Ch 5: Business Cycle

Business Cycle

The economic history of most countries shows alternating periods of prosperity and downturns. These recurring fluctuations in overall economic activity are known as business cycles or trade cycles.

The business cycle has two main phases:

1. **Good Times:** Businesses are doing well, and more people have jobs.
2. **Bad Times**: Businesses slow down, and more people are unemployed.

In short, the business cycle is the economy's pattern of growing and shrinking over time.

These changes affect important things like a country's total income, GDP, job availability, and people's earnings.

Business cycles happen repeatedly, but they don't follow a strict schedule. Some cycles are long and last several years, while others are short and end in just two or three years.

Phases of Business Cycle

We have seen above that business cycles or the periodic booms and slumps in economic activities reflect the upward and downward movements in economic variables. A typical business cycle has four distinct phases. These are:

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

1. Expansion Phase

Economic Growth: National output, employment, aggregate demand, capital investment, and consumer spending all increase.

Sales & Profits Rise: Businesses sell more and make higher profits, leading to rising stock prices and increased bank credit.

Full Employment: Employment is at its maximum possible level, with almost zero involuntary unemployment.

Whatever unemployment is there is either:

- **Frictional Unemployment**: Temporary unemployment caused by job changes, strikes, or mobility issues.
- **Structural Unemployment**: Unemployment caused by changes in industries or the economy's structure.

Rising Prices & Costs: Prices and production costs tend to rise quickly.

High Investment & Demand: Strong demand for all types of goods and services leads to more investment and higher production.

Increased Prosperity: People enjoy higher living standards with rising incomes, production, and consumer confidence.

Peak Approaching: The expansion eventually slows down and reaches its peak.

2. Peak Phase

Top of the Cycle: This is the highest point of economic activity.

Shortage of Inputs: Inputs like materials and labor become harder to find, driving up their prices.

Rising Output Prices: Rapidly increasing prices lead to a higher cost of living, especially for those with fixed incomes.

Demand Stagnates: Consumer demand stabilizes as high prices cause people to reduce spending on things like housing and durable goods.

End of Expansion: Growth stops, stabilizes briefly, and then begins to reverse.

3. Contraction

Demand Declines: After the peak, demand starts to fall, leading to slower growth in certain sectors.

Overproduction: Producers may not realize demand has decreased and continue producing at high levels, creating excess supply.

Mismatch Between Supply & Demand: Supply exceeds demand, which initially happens in a few sectors but spreads rapidly.

Investment Drops: Businesses cut future investments, cancel orders for equipment and inputs, and reduce hiring.

Chain Reaction: Input suppliers, including capital goods producers, also cut orders and reduce production.

Falling Prices & Incomes: Falling input demand lowers input prices, which leads to reduced wages and lower incomes.

Consumer Behavior: Consumers expect further price drops and postpone purchases, worsening the decline in demand.

Severe Contraction/Recession

- A recession is a period of significant decline in economic activity that lasts for an extended period, typically measured over two consecutive quarters (6 months) or more.

Recession occurs during the contraction phase of the business cycle.

- Contraction starts when economic growth slows down, demand decreases, and production is cut back.
- If the contraction deepens and lasts long enough, it is officially recognized as a recession.

Severe Contraction/ Recession Characteristics

- Investment, production, and employment all fall sharply.
- Confidence drops, and businesses become pessimistic about the future.
- Bank credit shrinks, stock prices fall, and unemployment rises despite lower wages.

Recession to Depression: If recession becomes severe, it may lead to a trough or depression.

4. Trough & Depression

- **Severe Economic Slump:** Depression is the most severe form of recession, marked by extremely slow or negative economic growth.
- **National Income Falls:** National income and expenditure drop rapidly, causing low demand for goods and services.
- **Price Decline:** Prices fall to their lowest levels, forcing businesses to shut down production facilities.
- **High Unemployment:** Companies cannot sustain their workforce, leading to widespread unemployment and low disposable incomes.

Interest Rate Decline: Interest rates drop, but people and businesses avoid borrowing due to low confidence.

Credit Shortage: Credit availability may decline due to banking or financial crises.

Excess Capacity: Many industries, especially capital and durable goods sectors, suffer from excess capacity (unused resources).

Bankruptcies: High levels of bankruptcies and liquidations reduce trade and commerce.

Bottom of the Cycle: All economic activities reach their lowest point during the trough, causing significant distress.

Example: The Great Depression (1929-1933) is a historical reference for the level of misery caused during a depression.

Recovery/Expansion

Trough Ends: The economy reaches its lowest point (trough) and starts to recover.

New Optimism: The trough marks the end of pessimism and the beginning of a hopeful outlook.

Labour Market Improves: High unemployment forces workers to accept lower wages, reducing production costs.

Business Confidence Returns: Businesses anticipate lower costs and a better environment, leading to renewed investments.

Bank Credit Expands: Banks start lending more, and businesses rebuild inventories.

Technological Advancements: New technologies may require fresh investment in machines and capital goods.

Demand & Prices Rise: Employment increases, aggregate demand picks up, and prices gradually increase.

Increased Investment: Higher investment boosts production and employment, raising incomes and consumer spending.

Cycle Continues: With more spending and demand, economic expansion begins again.

Economic Indicators of Business Cycle

It's really hard to figure out exactly when business cycles will change. Economists try to predict these changes by watching different activities in the economy. These activities are called indicators because they help show where the economy is heading.

There are three types of indicators:

1. Leading indicator
2. Lagging indicator
3. Coincident indicator

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.

Leading indicators though widely used to predict changes in the economy, may not always be accurate.

Examples of Leading Indicators

- Stock prices
- Profit margins and profits
- Housing indices
- Interest rates
- Prices (general price levels)
- 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

Co-incident Indicators

Coincident 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.

Examples of Co-incident Indicators

- Gross Domestic Product (GDP)
- Industrial production
- Inflation
- Personal income
- Retail sales
- Financial market trends (e.g., stock market prices)

Lagging Indicator

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.

Examples of Lagging Indicators

- Unemployment
- Corporate profits
- Labor cost per unit of output
- Interest rates
- Consumer Price Index (CPI)
- Commercial lending activity

Examples of Business Cycle

Great Depression (1930s):

- The Great Depression began in the U.S. and spread globally, causing a major decline in production, jobs, and income.

- Economists differ on the causes: John Maynard Keynes blamed low spending, while others pointed to bank failures and low money supply. Some also blamed deflation, excessive debt, and low profits.

- Recovery began in 1933 with increased money circulation, higher government spending (especially during WWII), and gradual improvements in business activities.

Examples of Business Cycle

IT Bubble Burst (2000)

- From 1997 to 2000, internet companies (dot-coms) boomed due to investor excitement over the internet's potential. Stock prices soared, often just from adding ".com" to a company name.

- Many companies burned through cash without making profits and offered services for free, hoping to charge later. By 2001, the bubble burst, stock prices crashed, and many companies went bankrupt or were taken over, leading to an economic slowdown.

Examples of Business Cycle

Global Economic Crisis (2008-09)

- After the IT bubble burst, the U.S. lowered interest rates, making loans cheaper. People rushed to buy houses, pushing up housing prices.
- Banks began giving risky loans to people with low credit (sub-prime borrowers), assuming house prices would keep rising. By 2006, oversupply caused prices to fall, leading to mass defaults on mortgages.
- Banks suffered huge losses, and the financial crisis spread globally, leading to a major economic downturn by 2008.

Features of Business Cycle

1. Periodic but Unpredictable:

- Business cycles tend to repeat over time, going through phases of growth and slowdown.
- However, the length of each cycle isn't fixed—one cycle may last 5 years, and another may last 10 years. Similarly, the size of the ups and downs (intensity) also changes.
- Some recessions are mild, and others (like the Great Depression) are severe.

2. Distinct Phases:

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.

3. Origin in Free Markets:

- Business cycles are most common in free-market economies because production and pricing are driven by supply and demand, not controlled by the government.
- Changes in consumer spending, business confidence, or investment can quickly cause ups and downs.
- For example, if people suddenly buy more goods, businesses will expand. But if demand drops, businesses may cut jobs and slow production.
- In other market forms, like command economies (where the government controls production and prices), business cycles are less frequent or less visible because the government can step in to stabilize production and prices.

4. Pervasive Impact:

- Business cycles are widespread because problems in one sector can quickly spread to others.
- For example, a slowdown in the car industry can reduce demand for steel, rubber, and glass, leading to job losses in those sectors.
- Even banks may be affected if fewer car loans are issued.
- This ripple effect shows how closely industries are connected, making it hard to contain economic downturns to just one sector.

5. Some Sectors are Hit Harder:

Although all sectors are adversely affected by business cycles, some sectors are **disproportionately affected**.

- **Capital Goods Industries:** These industries make machinery or equipment used by businesses. When the economy slows, companies stop buying expensive equipment, so these industries get hit hard.

- **Durable Goods Industries**: These industries make long-lasting items like furniture or cars. During a slowdown, people delay buying such items, affecting these industries more.

- **Industrial Sector: C**ompared to agricultural sector, the industrials sector is more prone to the adverse effects of trade cycles.

6. Complex Causes:

Business cycles don't have a single cause—they can be triggered by various factors:

- Changes in consumer spending or business investment.
- Changes in government policies or interest rates.
- Global events, like wars or pandemics.
- Technological changes or innovations.

Because of these many possible causes, it's difficult to predict business cycles accurately before they occur.

7. Affect All Economic Variables:

Business cycles don't just affect one thing—they impact many areas of the economy at the same time:

Output: Factories produce more during expansion and less during contraction.

Employment: More jobs during expansion; layoffs during contraction.

Investment: Businesses invest more during growth but stop during slowdowns.

Consumption: People spend more when the economy is growing and save more when it slows.

Interest Rates: Central banks may lower interest rates during recessions to encourage borrowing and spending.

Trade and Prices: Trade activity and price levels fluctuate along with the business cycle.

8. Spread Internationally:

- Business cycles are contagious—they often start in one country and spread to others, especially through trade.
  - Example: The Great Depression of the 1930s began in the U.S. and spread to many other countries because trade relations were strong. Countries that traded heavily with the U.S. felt the economic impact more deeply.

9. Social Impact:

- Business cycles can significantly affect the well-being of society. During recessions, people may lose jobs, face reduced income, and struggle with higher prices.
- Prolonged economic downturns can lead to widespread poverty, mental stress, and social unrest.
- Governments and central banks often try to stabilize the economy to reduce these negative effects.

Causes of Business Cycle

Internal Causes

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

External Causes

- War
- Post War Reconstruction
- Technology shock
- Natural Factors
- Population growth

Internal Causes (Factors within the economy):

1. **Fluctuations in Effective Demand:**

- As per Keynes, aggregate effective demand (the ability and willingness to buy goods at different prices) drives economic activities.
- Higher demand leads to increased production, income, and employment.
- If demand surpasses supply, inflation occurs.
- Low demand reduces output, income, and jobs, creating recessions or depressions.
- Export and import variations also affect aggregate demand and can cause economic fluctuations.

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.
- Or investment may 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:

- Changes in government spending, especially during or after wars, can destabilize the economy and lead to business fluctuations.

4. Macroeconomic Policies:

- Expansionary policies (e.g., increased government spending, tax cuts, lower interest rates) boost aggregate demand and create booms.

- Anti-inflationary measures (e.g., higher taxes, reduced government spending, increased interest rates) reduce aggregate demand and slow down the economy, sometimes leading to recessions.

5. Money Supply:

- According to Hawtrey, business cycles are monetary phenomena.
- An increase in money supply boosts demand and economic activities, but excessive credit can cause inflation.
- A drop in money supply can trigger recessions by reducing aggregate demand.

6. Psychological Factors in Business Cycles

I. Pigou's Theory:

- Business decisions are often driven by expectations of the future.
- **Optimism**: If businesses and consumers are confident about future growth, they invest more and increase production, leading to expansion.
- **Pessimism:** When there is uncertainty or fear of economic decline, businesses reduce investment, consumers cut spending, and economic contraction follows.

II. Schumpeter's Innovation Theory:

- **New inventions** or technological breakthroughs create opportunities for new industries and markets.
- For example, the invention of smartphones led to a boom in the telecom and app development sectors.
- However, once the innovation matures or demand saturates, the economy may slow down until the next innovation arrives.

III. Kaldor's Cobweb Theory:

- Businesses often base production decisions on current **prices.**
- For example, if agricultural prices are high today, farmers may produce more next season.
- However, this increased supply may lead to lower prices in the future, causing reduced profits and potential layoffs.
- This fluctuation in prices and production can lead to periodic booms and busts in the economy.

External Causes (Factors outside the economy):

1. Wars:

Resources shift to producing war goods (e.g., weapons), reducing other goods' production, causing lower income, profits, and employment. This may trigger downturns.

2. Post-War Reconstruction:

Rebuilding infrastructure (e.g., houses, bridges, roads) increases effective demand, output, employment, and income, leading to economic recovery.

3. Technology Shocks:

Technological advances require heavy investments, boosting employment and profits. For example, the mobile phone industry created a telecom boom.

4. Natural Factors:

Droughts or floods reduce agricultural output, affecting farmer income and demand for industrial goods. Lower food production pushes up food prices, reducing consumers' purchasing power for industrial goods and causing recessions.

5. Population Growth:

If population grows faster than the economy, lower savings and investments reduce income and employment, leading to slower economic activities.

Cyclical Business

Business cycles do not affect all sectors uniformly—some sectors are more sensitive to economic fluctuations than others.

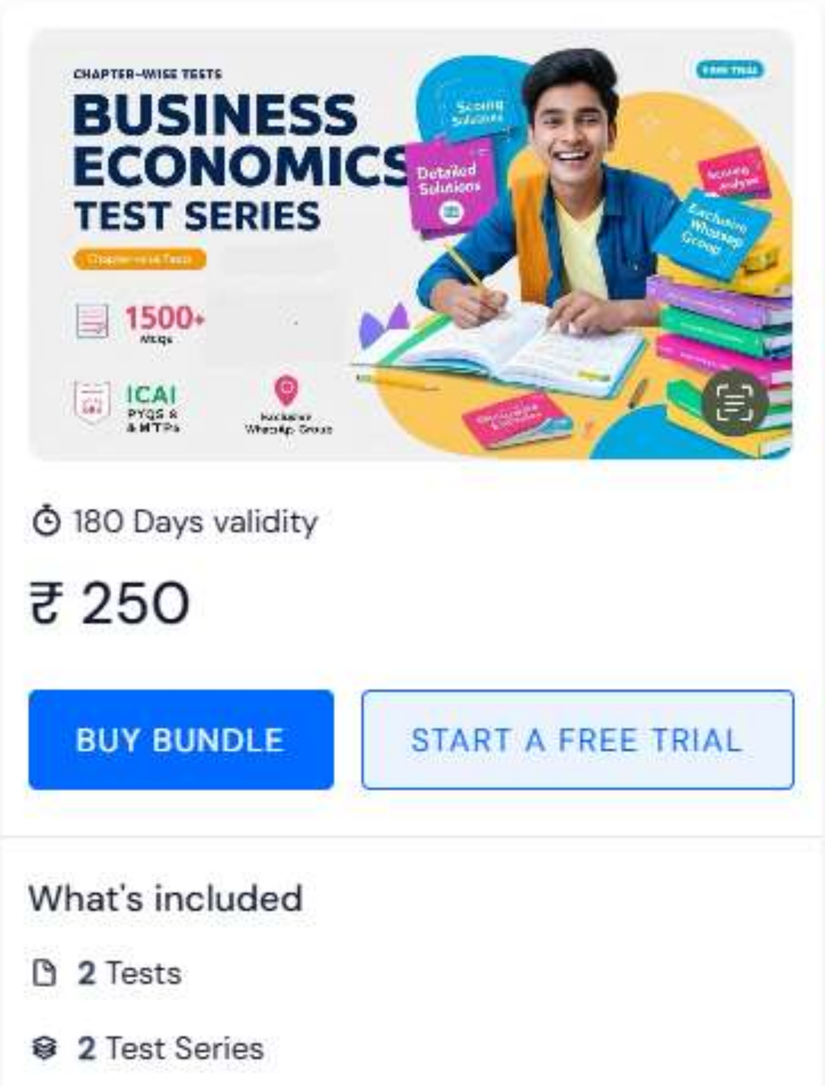
Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "cyclical" businesses. These include fashion retailers, electrical goods, house-builders, restaurants, advertising, overseas tour operators, construction and other infrastructure firms.

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.)

Relevance Of Business Cycles In Business Decision Making

- Business cycles impact all aspects of an economy, affecting demand, profits, and business success.
- Understanding cycles helps businesses create effective policies based on economic conditions.
- Prosperity opens up new opportunities for investment, employment, and production, promoting business growth.
- Recessions or depressions reduce opportunities and profits, influencing business decisions.
- Businesses must adjust production, labor, and expansion strategies according to the cycle stage.



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