CHAPTER – 5

BUSINESS CYCLES

SOME FAMOUS CASES OF BUSINESS CYCLES: -

CASE 1:- GREAT DEPRESSION OF 1930: *The world economy suffered the longest, deepest, and the most widespread depression of the 20th century during 1930s*.
It started in the US and became worldwide.

Outcome-

- It caused wide spread distress in the world as production, employment, income and expenditure fell
- The global GDP fell by around 15% between 1929 and 1932.

Reasons Quoted –

- **British economist John Maynard Keynes -** Regarded lower aggregate expenditures in the economy.
- **Monetarists -** Opined that the Great Depression was caused by the banking crisis and low money supply.
- **Other economists -** Blamed deflation, over- indebtedness, lower profits and pessimism to be the main causes of Great Depression.

Recovery-

- 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.

CASE 2:- INFORMATION TECHNOLOGY BUBBLE BURST OF 2000:

Information Technology (IT) bubble or Dot.Com bubble roughly covered the period 1997-2000.

Scenario -

- ✓ During this period, many new Internet–based companies (commonly referred as dot-com companies) were started.

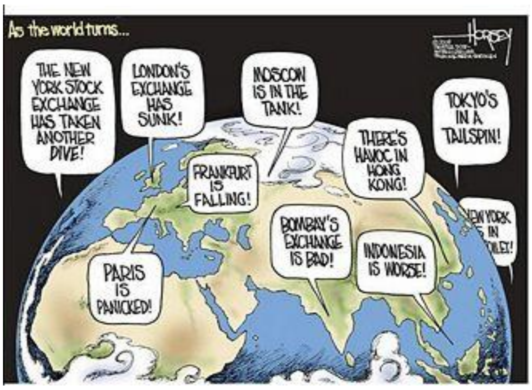
- ✓ The low interest rates in 1998–99 encouraged the start-up internet companies to borrow from the markets.
- ✓ Due to rapid growth of internet and seeing vast scope in this area, venture capitalists invested huge amount in these companies.
- ✓ Due to over- optimism in the market, investors were less cautious.
- ✓ There was a great rise in their stock prices.
- ✓ Companies could cause their stock prices to increase by simply adding an “e-“prefix to their name or a ".com" to the end.
- ✓ 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.
- ✓ These companies saw high growth and a type of bubble developed.
- ✓ The "growth over profits" mentality led some companies to engage in lavish internal spending, such as elaborate business facilities.

After Effect-

- ❖ 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.

CASE 3:- GLOBAL ECONOMIC CRISIS (2008-09):

The recent global economic crisis owes its origin to US financial markets.



Reasons

- Following Information Technology bubble burst of 2000, the US economy went into recession.
- In order to take the economy out of recession, the US Federal Reserve (the Central Bank of US) reduced the rate of interest.

- This 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.
- Increased demand for houses led to increased prices for them.
- The rising prices of housing led both households and banks to believe that prices would continue to rise.
- 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.
- Houses were built in excess during the boom period and due to their oversupply in the market, house prices began to decline in 2006.

Outcome-

- Housing bubble got burst in the second half of 2007.
- With fall in prices of houses which were held as mortgage, the sub - prime households started defaulting on a large scale in paying of their instalments.
- This caused huge losses to the banks.
- Losses in banks and other financial institutions had a chain effect and soon the whole US economy and the world economy at large felt its impact.

OTHER EXAMPLES OF BUSINESS CYCLES

- *During 1920s, UK saw rapid growth in Gross Domestic Product (GDP), production levels and living standards. The growth was fuelled by new technologies and production processes such as the assembly line. The economic growth also caused an unprecedented rise in stock market values.*
- *China's recent economic slowdown and financial mayhem are fostering a cycle of decline and panic across much of the world, as countries of nearly every continent see escalating risks of prolonged slumps, political disruption and financial losses.*

BUSINESS CYCLES

Economics is concerned with fluctuations in economic activities. There have been periods of prosperity alternating with periods of economic downturns. ***These rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles.***

A trade cycle is composed of –

Expansion - Periods of good trade characterised by rising prices and low unemployment percentage, altering with

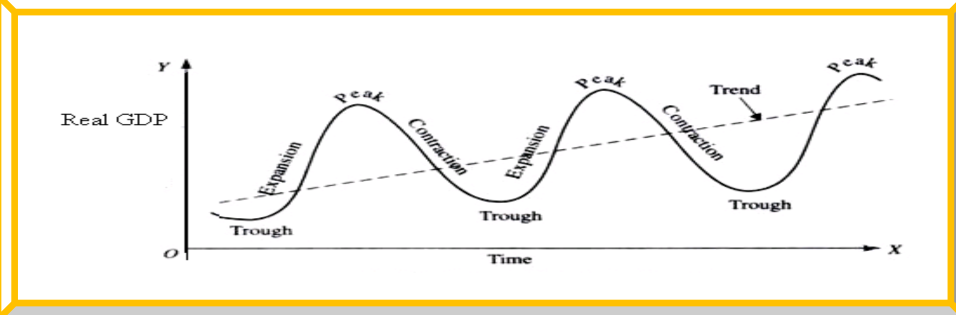
Contraction- Periods of bad trade characterised by falling prices and high unemployment percentages.

*Economic fluctuations 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 have been long, lasting for several years while others have been short ending in two to three years.*

PHASES OF BUSINESS CYCLE -

A typical business cycle has four distinct phases. These are:

1. Expansion (also called Boom or Upswing)
2. Peak or boom or Prosperity
3. Contraction (also called Downswing or Recession)
4. Trough or Depression The four phases of business cycle are shown in



The broken line (marked **'trend'**) represents the steady growth line or the growth of the economy when there are no business cycles.

The figure starts with 'trough' when the overall economic activities i.e. production and employment, are at the lowest level. As production and employment expand, the economy revives, and it moves into the expansion path. Since expansion cannot go on indefinitely, after reaching the 'peak', the economy starts contracting. The contraction or downturn continues till it reaches the lowest turning point i.e. 'trough'. After remaining at this point for some time, the economy revives again and a new cycle starts.

1. EXPANSION:

The expansion phase is characterised by

Increase in-

- National output
- Employment
- Aggregate demand
- Capital and consumer expenditure
- Sales, profits, rising stock prices
- Bank credit.

People enjoy-

- Increasing prosperity
- High standard of living
- High levels of consumer spending
- Business confidence
- Production
- Factor incomes
- Profits and investment

Status of Unemployment:-

Involuntary unemployment is almost zero and whatever unemployment is there is either **frictional or structural.**

- Prices and costs also tend to rise faster.
- Good amounts of net investment occur, and demand for all types of goods and services rises.
- This state 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.

2. PEAK:

- This is the top or the highest point of the business cycle.
- In the later stages of expansion, inputs are difficult to find and 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.
- Actual demand stagnates.

This 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.

3. CONTRACTION:

- Once peak is reached, increase in demand is halted and starts decreasing in certain sectors.

- During contraction, there is fall in the levels of investment and employment.
- Producers do not instantaneously recognise the pulse of the economy and continue anticipating higher levels of demand, and therefore, maintain their existing levels of investment and production.
- The consequence is a discrepancy or **mismatch between demand and supply**. Supply far exceeds demand.
- **Initially, this happens only in few sectors** and at a slow pace, **but rapidly spreads to all sectors.**
- Producers being aware of the fact that they have indulged in excessive investment and over production, respond by holding back future investment plans, cancellation and stoppage of orders for equipments and all types of inputs including labour.
- This in turn generates a chain of reactions in the input markets and producers of capital goods and raw materials in turn respond by cancelling and curtailing their orders.
- This is the turning point and the beginning of recession.

Recessionary Phase Begins :-

- Decrease in input demand pulls input prices down; incomes of wage and interest earners gradually decline resulting in decreased demand for goods and services.
- Producers lower their prices in order to dispose of their inventories and for meeting their financial obligations.
- 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.
- The discrepancy between demand and supply gets widened further.
- This process gathers speed and recession becomes severe.
- 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.

4. TROUGH AND DEPRESSION: -

Depression is the severe form of recession and is characterized by extremely sluggish economic activities.

During this phase of the business cycle –

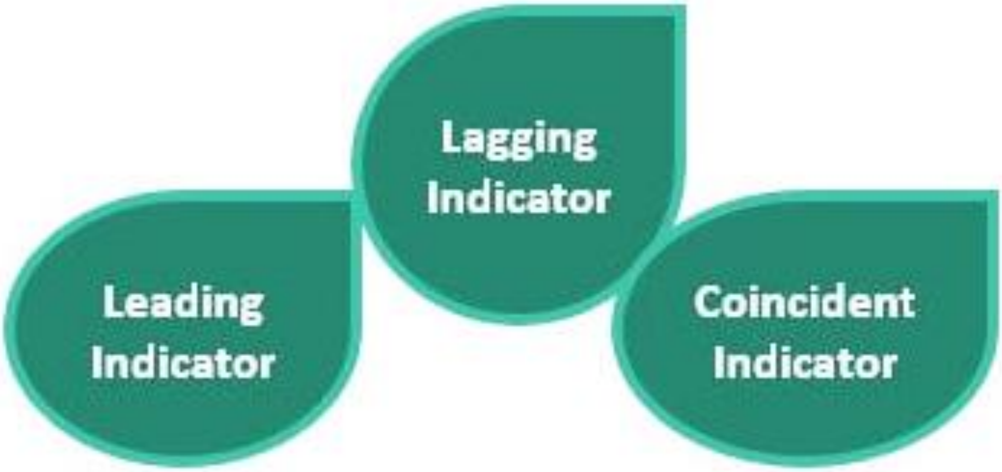
- Growth rate becomes negative and the level of national income and expenditure declines rapidly.
- Demand for products and services decreases, prices are at their lowest and decline rapidly forcing firms to shutdown several production facilities.
- Since companies are unable to sustain their work force, there is mounting unemployment which leaves the consumers with very little disposable income.
- A typical feature of depression is the fall in the interest rate.
- With lower rate of interest, 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.
- It also happens that the availability of credit also falls due to possible banking or financial crisis.
- 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.

It is a very agonizing period causing lots of distress for all. The great depression of 1929-33 is still cited for the enormous misery and human sufferings it caused.

***Recovery*:**
The economy cannot continue to contract endlessly. It reaches the lowest level of economic activity called trough and then starts recovering. Trough generally lasts for some time and marks the end of pessimism and the beginning of optimism. This reverses the process.

- **The process of reversal is initially felt in the labour market.**
- Pervasive unemployment forces the workers to accept wages lower than the prevailing rates.
- The producers anticipate lower costs and better business environment.
- A time comes when business confidence takes of and gets better, consequently they start to invest again and to build stocks;
- 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.
- Besides, **price mechanism acts as a self-correcting process in a free enterprise economy.**
- The spurring of investment causes recovery of the economy.
- This 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.

No economy follows a perfectly timed cycle and that the business cycles are anything but regular. They vary in intensity and length. There is no set pattern which they follow. Some cycles may have longer periods of boom, others may have longer period of depression.



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. Indicators are of following types –

1. **Leading Indicator - 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**. These may be in the form of

- 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
- Money growth rate

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. 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.

2. **Lagging Indicators** – 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'. If leading indicators signal the onset of business cycles, lagging indicators confirm these trends.** Lagging indicators consist of measures that change after an economy has entered a period of fluctuation.

   Some examples of lagging indicators are –

   - Unemployment
   - Corporate profits
   - Labour cost per unit of output
   - Interest rates
   - Consumer price index
   - Commercial lending activity

3. **Coincident Indicator** - 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**. In other words, 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**. A few examples of coincident indicators are –

   - Gross Domestic Product
   - Industrial production
   - Inflation
   - Personal income
   - Retail sales
   - Financial market trends such as stock market prices

FEATURES OF BUSINESS CYCLES

Different business cycles differ in duration and intensity. But there are certain features which they commonly exhibit:

- Business cycles **occur periodically** although they **do not exhibit the same regularity.** The duration of these cycles vary. The **intensity of fluctuations also varies.**
- Business cycles have **distinct phases of expansion, peak, contraction and trough.** These phases seldom display smoothness and regularity. The length of each phase is also not definite.
- Business cycles **generally originate in free market economies.** They are pervasive as well. **Disturbances in one or more sectors get easily transmitted to all other 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 industrial sector is more prone to the adverse effects of trade cycles.**
- Business cycles are **exceedingly complex phenomena;** they **do not have uniform characteristics and causes.** They are caused by varying factors. Therefore, it is difficult to make an accurate prediction of trade cycles before their occurrence.
- **Repercussions** of business cycles get simultaneously **felt on nearly all economic variables** viz. **output, employment, investment, consumption, interest, trade** and **price levels.**
- 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.**
- Business cycles have **serious consequences on the well being of the society.**

CAUSES OF BUSINESS CYCLES

Business Cycles may occur due to external causes or internal causes or a combination of both.

INTERNAL CAUSES:

The Internal causes or endogenous factors which may lead to boom or bust are:

1. ***Fluctuations in Effective Demand:-*** According to Keynes, fluctuations in economic activities are due to fluctuations in aggregate effective demand.

Increase in aggregate effective demand causes conditions of expansion or boom-

- 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.
- There will be more output, income and employment.
- If aggregate demand outstrips aggregate supply, it causes inflation.

Decrease in aggregate effective demand causes conditions of recession or depression-

- If the aggregate demand is low, there will be lesser output, income and employment. 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.

The bust cycle eventually stops on its own when prices are so low that those investors that still have cash start buying again. *However, this can take a long time, and even lead to a depression.* ***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.*

2. ***Fluctuations in Investment:***
   - According to some economists, fluctuations in investments are the prime cause of business cycles.
   - Investment spending is considered to be the most volatile component of the aggregate demand.
   - Investments fluctuate quite often because of 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 also rise when the rate of interest is low in the economy.
- **Increases in investment shift the aggregate demand to the right,** leading to an economic expansion.
- Decreases in investment have the opposite effect.

3. Variations in government spending:

- Fluctuations in government spending with its impact on aggregate economic activity result in business fluctuations.
- Government spending, especially during and after wars, has destabilizing effects on the economy.

4. Macroeconomic policies:

- Macroeconomic policies **(monetary and fiscal policies)** also cause business cycles.
- Expansionary policies, such as increased government spending and/or tax cuts, are the most common method of boosting aggregate demand. This results in booms.
- **Softening of interest rates, leads to inflationary effects and decline in unemployment rates.**
- **Anti - inflationary measures, such as reduction in government spending, increase in taxes and interest rates cause a downward pressure on the aggregate demand** and the economy slows down.
- At times, such slowdowns may be drastic, showing negative growth rates and may ultimately end up in recession.

5. Money Supply:

- According to **Hawtrey, trade cycle is a purely monetary phenomenon**.
- Unplanned changes in supply of money may cause business fluctuation in an economy.
- An **increase in the supply of money causes expansion in aggregate demand** and in economic activities.
- Excessive increase of credit and money also set of inflation in the economy.
- 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.
- Decrease in the supply of money may reverse the process and initiate recession in the economy.

6. ***Psychological factors:***

- 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.
- **If entrepreneurs are optimistic about future market conditions, they make investments, and as a result, the expansionary phase may begin.**
- The opposite happens when entrepreneurs are pessimistic about future market conditions.
- 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.
- According to **Schumpeter's innovation theory, trade cycles occur as a result of innovations** which take place in the system from time to time.
- The cobweb theory propounded by **Nicholas Kaldor** 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:

The External causes or exogenous factors which may lead to boom or bust are:

1. ***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.

2. ***Post War Reconstruction:***
   - After war, the country begins to reconstruct itself.
   - Houses, roads, bridges etc. are built and economic activity begins to pick up.
   - All these activities push up effective demand due to which output, employment and income go up.

3. ***Technology shocks:***
   - Growing technology enables production of new and better products and services.
   - These products generally require **huge investments for new technology adoption**.
   - This 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.

4. ***Natural Factors:***
   - **Weather cycles cause fluctuations in agricultural output** which in turn cause instability in the economies, especially those economies which are mainly agrarian.
   - In the years when there are draughts or excessive foods, 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.

5. ***Population growth:***
   - If the **growth rate of population is higher than the rate of economic growth, there will be lesser 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.

6. Other Causes:

- Economies of nearly all nations are interconnected through trade.
- Therefore, depending on the amount of bilateral trade, business fluctuations that occur 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.

RELEVANCE OF BUSINESS CYCLES IN BUSINESS DECISION MAKING

Knowledge regarding business cycles and their inherent characteristics is important for a businessman to frame appropriate policies. For example, **the period of prosperity opens up new and superior opportunities for investment,** employment and production and thereby promotes business. In contrast, **a period of recession or depression reduces business opportunities and profits.** A profit maximising firm has to consider the nature of the economic environment while making business decisions, especially those related to forward planning.

Business cycles have tremendous influence on business decisions. **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. Firms should exercise the capability to expand or rationalize production operations so as to suit the stage of the business cycle. Business managers need to work effectively to arrive at sound strategic decisions in complex times across the whole business cycle, **managing through boom, downturn, recession and recovery.**

Economy-wide trends can have significant impact on all types businesses. However, it should be kept in mind that business cycles do not affect all sectors uniformly. **Some businesses are more vulnerable to changes in the business cycle than others.** 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. It may also happen that **some businesses actually benefit 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**.

Overcoming the effects of economic downturns and recessions is one of the major challenges of sustaining a business in the long-term. The phase of the business cycle is **important for a new business to decide on entry into the market**. The stage of business cycle is also an important determinant of the **success of a new product launch.** Surviving the sluggish business cycles require businesses to plan and set policies with respect to product, prices and promotion