those that focus on theory and those that focus on history. My opinion is that Horwitz is correct that the ABCT needs to be updated in regards to its explanation of what effect central banks suppressing interest rates has on the boom and bust cycle. Austrian School economists have their work cut out for them in terms of updating and revising the ABCT so that theory matches history.

In regard to Cochran (2010), future research could be done on revising and updating the Austrian Business Cycle Theory to more accurately explain the Great Recession. As stated above, Cochran (2010) maintains that the ABCT is a theory revolving around the bust period, not the recession. An updated ABCT would go a long way in making the theory more compelling to mainstream economists and the general public.

In regard to Murphy (2015), future research could be done to provide supporting evidence that Milton Friedman's "plucking model" was wrong in the case of the Great Recession.

In regard to Young (2012), future research could be done on conducting more studies on the time structure of production in the 2002-2007 period to see verify if Young's conclusion is correct that the business cycle followed the Austrian Business Cycle Theory closely.

In regard to Snowden (2015), future research could be done on the overstimulation of consumption by the Fed and whether Snowden's comparison with the 1930's is, in fact, accurate.

In regard to Congdon (2015), future research could be done on independently testing Piketty's argument whether the widening gap between the top 1% and everyone else in the decades leading to the Great Recession

drove the financial crisis of 2008. Future research could run Gongdon's experiments again with new data taken from the 2007-9 era and see whether Congdon (2015) is correct in his assessment. A further empirical rebuff of Piketty would help strengthen the Austrian School argument in the mainstream economic discourse.

In regard to Koppl and Luther (2012), future research could be done with Austrian School economists who stay the course on central bank non-intervention and taking the Hayekian position on "animal spirits." In my opinion, Koppl and Luther (2012) are correct when they say that the Hayekian approach can make a comeback against Keynesianism if such economists engage the mainstream in monetary and macro-economic debate. Keynesians need not have the final word on "animal spirits" studies: exiting the Great Recession has led many investors to display bear-like behavior, however an economic recovery, particularly in the financial sector, provided by market forces left to their own devices, can lead to more bull-like behavior in the near future. Austrian economists need to tackle this issue head-on if they want to regain exposure in the mainstream.

In regard to Bean (2020), future research could be done to follow up with his assertion that interventions on the part of central banks were imperative to the economic recovery from the Great Recession. While Bean (2020) does not explicitly say that such interventions were desirable, the implication in this work is that they made the recovery easier than taking a laissez-faire, hands-off approach.

5. Conclusion

In conclusion, we have seen that the 2007-8 Great Recession was caused by a burst of the housing bubble that then spilled over into every other industry across the world. This financial crisis had an effect on the Federal Reserve's monetary policy and the U.S. Congress' macroeconomic policy. What the above literature review shows us is that there are many differing views on what caused the Great Recession and even more differing views on what the right monetary policy is to fix it and ensure it never happens again. First, we looked at the Austrian School approach that advocates a more laissez-faire policy at central bank monetary policy. Then, we looked at the mainstream, Keynesian approach that supports a more interventionist policy at central bank monetary policy. We compared these two different schools' approaches to handling the 2008 financial crisis to see which had better results. Many central banks around the world opted for the Keynesian approach. The result was a resurgence in Keynesianism worldwide. What we should take away from this analysis is that while the Great Recession may be over, the interventionist monetary policies that resulted are still with us today. The question going forward is: Will the Fed stick to those failed policies or change course to ensure that financial disaster does not happen again?

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