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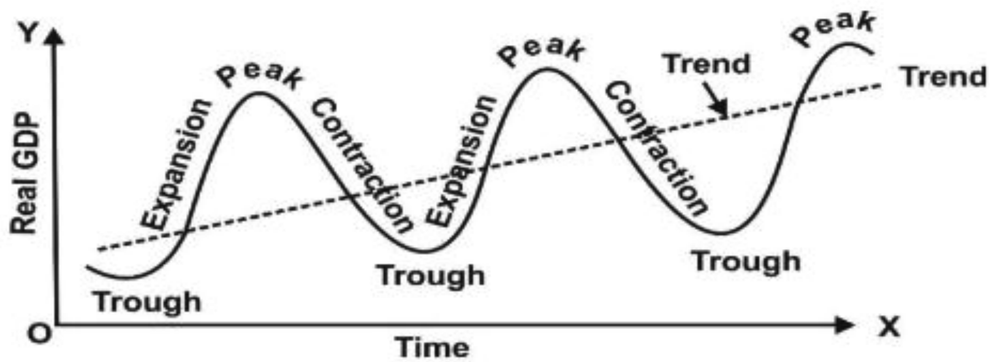
CHAPTER

BUSINESS CYCLES

PHASES OF BUSINESS CYCLE

Business cycle or booms and slumps in the economic activities reflect the upward & downward movements in economic variables. 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***
4. ***TROUGH or DEPRESSION***



Phase of business Cycle

EXPANSION:

- The expansion phase is characterised by increase in national output, employment, aggregate demand, capital and consumer expenditure, sales, profits, rising stock prices and bank credit.
- This state continues till there is full employment of resources and production is at its maximum possible level using available productive resources.
- Involuntary unemployment is almost zero and whatever unemployment is there is either frictional *(i.e. due to change of jobs, or suspended work due to strikes or due to imperfect mobility of labour)* or structural *(i.e. unemployment caused due to structural changes)*
- Prices and costs also tend to rise faster. Good amounts of net investment occur, and demand for all types of goods and services rises. There is altogether increasing prosperity and people enjoy high standard of living due to high levels of consumer spending, business confidence, production, factor incomes, profits, and investment. The growth rate eventually slows down and reaches its peak.

PEAK

- 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. 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.

CONTRACTION

- As mentioned above, 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. Supply far exceeds demand. Initially, this happens only in few sectors and at a slow pace, but rapidly spreads to all sectors. Producers knowing, they have indulged in excessive investment and over production, respond by holding back future investment plans, cancellation, and stoppage of orders for equipment 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. 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 off 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.

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 shut down 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.
- Often, 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. For example, 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.
- A time comes when business confidence takes off 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.
- 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 fulfil the demand more goods and services are produced. Employment of labour increases, unemployment falls and expansion takes place in the economic activity.
- It is to be reemphasized that 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. It is very difficult to predict the turning points of business cycles.

EXAMPLES OF BUSINESS CYCLES

a) *GREAT DEPRESSION OF 1930*
b) *INFORMATION TECHNOLOGY BUBBLE BURST OF 2000*
c) *GLOBAL ECONOMIC CRISIS (2008-2009) [MOST RECENT EXAMPLE]*

- **FEATURES OF BUSINESS CYCLES: -**

  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 varies. 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.
  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.

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:***

a) Leading Indicators- 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. In simple words it is a measurable economic factor that changes before the economy starts to follow a particular pattern or trend. i.e. they change before the real output changes. Leading indicators, though widely used to predict changes in the economy, are not always accurate.

- EXAMPLES-changes in stock prices, profit margins and profits, indices such as housing, interest rates and prices are generally seen as precursors of upturns or downturns

b) 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. We can say that it is an indicator which changes after real output changes.

- EXAMPLES- Unemployment, corporate profits, labour cost per unit of output, interest rates, the consumer price index and commercial lending activity

c) Coincident Indicators- Coincident economic indicators, also called concurrent indicators, coincide, or occur simultaneously with the business-cycle movements. Since they coincide 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. We can say that it is an indicator that coincides or occur simultaneously with the business-cycle movements.

- EXAMPLES- Gross Domestic Product, industrial production, inflation, personal income, retail sales and financial market trends such as stock market prices

1. *CAUSES OF BUSINESS CYCLES:*

1) INTERNAL CAUSES

- Fluctuations in Effective Demand
- Fluctuations in investment
- Variations in government spending
- Macroeconomic policies
- Money Supply
- Psychological factors

2) EXTERNAL CAUSES

- Wars
- Post War Reconstruction
- Technology shocks

- Natural Factors
- Population growth

• *IMPORTANT TERMS*

a) **Procyclical:** means something with a positive effect i.e. moving in the same direction as the overall state of an economy. For example GDP, Labour, marginal cost and Residential investment.

b) **Countercyclical:** means an indicator that tends to move in opposite direction as the overall state of an economy i.e. negative effect. For example, stock market, unemployment etc.

c) **Acyclical:** means an indicator that tends to move independent from overall state of an economy. For example, Fashion trend and economic growth.

MULTIPLE CHOICE QUESTIONS

1. The term business cycle refers to ___________.
   a) The ups and down in production of commodities
   b) The fluctuating levels of economic activity over a period
   c) Decline in economic activities over prolonged period
   d) Increasing unemployment rate and diminishing rate of savings.
2. A significant decline in general economic activity extending over a period is _______
   a) Business cycle
   b) Contraction phase
   c) Recession
   d) Recovery
3. The trough of a business cycle occurs when _________ hits its lowest point.
   a) Inflation in the economy
   b) The money supply
   c) Aggregate economic activity
   d) The unemployment rate
4. The lowest point in the business cycle is referred to as the _________
   a) Expansion
   b) Boom
   c) Peak
   d) Trough
5. A leading indicator is __________
   a) A variable that tends to move along with the level of economic activity
   b) A variable that tends to move in advance of aggregate economic activities
   c) A variable that tends to move consequent on the level of aggregate economic activity
   d) None of the above
6. A variable that tends to move later than aggregate economic activity is called _________
   a) A leading variable
   b) A coincident variable
   c) A lagging variable
   d) A cyclical variable
7. Industries that are extremely sensitive to the business cycle are the ____________
   a) Durable goods and service sectors
   b) Non-durable goods and services sectors
   c) Capital goods and Non- durable goods sectors
   d) Capital goods and durable goods sectors
8. A decrease in government spending would cause __________.
   a) The aggregate demand curve to shift to the right
   b) The aggregate demand curve to shift to the left
   c) A movement down and to the right along the aggregate demand curve
   d) A movement up and to the left along the aggregate demand curve

9. Which of the following does not occur during an expansion?
   a) purchase of all types of goods tend to increase
   b) Employment increases as demand for labour rises
   c) Business profits and business confidence tend to increase
   d) None of the above
10. Which of the following best describes a typical business cycle?
   a) Economic expansions are followed by economic contractions
   b) Inflation is followed by rising income and unemployment
   c) Economic expansions are followed by economic growth and development
   d) Stagflation is followed by inflationary economic growth
11. During recession, the unemployment rate ____________ and output _________
   a) Rises; falls
   b) rises; rises
   c) falls; rises
   d) falls; falls
12. Leading economic indicators
   a) Are used to forecast probable shifts in economic policies
   b) Are generally used to forecast economic fluctuations
   c) Are indicators of stock prices existing in an economy
   d) Are indicators of probable recession and depression
13. When aggregate economic activity is declining, the economy is said to be in
   a) Contraction
   b) An expansion
   c) A trough
   d) A turning point
14. Peaks and troughs of the business cycle are known collectively as
   a) Volatility
   b) Turning points
   c) Equilibrium points
   d) Real business cycle events.
15. The most probable outcome of an increase in the money supply is
   a) Interest rates to rise, investment spending to rise, and aggregate demand to rise
   b) Interest rates to rise, investment spending to fall, and aggregate demand to fall
   c) Interest rates to fall, investment spending to rise, and aggregate demand to rise
   d) Interest rates to fall, investment spending to fall, and aggregate demand to fall
16. Which of the following is not a characteristic of business cycles
   a) Business cycles have serious consequences on the wellbeing of the society.
   b) Business cycles occur periodically, although they do not exhibit the same regularity.
   c) Business cycles have uniform characteristics and causes.
   d) Business cycles are contagious and unpredictable.
17. Economic recession shares all of these characteristics except.

a) Fall in the levels of investment, employment
b) Incomes of wage and interest earners gradually decline resulting in decreased demand for goods and services
c) Investor confidence is adversely affected and new investments may not be forthcoming
d) Increase in the price of inputs due to increased demand for inputs

18. The different phases of a business cycle
a) Do not have the same length and severity
b) Expansion phase always last more than ten years
c) Last many years and are difficult to get over in short periods
d) None of the above

19. Which of the following is not an example of coincident indicator?
a) Industrial production
b) Inflation
c) Retail sales
d) New orders for plant and equipment

20. According to _________ trade cycles occur due to onset of innovations.
a) Hawtrey
b) ADAM Smith
c) J M Keynes
d) Schumpeter

21. The term "business cycle" most closely refer to the __________
a) Alternating periods of expansions and recessions
b) Accounting period used by firms
c) Fluctuating profits of firms
d) Fiscal year

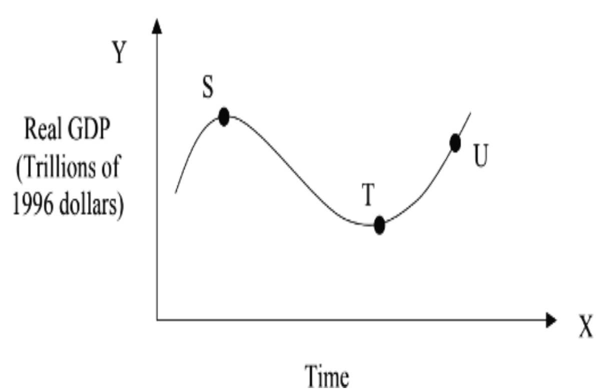
22. The four parts of the business cycle occur in the following order __________
a) Expansion, trough, peak, recession
b) Recession, trough, expansion, peak
c) Recession, trough, peak, expansion
d) Expansion, trough, recession, peak

23. A recession is a time with __________
a) A decrease in the unemployment
b) A decrease in the level of total production
c) A decline in the price level
d) A decline in interest rates

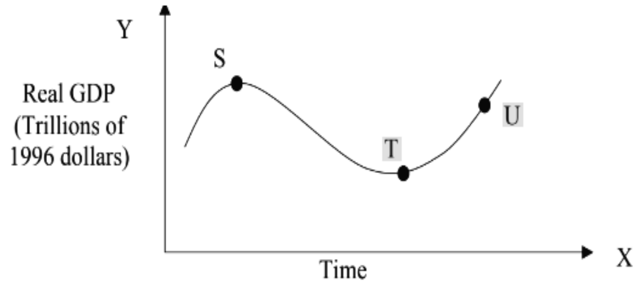
24. A recession is a popularly defined as __________.
a) No change in the dollar (money value of economic output over a period of time)
b) No change in real GDP over a period
c) At least 6 months during which real GDP decrease
d) An increase in real economic output from one period to the next

25. During a recession, real GDP _______ and unemployment _________
a) Increases; decreases
b) Decreases; increases
c) Increases; Increases
d) Decreases; decreases

26. In the below figure, the distance between points S and T represents



a) A peak
b) An expansion
c) A recession
d) A trough



27. In the above figure, the letter S, T and U represent which position in the business cycle?
    a) Recession, expansion, and peak, respectively
    b) Expansion, peak and recession, respectively
    c) Peak, expansion, and recession, respectively
    d) Peak, trough, and expansion, respectively

28. Match the following:

Stage of business Cycle	Features
i) Rising employment and real wages	(A) Recession
ii) Fall in the rate of growth	(B) Boom
iii) Fall in the level of real national Product	(C) Slowdown
iv) Setting in of the rising trend of national outputs features	(D) Recovery

a) (i) (B), (ii) (c), (iii) (A), (iv) (D)
b) (i) (A), (ii) (B), (iii) (C) , (iv) (D)
c) (i) (D), (ii) (C), (iii) (B), (iv) (D)
d) None of the above

29. In which of the following stage of economics cycle, both employment and output expand and level of aggregate demand for goods and services is high?
    a) Economic recession
    b) Economic boom
    c) Economic recovery
    d) Economic slowdown

30. During the slowdown of economy ____________
    a) GDP is decreasing
    b) GDP is increasing
    c) GDP is increasing at slower rate
    d) None of the above

31. The cobweb theory was propounded by
    a) Nicholas Kaldor
    b) Adam Smith
    c) J.M. Keynes
    d) Hawtrey

32. What is another name for soft lending?
    a) Recession
    b) Economic slowdown
    c) Revival
    d) None of the above

33. What is leading indicator in the following
    a) Change in GDP
    b) Change in stock
    c) Unemployment
    d) None

34. Boom is characterized by _______________.
    a) Increase in growth rate & decrease in output
    b) Decrease in growth rate & Increase in output

c) Increase in growth rate & Increase in output
d) Decrease in growth rate & decrease in output

35. When aggregate economic activity is increasing the economy is said________.
a) An expansion
b) A contraction
c) A peak
d) A turning point

36. Research on the effect of recession on the real level of GDP shows that _______ .
a) Recession causes only temporary reduction in real GDP, which are offset by growth during the expansion phase
b) Recession causes large, permanent reduction in the real level of GDP
c) Recession causes both temporary & permanent decline in real GDP but most of the decline is temporary
d) Recession causes both temporary and permanent declines in real

37. The tendency of many different economic variable to have regular and predictable patterns across industries over the business cycle is called _________
a) Persistence
b) Comovement
c) Periodicity
d) Recurrence

38. The tendency for declines in economic activity to be followed by further declines and for growth in economic activity to be followed by more growth is called __________.
a) Persistence
b) Comovement
c) Periodicity
d) Recurrence

39. An economic variable that moves in the same direction as aggregate economic activity (up in expansions, down in contraction) is called______
a) Procyclical
b) Countercyclical
c) Acyclical
d) A leading variable

40. A An economic variable that moves in the opposite direction as aggregate economic activity (down in expansions, up in contraction) is called______
a) Procyclical
b) Countercyclical
c) Acyclical
d) A leading variable

41. An economic variable that does not move in a consistent pattern with aggregate economic activity is called __________
a) Procyclical
b) Countercyclical
c) Acyclical
d) A leading variable

42. A variable that tends to move at the same time as aggregate economic activity is called_______
a) A leading variable
b) A coincident variable
c) A lagging variable
d) An acyclical variable

43. Which of the following macroeconomic variable is procyclical and coincident with the business cycle?

a) Residential investment
b) Nominal interest rate
c) Industrial Production
d) Unemployment

44. Which of the following macroeconomics variables is procyclical and leads the business cycle?
a) Business fixed investment
b) Residential Investment
c) Nominal interest rates
d) Unemployment

45. Which of the following macroeconomic variable is procyclical and lags the business cycle?
a) Business fixed investment
b) Employment
c) Stock Prices
d) Nominal interest rate

46. What are the two main component of business cycle theories?
a) A description of shocks and a model of how the economy respond to them
b) A model of how people decide to spend and a description of the government's role in the economy
c) A model of how equilibrium is reached and a description of the government's role in the economy
d) A description of shocks and a description of the government role in the economy.

47. Which one is internal cause of business cycle.
a) Wars
b) Money supply
c) Natural factors
d) None of the above

ANSWER KEY

1	(b)	2	(c)	3	(c)	4	(d)	5	(b)
6	(c)	7	(d)	8	(b)	9	(d)	10	(a)
11	(a)	12	(b)	13	(a)	14	(b)	15	(c)
16	(c)	17	(d)	18	(a)	19	(d)	20	(d)
21	(a)	22	(b)	23	(b)	24	(c)	25	(b)
26	(c)	27	(d)	28	(a)	29	(b)	30	(a)
31	(a)	32	(b)	33	(b)	34	(c)	35	(a)
36	(c)	37	(c)	38	(a)	39	(a)	40	(b)
41	(c)	42	(b)	43	(c)	44	(b)	45	(b)
46	(a)	47	(b)						