Business Cycles :

→ Rhythemic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or Trade Cycles.

→ Composed of Periods

High demand   Low Demand

Good Trade (Demand > Supply)
- Demand ↑ Supply ↑
- Rising Prices
- Low Unemployment

Bad Trade (Demand < Supply)
- Demand ↓ Supply ↓
- Falling Prices
- High unemployment

* Demand ↑
↓
Supply ↑
↓
Profit ↑
↓
Employment ↑
↓
Customer Income ↑

Note: Little bit inflation in an Economy is Good.

→ The Economic fluctuations are recurrent & occur periodically.

recurrent ↓ (occur again & again)

periodically ↓
- Not at Regular intervals
- Not of same length.

Phases of Business Cycles :

1) Expansion | Boom | upswing

2) Peak | Prosperity

3) contraction | Downswing | Recession

4) Trough | Depression (Lowest Point)

→ **Trend** :

it represents steady Growth line (or) growth of the economy.

1) Expansion :

GDP ↑ ⇒ Production ↑

↓

Employment ↑

↓

Consumer Income ↑

↓

Aggregate Demand ↑

↓

Supply ↑ ⇒ Investment ↑ ⇒ Capital Exp. ↑

↓

Profit ↑

↓

Stock Prices ↑

↓

Bank credit ↓

- Expansion stage continues till there is Full employment of resources. (Production is at its maximum possible level.
- Involuntary Unemployment is zero.
  Unemployment is either -

a) Frictional : due to change of Jobs, suspended work due to strikes!!

b) Structural - structural changes in economy
- mismatch between skills.
Workers have & skills required in market.

3. Prices & costs tends to rise faster:
Input output

4. Increasing Prosperity, People enjoy high standards of living.

5. Growth Rate eventually slows down & reaches its Peak.

2) Peak

→ Resources are Fully utilised.

→ Input Prices ↑ ⇒ cost ↑

↓

output Prices ↑

↓

Fixed Income Earners will review Consumption expenditure on durable Goods.

↓

Actual demand stagnates

→ 1. Highest Point of Business cycle.

2. In later stages of Expansion:
   - Input Prices increases (Demand > supply)
   - output Prices rise rapidly.
3. End of Expansion:
   - It occurs when Economic growth stabilizes for a short time & then move in Reverse direction.

3) **Contraction :**

Demand ↓ in certain Sectors

Supply > Demand (But Producers donot recognise this & continue anticipating higher levels of demand.)

↓

This generates a chain reaction in Input mkt.
- **Holding back Future Investment Plans**
- Cancellation of Equipment order/ All types of Inputs

↓

(Beginning of Recession)

↓

Output Prices ↓ (Customers expect Further decline)

↓

Unemployment ↑

↓

Fall in the Price of Inputs

↳ Income ↓

↓

Aggregate Demand ↓

↓

Investment / Cap. Exp. ↓

↓

Bank Credit ↓

1. With reduced consumer spending, Gap b/w demand & supply widened further.

2. Business firms become pessimistic about future state of Economy & their is fall in Profit expectation.
   ↳ Investment ↓

3. Bank credit shrinks (borrowing decline)

4. Investor confidence is at lowest
   ↳ stock Prices fall.

5. Severe Contraction pushes Economic into Depression.

4) Trough or Depression :
- Depression is the severe form Recession
- Growth Rate becomes Negative.
- Extremely sluggish Economic Activitylies
- Level of National Income & expenditure declines rapidly.

* Demand ↓
↓ Prices are at lowest
↓
Forcing firms to shut-down
↓
Mounting Unemployment
↓
Very little disposal Income.

* Fall in Interest Rate
↓
People hold more cash
↳ Despite lower Int. Rate demand for credit declines because ~~Investment~~/ Entrepreneur confidence has fallen.

- Possible banking (or) Financial crisis.
- Excess capacity in capital & consumer durable Goods industry.
- Large no of bankruptcies & liquidation reduce magnitude of Trade and Commerce.

Ex. Great Depression 1929-1932.

5) Recovery : (starts Expansion)

- Process of Recovery is initially felt in Labour market.

↓

Workers accept wages lower than Prevailing rates in the Past

↓

Producers anticipate lower cost.

↓

Business confidences takes off

↓

Banking System starts expanding credit

↓

Fresh Investment into Machines & Capital Goods

↓

Employment Increases

↓

Income increases

↓

Aggregate demand picks up & Prices gradually rise.

* This spurring* of Investment causes recovery of Economy.

↓

This acts as a turning Point from Depression to expansion

* Encouragement to Investment.

"Economic Indicators"

Economists use changes in a Variety of activities to measure the business cycle & to predict where the Economy is headed. These are called Indicators.

- Leading
- Lagging
- Co-incident (or) Concurrent

1) Leading Indicator :

↳ measurable Economic factor that changes before economy starts to follow a particular pattern (or) trend.

↳ Example : 1) change in Stock Prices
2) Interest Rate
3) Value of New order for Plant & Equipment, Consumer goods
4) Building Permits for private House
5) Index of Consumer Confidence
6) Profit Margin.

2) Lagging Indicators :
- Reflect Economy's historical performance
- changes in these indicators are observable only, after economic trend | pattern has already occurred.

Example :
1. Unemployment
2. Corporate Profits
3. Consumer Price Index
4. Labour cost per unit

(Imp.)
* Leading Indication Signal onset of business cycles. (onset → Beginning)
Lagging indicators Confirm these trends.

3. Co-incidental Indicator :
- Coincide (or) occur Simultaneously with business cycle movements.
- Describe the current state of Business cycle.
- Gives information about 'Rate of change' of expansion or contraction at same time, it happens. Ex. GDP, Inflation, Industrial Prodn, personal Income.

Causes of Business Cycles :

External   Internal

1. Internal causes (or) Endogenous :

a) Fluctuation in Effective Demand

- According to Keynes, Fluctuation in Economic activities are due to fluctuations in Aggregate demand.

Higher demand
↓
Supply ↑ (Production ↑)
↓
More Income and Employment

- If AD > AS, it causes Inflation

- If AD ↓
↓
Supply ↓
↳ Low Employment and Income

(Investors sell stocks, buy safe Investments such as bonds, Gold.

* The bust cycle / contraction eventually stops when Prices are so low that Investors who still have cash starts buying again.

- Variations in Export and Import can lead to business Fluctuations as well.

- ↑ in AD → Expansion / Boom
- ↓ in AD → Recession

2) Fluctuations in Investment :
According to some Economists, Fluctuations in investments are prime cause of Business cycle.

* Investment spending is the most volatile component of Aggregate demand.
* Investment Fluctuates quite often because of changes in profit expectation of Enterpreneur.

* New Inventions:
Entrepreneurs increase their investment in projects which are cost-efficient or more profit earning.

* Low Interest Rate: ↑ in Investments

↑ Investments → ↑ in Aggregate demand
(Rightward Shift)

3) Variations in Govt Spending:
- Govt. spending, especially during & after war has destabilizing effects on economy.

4) Macro Economic Policies:
- Expansionary Policies - Such as Increase Govt spending / Tax cuts are the most common methods of boosting AD.

- Softening of Int. Rate
Inflation   Decline in Unemployment

- Anti Inflationary measures
  1. Reduction in Govt. spending
  2. Increase in Tax Rate
  3. Increase in Interest Rate
     ↳ AD↓

5) Money Supply :
- According to Hawtrey, trade cycle in a purely monetary phenomenon.
- unplanned changes in supply of money may cause business fluctuation.

* Increase in supply of money
  - ↑ in Aggregate demand
    ↳ Inflation

* Decrease in supply of money may reverse the process
  ↓
  This initiates Recession in Economy.

6) Psychological Factors :
- According to Pigou, business activities are based on anticipation of Business Community & are affected by optimism (or) Pessimism.

* optimism - Investment ↑
(Expansion)
* Opposite happens in Pessimism
(Contraction)

⇒ Schumpeter's Innovation Theory

Trade Cycles occur as a result of Innovation.
↳ Investment ↑

⇒ Cobweb Theory by Nicholas Kaldor
↓
Agricultural Market

1. Business cycles result from the fact that Present Prices Substantially influence production at some future date.

2. Present Fluctuation in Price may become responsible for fluctuation in output and employment at some subsequent Period.

2. External Causes or Exogeneous:

1. War:

- During war times, production of war goods like weapons, arms etc increases.

- most of the resources of country are diverted for their production

- Fall in Production of Capital & Consumer Goods
  ↓
  Fall in Income, Employment (Contraction)

2. Post-war Reconstruction:
- After war, Houses, Roads, infrastructure etc. are built & economic activities begins to pick up.
  ↓
  AD ↑
  ↓
  Income, Employment ↑

3. Technology Shocks :

Growing technology enables production of new better products and services

↓

Requires huge Investment for Technology adoption

↓

Investment ↑ ⇒ Employment, Income ↑

4. Natural Factors

↳ Weather Cycles cause fluctuations in Agriculture output

* Drought / Excessive Floods :

Agricultural output ↓

↓

Income of farmers ↓

They will reduce demand for Industrial Goods

Prices ↑

↓

Input for other Industries ↑

Date

5) Population Growth :

- If Growth Rate of Population > Rate of Economic Growth

↓

Lesser Saving in the Economy

↓

Reduce Investment, Employment & Income.

* Relevance of Business Cycles in Business Decision-making :

1) Knowledge regarding business cycles & their characteristics is important for a Businessman to frame appropriate Policies.

Expansion → opportunities for Investment, Employment & Production.

Recession → Reduces Business opportunities

2) Different Phases of cycle requires fluctuating level of Input use, especially labour input.

Date

6) understanding what phase of Business cycle an economy is in and what implication economic conditions have for their current $ Future business activity.
It helps business to better anticipate market and respond with great alterness.

3. Business whose fortunes are closely linked to the rate of Economic growth
↓
Cyclical Business

Examples:
Fashion Retailers,
Electrical Goods,
House Builders, Restaurant, Construction etc

During Boom - Strong demand

During Slump - Sharp drop in demand
(Contraction)

4) It may also happen that some business may benefit from Economic down turn

Products: a) Good value for money
b) Cheaper alternative

5) Phase of Business Cycle is important for New Business to decide on
(a) Entry into the MKT.
(b) New Product Launch.