BUSINESS CYCLES

INTRODUCTION :

These rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles. A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentage, altering with periods of bad trade characterised by falling prices and high unemployment percentages.

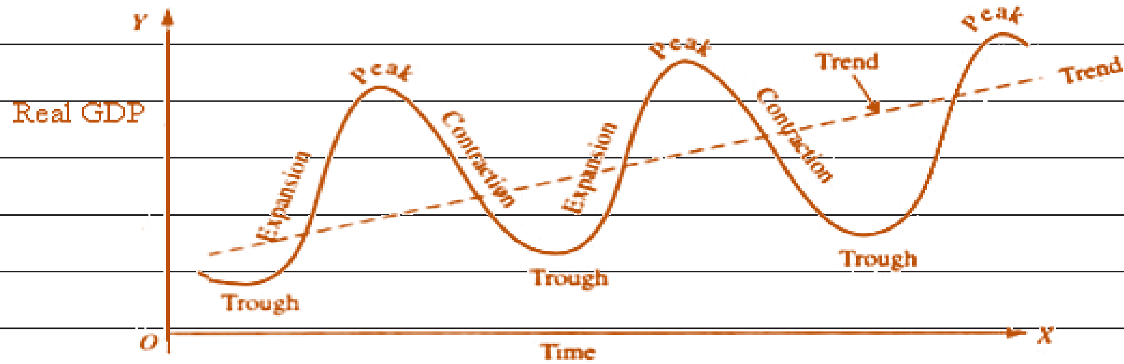
PHASES OF BUSINESS CYCLE :

The 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:

- Expansion (also called Boom or Upswing)
- Peak or boom or Prosperity
- Contraction (also called Downswing or Recession)
- Trough or Depression

The broken line (marked 'trend') represents the steady growth line or the growth of the economy when there are no business cycles. The figure starts with 'trough' when the overall economic activities i.e. production and employment, are at the lowest level. As production and employment expand, the economy revives, and it moves into the expansion path. However, since expansion cannot go on indefinitely, after reaching the 'peak', the economy starts contracting. The contraction or downturn continues till it reaches the lowest turning point i.e.

'trough'. However, after remaining at this point for some time, the economy revives again and a new cycle starts.



♣ 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 the 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 in the economy). Prices and costs also tend to rise faster. Good amounts of net investment occur, and demand for all types of goods and services rises.

♣ Peak: The term peak refers to the top or the highest point of the business cycle. 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:** The economy cannot continue to grow endlessly. 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. The consequence is a discrepancy or mismatch between demand and supply. Supply far exceeds demand. Initially, this happens only in few sectors and at a slow pace, but rapidly spreads to all sectors.

- **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 shutdown 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.

- **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. The producers anticipate lower costs and better business environment. 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. Besides, price mechanism acts as a self-correcting process in a free enterprise economy.

FEATURES OF BUSINESS CYCLES

- Business cycles occur periodically although they do not exhibit the same regularity. The duration of these cycles vary. The intensity of fluctuations also varies.
- 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.
- 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.
- 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.
- 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.

- Repercussions of business cycles get simultaneously felt on nearly all economic variables viz. output, employment, investment, consumption, interest, trade and price levels.
- 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.
- Business cycles have serious consequences on the well-being of the society

CAUSES OF BUSINESS CYCLES

Internal Causes: The Internal causes or endogenous factors which may lead to boom or bust are:

- Fluctuations in Effective Demand: According to Keynes, fluctuations in economic activities are due to fluctuations in aggregate effective demand (Effective demand refers to the willingness and ability of consumers to purchase goods at different prices). In a free market economy, where maximization of profits is the aim of businesses, a higher level of aggregate demand will induce businessmen to produce more. As a result, there will be more output, income and employment. However, if aggregate demand outstrips aggregate supply, it causes inflation.

- 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.

- Variations in government spending: Fluctuations in government spending with its impact on aggregate economic activity result in business fluctuations. Government spending, especially during and after wars, has destabilizing effects on the economy.

- Macroeconomic policies: Macroeconomic policies (monetary and fiscal policies) also cause business cycles. Expansionary policies, such as increased government spending and/or tax cuts, are the most common method of boosting aggregate demand. This results in booms. Similarly, softening of interest rates, often motivated by political motives, leads to inflationary effects and decline in unemployment rates. Ant 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. At times, such slowdowns may be drastic, showing negative growth rates and may ultimately end up in recession

- Money Supply: According to Hawtrey, trade cycle is a purely monetary phenomenon. Unplanned changes in supply of money may cause business fluctuation in an economy. An increase in the supply of money causes expansion in aggregate demand and in economic activities. However, excessive increase of credit and money also set off inflation in the economy. Capital is easily available, and therefore consumers and businesses alike can borrow at low rates.

Psychological factors: According to Pigou, modern business activities are based on the anticipations of business community and are affected by waves of optimism or pessimism. Business fluctuations are the outcome of these psychological states of mind of businessmen. 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.

External Causes: The External causes or exogenous factors which may lead to boom or bust are:

- Wars: During war times, production of war goods, like weapons and arms etc., increases and most of the resources of the country are diverted for their production. This affects the production of other goods - capital and consumer goods. Fall in production causes fall in income, profits and employment. This creates contraction in economic activity and may trigger downturn in business cycle.
- Post War Reconstruction: After war, the country begins to reconstruct itself. Houses, roads, bridges etc. are built and economic activity begins to pick up. All these activities push up effective demand due to which output, employment and income go up.
- 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. For example, due to the advent of mobile phones, the telecom industry underwent a boom and there was expansion of production, employment, income and profits.
- Natural Factors: Weather cycles cause fluctuations in agricultural output which in turn cause instability in the economies, especially those economies which are

mainly agrarian. In the years when there are draughts or excessive floods, agricultural output is badly affected. With reduced agricultural output, incomes of farmers fall and therefore they reduce their demand for industrial goods.

Population growth: If the growth rate of population is higher than the rate of economic growth, there will be lesser savings in the economy. Fewer saving will reduce investment and as a result, income and employment will also be less. With lesser employment and income, the effective demand will be less, and overall, there will be slowdown in economic activities.

RELEVANCE OF BUSINESS CYCLES IN BUSINESS DECISION MAKING :

Business cycles affect all aspects of an economy. Understanding the business cycle is important for businesses of all types as they affect the demand for their products and in turn their profits which ultimately determines whether a business is successful or not. Knowledge regarding business cycles and their inherent characteristics is important for a businessman to frame appropriate policies. Business cycles have tremendous influence on business decisions. The stage of the business cycle is crucial while making managerial decisions regarding expansion or down-sizing. Businesses have to advantageously respond to the need to alter production levels relative to demand. Economy-wide trends can have significant impact on all types businesses. However, it should be kept in mind that business cycles do not affect all sectors uniformly. Some businesses are more vulnerable to changes in the business cycle than others. Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "cyclical" businesses.