Knowledge Portal

BUSINESS ECONOMICS

CHAPTER 5:

BUSINESS ECONOMICS

By CA SANCHIT GROVER

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About the Author

Completed his CA Course securing place in Top 6 All India Ranks - both at IPC and CPT level

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<u>What to study in this chapter</u>

- Meaning of the term 'Business Cycles'
- Different Phases of Business Cycles
- What are features of each Busines Cycle
- Causes of Business Cycles - Internal and External Causes
- Relevance of stuyd of business cycles in business decision making

<u>Understanding the meaning of term 'Business Cycles"</u>

One of the basic underlying feature of any economy across the globe is the fluctuation in economic activities over a period of time. There have been periods of prosperity followed by periods of downturns in economic activity. *These <u>rhythmic fluctuations in aggregate economic activity</u> that an economy experiences over a period of time are called business cycles or trade cycles*

> A business cycle **is the natural rise and fall of economic growth** that occurs over time.
>
> In other words, ***business cycle refers to alternate expansion and contraction of overall business activity*** as manifested in fluctuations in measures of aggregate economic activity, such as, gross national product, employment and income.
>
> Business cycles or the periodic booms and slumps in economic activities **reflect the upward and downward movements in economic variables**

A typical business cycle or trade cycle consists of the following:-

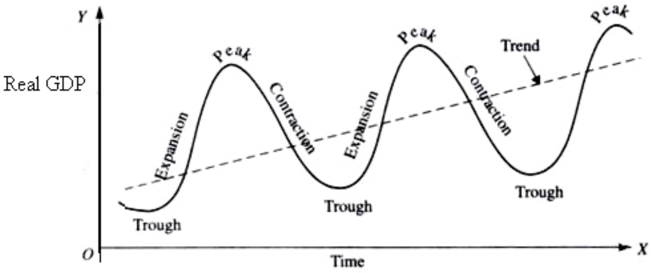
Periods of good trade	Characterized by:- ▪ Rising prices ▪ Low unemployment percentage
Periods of bad trade	Characterized by:- ▪ Falling prices ▪ High unemployment percentage

<u>Characteristics of Business Cycles or Economic fluctuations</u>

- They are recurrent and occur periodically
- They occur again and again but not always at regular intervals, nor are they of the same length. *(some business cycles may be lasting for several years while others may be short ending in two to three years.)*

<u>Different Phases of Business Cycle</u>

Experience of various countries suggest that their economies grow over a period of time but this growth story is filled with business cycles (their GDP line going up, declining but gaining momentum again). Ultimately growth of any economy can be projected in the following figure:-



Observations from above diagram
▪ Steady broken line in the middle represents steady growth of the economy (excluding the impact of business fluctuation). This line basically shows overall **'trend'** of the economy over a period of time ▪ The first stage in the above diagram is called **'trough'** when the overall economic activities i.e. production and employment, are at the lowest level. ▪ This is followed by **'expansion path'** - when production and employment expand and the economy starts reviving, ▪ The stage of expansion goes on till the economy reaches the point called **'peak'**, however beyond that this stage cannot go on indefinitely. Hence after reaching the 'peak', the economy starts on 'contraction path' when the level of economic activity starts declining ▪ The contraction or downturn continues till it reaches the lowest turning point i.e. **'trough'.** However, after remaining at this point for some time, the economy revives again and a new cycle starts.

Features of different phases of Business cycles	
Expansion	▪ Increase in national output, employment, aggregate demand, capital and consumer expenditure ▪ Increase in sales, profits of business entities resulting to rising stock prices, increased credit availability from banks ▪ Negligible involuntary employment *(almost Zero)*. Unemployment, if any, in the economy would be because of following reasons:- ✓ Frictional unemployment *(i.e. due to change of jobs, or suspended work due to strikes or due to imperfect mobility of labour)* ✓ Structural unemployment *(i.e. unemployment caused due to structural changes in the economy)* ▪ Investment happening is good and hence demand for goods and services is also very high. Resultantly, prices and costs tend to rise faster ▪ Increasing prosperity and people enjoy high standard of living due to high levels of consumer spending, business confidence, production, factor incomes, profits and investment
Point to note The stage of expansion continues till there is full employment of resources and production is at its maximum possible level using the available productive resources. The growth rate eventually slows down and reaches its peak.	
Peak	The term peak refers to the top or the highest point of the business cycle. In other words, after this point, stage of expansion ends and stage of contraction starts. ***Reasons*** ▪ In the later stages of expansion, inputs are difficult to find as they are short of their demand and therefore input prices increase. ▪ Output prices also rise rapidly leading to increased cost of living and greater strain on fixed income earners. ▪ Consumers begin to review their consumption expenditure on housing, durable goods etc. Consequently, actual demand stagnates.

<u>Remember:</u> The economy cannot continue to grow endlessly. Point of 'Peak' is the end of expansion and it occurs when economic growth has reached a point where it will stabilize for a short time and then move in the reverse direction	
Contraction	*<u>How 'Contraction' starts:-</u>* 1) There is fall in the levels of investment and employment. *(Demand decreasing..!!)* 2) Producers do not instantaneously recognise the pulse of the economy and continue anticipating higher levels of demand. Therefore, they maintain their existing levels of investment and production *(with the hopes of a better future..!!)* 3) The consequence is a discrepancy or mismatch between demand and supply. **<u>Supply far exceeds demand.</u>** 4) Once this stage is reached, producers now realize that that they have indulged in excessive investment and over production. Hence, they respond by holding back future investment plans, cancellation and stoppage of orders for equipment and all types of inputs including labour. *(Supply side contracts..!!)* 5) As producers contract their supply, there is a chain of reactions in the input markets as well - producers of capital goods and raw materials in turn respond by cancelling and curtailing their orders. *(Fire of contraction starts spreading across sectors now…!!)* *<u>How consumers play a role in recession</u>* 1) Due to fall in prices of products (including inputs) incomes of wage and interest earners gradually decline resulting in decreased demand for goods and services. 2) Producers lower their prices in order to dispose off their inventories and for meeting their financial obligations. 3) Consumers, in their turn, expect further decreases in prices and postpone their purchases. With reduced consumer spending, aggregate demand falls, generally causing fall in prices. 4) The discrepancy between demand and supply gets widened further. This process gathers speed and recession becomes severe. *<u>Stage of severe recession</u>* ▪ Investments start declining; production and employment decline resulting in further decline in incomes, demand and consumption of both capital goods and consumer goods. ▪ Business firms become pessimistic about the future state of the economy and there is a fall in profit expectations which induces them to reduce investments. ▪ Bank credit shrinks as borrowings for investment declines, investor confidence is at its lowest. ▪ Stock prices fall and unemployment increases despite fall in wage rates. The process of recession is complete and the severe contraction in the economic activities pushes the economy into the phase of depression.
Trough and Depression:	Depression is the severe form of recession and is characterized by extremely sluggish economic activities. Main features of this stage are:- ▪ *<u>Growth rate becomes negative</u>* and the level of national income and expenditure declines rapidly. ▪ Demand for products and services decreases, prices are at their lowest and decline rapidly forcing firms to *shutdown* several production facilities. ▪ Companies are unable to sustain their work force, and hence job cuts. This leads to mounting *<u>unemployment</u>* and consequently the consumers are left with very little disposable income.

	▪ There is *<u>fall in the interest rate</u>* due to which people's demand for holding liquid money (i.e. in cash) increases. Despite lower interest rates, the demand for credit declines because investors' confidence has fallen. Credit generation remains low due to possible banking or financial crisis. (that are general consequences of depression) ▪ Industries, especially capital and consumer durable goods industry, suffer from excess capacity. ▪ Large number of bankruptcies and liquidation significantly reduce the magnitude of trade and commerce. At the depth of depression, all economic activities touch the bottom and the phase of trough is reached.
<u>Point to be note</u> The economy cannot continue to contract endlessly. It reaches the lowest level of economic activity called trough and then starts recovering	
Recovery	After a rough patch, there is end of pessimism and the beginning of optimism which reverses the process. This revival process generally happens in the following manner:- ▪ Pervasive unemployment forces the workers to accept wages lower than the prevailing rates. ▪ Due to this, the producers anticipate lower costs and better business environment. As business confidence gets better, they start to invest again and to build stocks; ▪ Slowly, the banking system starts expanding credit; technological advancements require fresh investments into new types of machines and capital goods; ▪ Employment increases, aggregate demand picks up and prices gradually rise. **Spurring of investment is the main factor** that acts as a turning point from depression to expansion. As investment rises, production increases, employment improves, income improves and consumers begin to increase their expenditure. Increased spending causes increased aggregate demand and in order to fulfill the demand more goods and services are produced. Employment of labour increases, unemployment falls and expansion takes place in the economic activity

<u>What are the different Indicators to detect which phase is going on</u>

Meaning of Indicators	It is very difficult to predict the turning points of business cycles. Economists use changes in a variety of activities to measure the business cycle and to predict where the economy is headed towards. These are called indicators.	
Types of Indicators		
Leading Indicators	**Meaning**	A leading indicator is a measurable economic factor that changes before the economy starts to follow a particular pattern or trend. *In other words, those variables that change before the real output changes are called 'Leading indicators'*. Leading indicators often change prior to large economic adjustments
	Examples	▪ Changes in stock prices, ▪ profit margins and profits, ▪ indices such as housing, interest rates and prices ▪ value of new orders for consumer goods, new orders for plant and equipment, building permits for private houses, ▪ fraction of companies reporting slower deliveries, ▪ index of consumer confidence and money growth rate
	Significance	Leading indicators, though widely used to predict changes in the economy, are not always accurate. Even experts disagree on the timing of these so-called leading indicators. For instance:- it may be weeks or months after a stock market crash before the economy begins to show signs of receding. Nevertheless, it may never happen.

Lagging indicators	**Meaning**	Lagging indicators reflect the economy's historical performance and changes in these indicators are observable only after an economic trend or pattern has already occurred. In other words, variables that change after the real output changes are called 'Lagging indicators'.
	Examples	▪ unemployment, ▪ corporate profits, ▪ labour cost per unit of output, ▪ interest rates, ▪ the consumer price index and ▪ commercial lending activity
	Significance	If leading indicators signal the onset of business cycles, lagging indicators confirm these trends
Coincident indicator	**Meaning**	Coincident economic indicators, also called concurrent indicators, coincide or occur simultaneously with the business-cycle movements. Since they coincide fairly closely with changes in the cycle of economic activity, they describe the current state of the business cycle
	Examples	▪ Gross Domestic Product, ▪ industrial production, inflation, ▪ personal income, ▪ retail sales and ▪ financial market trends such as stock market prices.
	Significance	These indicators give information about the rate of change of the expansion or contraction of an economy more or less at the same point of time it happens

<u>General Features of Business Cycles</u>

Business Cycles may differ in terms of duration and intensity, but all of them share the following common features:-

No fixed duration	Business cycles occur periodically although they do not exhibit the same regularity. The duration of these cycles vary.
Variance in intensity	Fluctuations are common phenomenon in any economy, however, the intensity of each business cycle varies
Lack of regularity in different phases	All business cycles have distinct phases of expansion, peak, contraction and trough. However, these phases seldom display any smoothness and regularity. Further, the length of each phase also differs *(hence nobody can be sure when recession has ended…!!*
Pervasive in nature	Business cycles typically generally originate in free market economies *(since forces of demand and supply decide the direction of such economies)*. Accordingly, the effect of these cycles is generally pervasive i.e. disturbances in one or more sectors get easily transmitted to all other sectors.
Disproportionate effect on different sectors	Although all sectors are adversely affected by business cycles, some sectors such as capital goods industries, durable consumer goods industry etc, are disproportionately affected. Moreover, compared to agricultural sector, the industrials sector is more prone to the adverse effects of trade cycles
Complex in nature	Business cycles are exceedingly complex phenomena. This is because of the reason that they do not have uniform characteristics and causes and they are caused by varying factors. Therefore, it is difficult to make an accurate prediction of trade cycles before their occurrence
Impact on all economic variables	Repercussions of business cycles get simultaneously felt on nearly all economic variables viz. output, employment, investment, consumption, interest, trade and price levels.

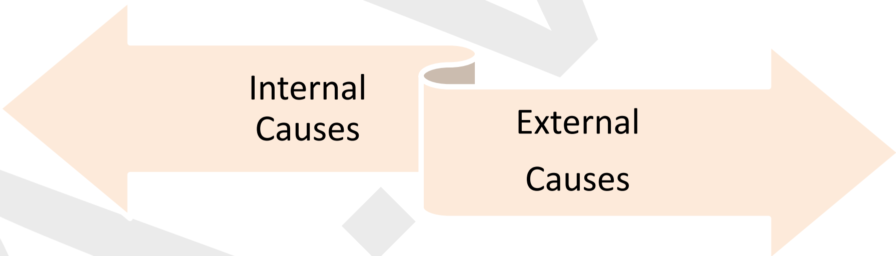
Contagious from one nation to another	Business cycles are contagious and are international in character. They begin in one country and mostly spread to other countries through trade relations. For example, the great depression of 1930s in the USA and Great Britain affected almost all the countries, especially the capitalist countries of the world. The recent sub prime crisis of US is another example that quickly spread across the globe.
Impact on social well being	Business cycles have serious consequences on the well being of the society. The period of recession is a very agonizing period causing lots of distress for all. For instance:- The great depression of 1929-33 is still cited for the enormous misery and human sufferings it caused.

<u>Some Real Life Examples of Business Cycles</u>

Great Depression of 1930	▪ Longest, deepest, and the most widespread depression of the 20th century during 1930s. ▪ Started in the US and became worldwide. ▪ Global GDP fell by around 15% between 1929 and 1932. Production, employment and income fell. *<u>What lead to it</u>* ▪ There is difference of opinion amongst economists regarding causes of Great Depression. ▪ While **British economist John Maynard Keynes** regarded lower aggregate expenditures in the economy to be the cause of massive decline in income and employment, ▪ Monetarists opined that the Great Depression was caused by the banking crisis and low money supply. ▪ Many other economists blamed deflation, over- indebtedness, lower profits and pessimism to be the main causes of Great Depression. *<u>Recovery</u>* ▪ The economies of the world began recovering in 1933. ▪ Increased money supply, huge international inflow of gold, increased governments' spending due to World War II etc., were some of the factors which helped economies slowly come out of recession and enter the phase of expansion and upturn.
Information Technology bubble burst of 2000	▪ Also termed as Dot.Com bubble. It roughly covered the period 1997-2000 *<u>What lead to it</u>* ▪ During this period, many new Internet–based companies (commonly referred as dot-com companies) were started. ▪ Due to rapid growth of internet, venture capitalists invested huge amount in these companies. These companies were also able to borrow from the market at low interest rates ▪ Due to over- optimism in the market, investors were less cautious. There was a great rise in their stock prices ▪ These companies offered their services or end products for free with the expectation that they could build enough brand awareness to charge profitable rates for their services later *(something we see even today in e-commerce space..!!)* *<u>The burst of Bubble</u>*

<table>
<tr><td></td><td>▪ The "growth over profits" mentality led some companies to engage in lavish internal spending, such as elaborate business facilities. These companies could not sustain long.
▪ The collapse of the bubble took place during 1999–2001.
▪ Many dot-com companies ran out of capital and were acquired or liquidated.
▪ Nearly half of the dot –com companies were either shut down or were taken over by other companies.
▪ Stock markets crashed and slowly the economies began feeling the downturn in their economic activities.</td></tr>
<tr><td>Global Economic Crisis (2008-09):</td><td><u>What lead to it</u>
▪ The recent global economic crisis owes its origin to <u>US financial markets</u>.
▪ After the year 2000, the US Federal Reserve (the Central Bank of US) reduced the rate of interest which led to large liquidity or money supply with the banks.
▪ With lower interest rates, credit became cheaper and the households, even with low creditworthiness, began to buy houses in increasing numbers.
▪ Excess liquidity with banks and availability of new financial instruments led banks to lend without checking the creditworthiness of borrowers (Loans were given even to sub-prime households and also to those persons who had no income or assets)
▪ Due to oversupply in the market, prices of houses (that were held as mortgages) declined significantly and hence the <u>sub – prime households started defaulting</u> on a large scale in paying off their instalments.
▪ This caused huge losses to the banks. Losses in banks and other financial institutions had a chain eect and soon the whole US economy and the world economy at large felt its impact.</td></tr>
</table>

<u>Causes of Business Cycles</u>



<table>
<tr><td colspan="2">Internal Causes</td></tr>
<tr><td>Fluctuations in Effective Demand</td><td>According to Keynes, fluctuations in economic activities are due to <u>fluctuations in aggregate effective demand</u>
*Effective demand refers to the willingness and ability of consumers to purchase goods at different prices.

<u>How aggregate demand leads to economic fluctuations</u>
<table>
<tr><td>Higher level of demand</td><td>▪ In a free market economy, where maximization of profits is the aim of businesses, a higher level of aggregate demand will induce businessmen to produce more. (since more production would mean more sale and hence more profits)
▪ As a result, there will be more output, income and employment
▪ However, if aggregate demand outstrips aggregate supply, it causes inflation</td></tr>
<tr><td>Lower level of demand</td><td>▪ If the aggregate demand is low, there will be lesser output, income and employment (since producers will cut their output to avoid situation of excess supply)</td></tr>
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<tr><td></td><td>Investors sell stocks, and buy safe-haven investments that traditionally do not lose value (such as bonds, gold and the U.S. dollar)
As companies lay off workers, consumers lose their jobs and stop buying anything but necessities. That causes a downward spiral</td></tr>
<tr><td>Impact of Foreign Trade</td><td>The difference between exports and imports is the net foreign demand for goods and services.
This is a component of the aggregate demand in the economy, and therefore variations in exports and imports can lead to business fluctuations as well.</td></tr>
</table>
<u>Conclusion</u>
<table>
<tr><td>Increase in Aggregate demand</td><td>• Conditions of expansion and boom</td></tr>
<tr><td>Decrease in Aggregate demand</td><td>• Conditions of recession and depression</td></tr>
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<tr>
<td>Fluctuations in Investment</td>
<td>
According to some economists, fluctuations in investments are the prime cause of business cycles.
<table>
<tr><td>Why do investments fluctuate</td><td>Changes in the profit expectations of entrepreneurs.
New inventions may cause entrepreneurs to increase investments in projects which are cost-efficient or more profit inducing.
Investment may rise when the rate of interest is low in the economy.</td></tr>
<tr><td>Effect of Fluctuations in Investment</td><td>Investment spending is considered to be the most volatile component of the aggregate demand.
Increases in investment shift the aggregate demand to the right, leading to an economic expansion (how increase in demand leads to boom is already explained above)
Decreases in investment have the opposite effect</td></tr>
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<tr>
<td>Variations in government spending</td>
<td>Fluctuations in government spending with its impact on aggregate economic activity result in business fluctuations (since it is an important component of aggregate demand..!!)
Government spending, especially during and after wars, has destabilizing effects on the economy.</td>
</tr>
<tr>
<td>Macroeconomic policies</td>
<td>
Macroeconomic policies mainly includes monetary and fiscal policies of the government.
<u>How these policies lead to business cycles</u>
<table>
<tr><td rowspan="2">Expansionary/ Inflationary policies</td><td>Examples</td><td>increased government spending
tax cuts
softening of interest rates,</td></tr>
<tr><td>Impact</td><td>Boost to aggregate demand, resulting to expansion and boom
Inflationary effects (mainly due to interest rate cuts) and decline in unemployment rates</td></tr>
<tr><td rowspan="2">Anti-Inflationary policies</td><td>Examples</td><td>reduction in government spending
increase in taxes
Increase in interest rates</td></tr>
<tr><td>Impact</td><td>downward pressure on the aggregate demand leading to slow down in the economy
At times, such slowdowns may be drastic, showing negative growth rates and may ultimately end up in recession.</td></tr>
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<td>Money Supply</td>
<td>According to Hawtrey, trade cycle is a purely monetary phenomenon. Unplanned changes in supply of money may cause business fluctuation in an economy.</td>
</tr>
</table>

	Increase in supply of money	▪ Expansion in aggregate demand leading to boom in economic activities. ▪ Capital is easily available, and therefore consumers and businesses alike can borrow at low rates *(This stimulates more demand, creating a virtuous circle of prosperity)* ▪ However, excessive increase of credit and money also set off inflation in the economy
	Decrease in money supply	▪ Decrease in money supply and/or contraction of credit creation by banks leads to lesser investible funds for businessmen and lesser disposable funds for consumers ▪ Due to lesser investment and lesser demand, there is fall in output, employment etc. and hence initiation of recession in the economy
Psychological factors	**Anticipation theory by Pigou**	
	Theory	▪ According to Pigou, modern business activities are based on the anticipations of business community and are affected by waves of optimism or pessimism. ▪ Business fluctuations are the outcome of these psychological states of mind of businessmen
	Stages of Optimism	If entrepreneurs are optimistic about future market conditions, they make investments, and as a result, the expansionary phase may begin.
	Stages of Pessimism	▪ Investors tend to restrict their investments. ▪ With reduced investments, employment, income and consumption also take a downturn and the economy faces contraction in economic activities.
	Other Theories	
	Innovation Theory by Schumpeter	According to Schumpeter's innovation theory, trade cycles occur as a result of innovations which take place in the system from time to time
	Cobweb theory by Nicholas Kaldor	▪ This theory holds that business cycles result from the fact that present prices substantially influence the production at some future date. ▪ The present fluctuations in prices may become responsible for fluctuations in output and employment at some subsequent period

External Causes	
Wars	▪ During war times, production of war goods, like weapons and arms etc., increases and most of the resources of the country are diverted for their production. ▪ This affects the production of other goods - capital and consumer goods. ▪ Fall in production causes fall in income, profits and employment. ▪ This creates contraction in economic activity and may trigger downturn in business cycle
Post War Reconstruction	▪ After war, when the country begins to reconstruct itself, expenditure is incurred for building houses, roads, bridges etc. due to which economic activity begins to pick up. ▪ All these activities push up effective demand due to which output, employment and income go up. *(thereby pushing the economy upwards..!!)*
Technology shocks	▪ Although growing technology enables production of new and better products and services, however these products generally require huge investments for new technology adoption. ▪ On account of this, technological advancement in any country leads to expansion of employment, income and profits etc. and give a boost to the economy.

	For example, due to the advent of mobile phones, the telecom industry underwent a boom and there was expansion of production, employment, income and profits.
Natural Factors	▪ These mainly include weather cycles which cause fluctuations in agricultural output. This leads to instability in the economies, especially those economies which are mainly agrarian. ▪ Even in other economics, there is an indirect impact caused in the following manner:- ✓ In the years when there are draughts or excessive floods, agricultural output is badly affected. With reduced agricultural output, incomes of farmers fall and therefore they reduce their demand for industrial goods. ✓ Reduced production of food products also pushes up their prices and thus reduces the income available for buying industrial goods. ✓ Reduced demand for industrial products may cause industrial recession.
Population growth	▪ The rate of savings in the economy directly depends on population growth. Where the population growth rate outpaces the economic growth rate, the result is lesser overall savings in the economy. ▪ Fewer saving will reduce investment and as a result, income and employment will also be less. ▪ With lesser employment and income, the effective demand will be less, and overall, there will be slowdown in economic activities.
Other reasons	▪ In the world of globalisation, it is natural that business fluctuations occurring in one part of the world get easily transmitted to other parts. ▪ Changes in laws related to taxes, trade regulations, government expenditure, transfer of capital and production to other countries, shifts in tastes and preferences of consumers are also potential sources of disruption in the economy

Why is study of Business Cycles relevant for Business Decision Making

Direct Impact on profits	Understanding the business cycle is important for businesses of all types as they affect the demand for their products and in turn their profits which ultimately determines whether a business is successful or not.	
Formulation of appropriate policies	Knowledge regarding business cycles and their inherent characteristics is important for a businessman to frame appropriate policies. For example, ▪ Period of prosperity opens up new and superior opportunities for investment, employment and production and thereby promotes business. ▪ Period of recession or depression reduces business opportunities and profits *(businessmen play defensive during this time..!!)*	
Planning regarding expansion and down sizing	▪ One of prime consideration to be kept in mind by any profit maximising firm while undertaking the function of ***forward planning***, is study of the ecnmic environment in which it is operating. ▪ The stage of the business cycle is crucial while making managerial decisions regarding **expansion or down-sizing**. ▪ Businesses have to advantageously respond to the need to alter production levels relative to demand. Different phases of the cycle require fluctuating levels of input use, especially labour input. ▪ Capability to expand or rationalize production operations so as to suit the stage of the business cycle is the key to long term success of any firm	
Impact due to nature of product	Products that vary directly with economic cycle	▪ Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "cyclical" businesses.

		▪ These include fashion retailers, electrical goods, house-builders, restaurants, advertising, overseas tour operators, construction and other infrastructure firms. ▪ During a boom, such businesses see a strong demand for their products but during a slump, they usually suffer a sharp drop in demand
	Products that vary inversely with economic cycle	▪ It may also happen that some businesses actually bene_t from an economic down turn. ▪ This happens when their products are perceived by customers as representing good value for money, or a cheaper alternative compared to more expensive products.
Ability to respond appropriately	Understanding what phase of the business cycle an economy is in and what implications the current economic conditions have for their current and future business activity, helps businesses to better anticipate the market and to respond with greater alertness. For instance:- Study of stage of business cycle helps a firm to determine the exact timing of its new product launch *(the ability to forecast the future economic climate is what determines the success of newly launched product..!!)*	

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