Phases

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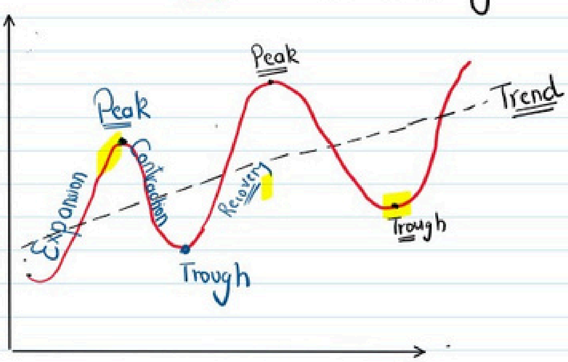
Ch-5 Business Cycles



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

Composed of periods

Good trade	Bad trade
Demand ↑ - Supply ↑	
- Rising prices	- falling prices [Low demand]
- Low unemployment	- High unemployment

Demand ↑ → Supply ↑ → Profit ↑ → Employment ↑ → Cust. Inc ↑

* The economic fluctuations are recurrent & occur periodically.

recurrent → Occur again & again

periodically → - not at regular intervals
- not of same length

* Phases of Business Cycle:

1) Expansion / Boom / Upswing
2) Peak / Prosperity
3) Contraction / Downswing / Recession
4) Trough / Depression

"Trend" represents the steady growth line or growth of the economy.

1) Expansion:

GDP ↑ - Production ↑

1] Expansion:

GDP ↑ - Production ↑
↓
Employment ↑
↓
Consumer Income ↑
↓
Aggregate Demand ↑
↓
Supply ↑ → Investment ↑ - Cap Exp ↑
↓
Profit ↑
↓
Stock prices ↑
↓
Bank credit ↑

1. This stage continues till there is full employment of resources - Production is at its max possible level.
2. 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 b/w skills workers have & skills required in Market]
3. Prices & costs tends to rise faster
   Output / Input
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 reduce consumption expenditure on durable goods
↓

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.

will reduce consumption expenditure on durable goods
↓
Actual demand stagnates

Stabilizes for a short time & then move in reverse direction.

3) Contraction.

Demand ↓ in certain sectors [but producers do not recognize this & continue Anticipating higher levels of demand]
↓
Supply > Demand
↓
This generates a chain reaction in Input Markets {
- Holding back future Investment plans
- Cancellation of equipment order / all types of inputs
}
↓
Beginning of Recession

Output prices ↓ · [customer expects 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 & there is fall in profit expectation
   ↳ Investment ↓
3. Bank Credit shrinks
   ↳ borrowings decline.
4. Investor confidence is at lowest
   ↳ Stock prices fall.
5. Severe Contraction pushes economy into Depression.

x——x

4) Trough or Depression

→ Depression is the severe form of Recession.

→ Growth rate becomes negative.

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→ Growth rate becomes negative.

→ Extremely sluggish economic activities

→ Level of National income & exp declines rapidly.

* Demand ↓
  ↓
  Prices are at lowest
  ↓
  Forcing firms to shutdown
  ↓
  Mounting unemployment
  ↓
  Very little disposable income

* Fall in Int rate
  ↙ People hold more cash
  ↓ Despite lower Int rate, demand for Credit declines bcz Investors/ Entrepreneurs confidence has fallen.

→ Possibe banking or financial crisis.

→ Excess capacity in capital goods & consumer durable industry.

→ Large no of bankruptcies & liquidation reduce magnitude of trade & commerce.

Ex- Great Depression of 1929-33

5] Recovery

→ Process of Recovery is initially felt in Labour Market
↓
Workers accept wages lower than prevailing rates
↓
Producers anticipate lower cost
↓
Business confidences takes off
↓
Banking system starts expanding credit
↓
Fresh Investment into Machines & cap Goods
↓
Employment Increases
↓
Income Increases
↓

Income Increases
↓
Aggregate demand picks up & prices gradually rise!

encouragement to Invest

* The spurring of Investment causes recovery of economy.
↓
This acts as a turning point from Depression to expansion.

x—x

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 orders for plant & equipment, consumer goods
4. Building permits for private house.
5. Index of consumer confidence
6. Profit Margins.

2) Lagging Indicator:

→ Reflect economy's historical performance.

→ Changes in these indicators are observable only after economic trend/pattern has already occurred.

Imp * Leading Indicators signal onset of business cycles. Lagging indicators confirm these trends.

Example:
1. Unemployment
2. Corporate profits
3. Consumer price Index
4. Labour cost p.u.

3) Co-incidental Indicator

→ Coincide or occur simultaneously with business cycle movements.

→ Describe the current state of business cycle.

→ Gives info. about rate of change of expansion or contraction at some time, it happens.

Ex- GDP
Inflation
Industrial production
Personal income.

* Features of Business Cycle

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

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

rarely

(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.

(d) 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.

(e) 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.

(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. 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.

(h) Business cycles have serious consequences on the well-being of the society.

x⟹x

Causes of Business Cycles

External   Internal

1. Internal causes or Endogenous :-

a. Fluctuation in Effective Demand.

→ According to Keynes, fluctuation in economic act. are due to fluctuations in aggregate demand

Higher Demand
↓
Supply ↑ (Production ↑)
↓
More Income & Emp.

→ If AD > AS, it causes Inflation.

→ If AD ↓
↓
Supply ↓
↓
Low Employment & Income

Investors Sell stocks, buy safe Investments such as bonds, Gold.

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

→ Variations in Export & Import can lead to business fluctuations as well.

↑ in AD → Expansion / boom
↓ in AD → Recession.

2] Fluctuations in Investment:

According to some economists, fluctuation in Investments

According to some economists (Keynes), fluctuation in Investments are prime cause of business cycle.

Imp * Investment spending is the most volatile component of Aggregate demand.

* Investment fluctuates quite often becz of changes in profit expectation of entrepreneurs.

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

* Low Int Rate - ↑ in Investment

↑ Investment → ↑ in Agg. Demand [Rightward shift]

3) Variations in Govt Spending

→ Govt Spending, especially during & after war has destabilizing effect on economy.

4) Macro-economic Policies :-

- Expansiory 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. Inc. in Tax Rate
3. Inc. in Interest rate
↓
AD↓

AD↓

5) Money Supply :-

According to Hawtrey, trade cycle is a purely monetory phenomenon.

→ Unplanned changes in Supply of money may cause business fluctuation.

* Inc. 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 Innovations.
↓ 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 & employment at some subseq. period

responsible for fluctuation in output & employment at some subseq. 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 prod. of cap & consumer goods
     ↓
     Fall in Income, Employment
     Contraction

2. **Post-War Reconstruction**:
   After War, Houses, roads, infrastructure etc are built & economic activities begins to pickup
   ↓
   AD increases
   Empl ↑ Income ↑

3. **Technology Shocks**:
   Growing technology enables production of new & better products and services.
   ↓
   Requires huge investment for Technology adoption
   ↓
   Inv. ↑
   Emp ↑ Inc ↑

4. **Natural factors**:
   └ Weather cycles cause fluctuations in agricultural output

└ Weather Cycles cause fluctuations in agricultural output

* Draught | Excessive floods - Agricultural output ↓

Income of farmers ↓

They will reduce demand for Industrial goods

Prices ↑

↓

Input for other Industries

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 bus. opp.

2. Diff. phases of cycle requires fluctuating level of input use, especially of labour input.

3. Business whose fortunes are closely linked to the rate of economic growth - Cyclical Business

rate of economic growth - Cyclical Business

Ex- 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.

Product- a) Good value for Money
b) Cheaper Alternative.

5. Phase of business Cycle is imp for new business to decide on a) Entry into the Market
b) New Product Launch.

6. Understanding what phase of Bus. cycle an economy is in & what implication economic conditions have for their current & future business activity.
It helps business to better ancipitate Market & respond with great alertness.

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