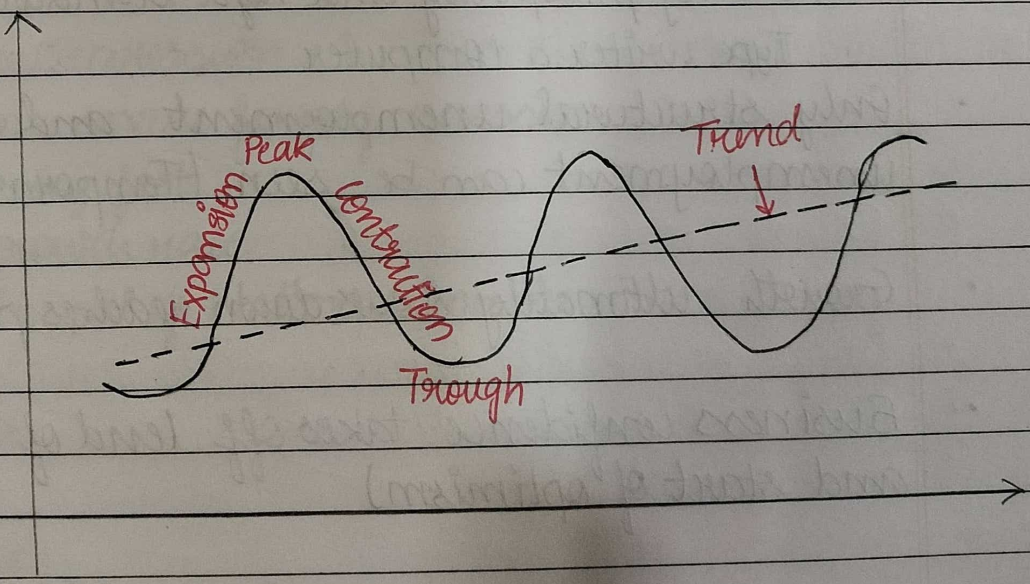
CH 5 Business Cycles

Introduction

- Rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles or Economic cycle.

- Business cycle refers to alternate expansion and contraction of overall business activity.

- Peak and trough are the Turning points of Business Cycles.



Phases of Business Cycle

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

1. Expansion (also called Recovery or Upswing)
2. Peak (also called Boom or Prosperity)
3. Contraction (also called Downswing or Recession)
4. Tough (also called Depression)

1. Expansion (Recovery / Upswing)

- Increase in national output, employment, aggregate demand in capital and consumer expenditure, sales, profit, stock prices and bank credit.

raw material ← jayada

- Full employment of resources (involuntary unemployment = 0)

I want to work but job is not available

- Increasing prosperity and high standard of living.

Type writer & Computer

- Only structural unemployment and Frictional unemployment can be seen. (Temporary employment)
- Growth ultimately slows down reaches peak.
- Business confidence takes off (end of Pessimism and start of optimism)

* Decline = Contraction
* Significant Decline = Recession
* Severe Decline = Depression

2. Peak (Prosperity)

- Increase in input prices (Raw material)
- Increase in output prices
- Increased cost of living
- Actual demand stagnates
- Highest stage in business cycle
- Economy becomes overheated and ~~difficult to control~~ unsustainable.
  inflation
- Highest GDP and Employment.

3. Contraction (Recession / Downswing)

- Decrease in levels of investment and employment
- Decrease in inputs prices - Decrease in wage and interest
- Decrease in aggregate demand - Decrease in prices.
- Decrease in cost : Decrease in profit expectations (pessimism)
- Decrease in bank credit; stock prices fall
- Income of wage and interest earners gradually declines

4. Trough or Depression

- Depression = severe form of recession
  gone down very fast
- Negative growth rate
- Decrease in level of National Income

Feb 2020
188 lac cr.
Aug 2020
131 lac cr.
May 2022
236 lac cr.

- Expenditure declines rapidly
  - ✓ Cost decreases - prices are at their lowest
- Firms shutdown
- Highest level of unemployment
- Decrease in interest rate - people's demand for holding liquid money (cash) increases.
- Decrease in demand for credit - fall in investors confidence
- Banking / financial crisis

2016 - 2020

NPA 14 lac cr.

62% PSB   Bad Debts

General Defaulter	Wilful Defaulter
Anil Ambani 143700 (cr.) has to give bank	Jatin Mehta 4200 cr. Lalit Modi 4000 cr. Jignesh Shah 5555 cr. Vijay Malya 9000 cr.

- Excess capacity in capital and consumer durable goods industry.
- Large number of bankruptcies and liquidation
- Decrease in trade and commerce

Types of Economic Indicators

- Leading Indicators
- Lagging Indicators
- Coincident Economic Indicators

1.0 Features of Business Cycles

(a) Business cycles occur periodically although they do not exhibit the same regularity. The duration of these cycles vary. The intensity of fluctuation also varies.

(b) 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.

(capitalism)

(c) 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.

*spreads

machine & tools TV, AC, car.

*** (d) Some sectors such as capital goods industries, durable consumer goods industry etc, are disproportionately affected.

(e) Complex phenomena - they do not have uniform characteristics and causes. Therefore, it is difficult to make an accurate prediction of trade cycles.

side effects

(f) Repercussions of business cycles get simultaneously felt on nearly all economic variables viz. output, employment, investment, consumption, interest, trade and price levels.

(g) Business cycles are contagious and are international in character. They begin in one country and mostly spread to other countries through trade relations.

1.1 Causes of Business Cycles

(A) Internal / Endogenous Causes

JM Keynes

1. Fluctuations in Effective Demand: (Actual Demand)
A higher level of aggregate demand will induce businessmen to produce more - more output, income and employment.
As against this, if the aggregate demand is low, there will be less output, income and employment.

2. Fluctuations in Investment:
New inventions may cause entrepreneurs to increase investments in projects which are cost-efficient / more profit inducing or investment may rise when the rate of interest is low in the economy. Increases in investment - increases aggregate demand - economic expansion.
Decrease in investment - economic contraction.

3. Variations in government spending: (Revenue, Development, Non-Development expenditure)
Increased government spending - expansionary effect and reduced government spending - contractionary effect.

Fiscal (Govt. tax) Monetary (RBI → ROI)

4. Macroeconomic policies: Expansionary policies results in boom.
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.

Anti-inflationary
↑Tax ↑ROI ⟶ Expansion
↓Tax ↓ROI ⟶ Contraction

Note For Point 5
Money supply ↑ ROI ↓ then Investment, Output, Employment, Aggregate demand Increases ⟶ Expansion

Money supply ↓ ROI ↑ then Investment, Output, Employment, Aggregate demand Decreases ⟶ Contraction

5. Money Supply: According to Hawtrey, trade cycle is a purely monetary phenomenon. An increase in the supply of money causes expansion in aggregate demand and in economic activities.
Decrease in the supply of money may reverse the process and initiate recession in the economy.

6. Psycological factors: According to Pigou, modern business activities are based on the anticipations of business community and are affected by waves of optimism or pessimism. 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.

- 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 Kaldar holds that business cycle result from the fact that presents prices substantially influence the production at some future date.

(B) External / Exogenous Causes

1. Wars: Production of war goods, like weapons and arms, etc, increases and most of the resources of the country are diverted for their production - production of other goods capital and consumer goods falls - fall in income, profits and employment - contradiction in economic activity.

2. Post War Reconstruction: Houses, roads, bridges, etc are built and economic activity begins to pick up - effective demand increases 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.

4. Natural factors: Droughts or excessive floods- agricultural output is badly affected. With reduced agricultural output, income of farmers falls 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 - reduced investment - income and employment will also be less - the effective demand will be less - slowdown in economic activities.