28.1 Introduction

The economic progress of capitalist countries has been marked by periodical and frequent fluctuations in the tempo of economic activity in investments, in output, in income and in employment. These economies are constantly experiencing such changes. The dynamic forces operating in the capital economy create various kinds of business or economic fluctuations. Some are abrupt, isolated and discontinuous. Some are continuous, lasting for long periods of time in the same direction while some are rhythmic and recurring in nature. Thus, according to their typical characteristics, fluctuations or movements in economic activity are commonly classified as: (1) secular trends; (2) seasonal fluctuations; (3) cyclical fluctuations; and (4) random fluctuations. However, among these, cyclical fluctuations have attracted the major attention of economists, as they create significant disturbances in the functioning of the economic system and their causation is not easily perceived.

28.1.1 Cyclical Fluctuations

Cyclical fluctuations are wave-like changes in economic activity characterised by recurring phases of expansion and contraction.

These oscillating movements take the shape of waves from peak to trough and from trough to peak as illustrated in Fig. 28.1. One complete period of such oscillation is called a cycle. Cycles have a free rhythm and are irregular. But they exhibit a recognised pattern of recurrent expansions and contractions.

Business Cycle

The cyclical movement of ups and downs in business and economic activity.

28.2 Features of a Business Cycle

The term "business cycle" or "trade cycle" in economics refers to the wave-like fluctuations in the aggregate economic activity, particularly in employment, output and income. In other words, trade cycles are ups and downs in economic activity. A trade cycle is defined in various ways by different economists. For instance, Mitchell defined a trade cycle as a fluctuation in aggregate economic activity. According to Haberler, "The business cycle in the general sense may be defined as an alternation of periods of prosperity and depression, of good and bad trade."

The business cycle refers to the cyclical variation in economic activity. Economic activity is empirically captured in terms of the rate of growth of gross domestic product (GDP), per capita income, level of employment, inflation rate and interest rates – referred to as macro-economic variables. These variables are not constant, but fluctuate over time.

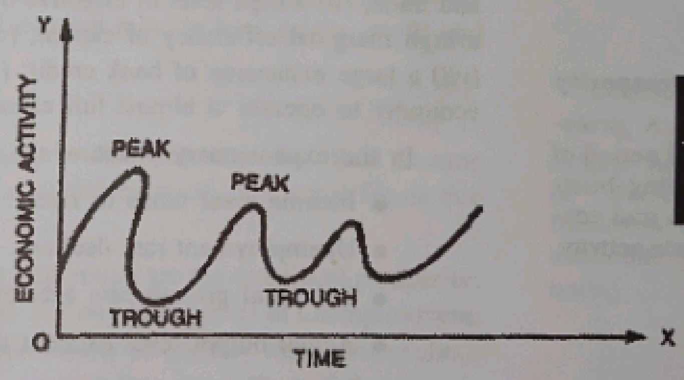


Fig. 28.1 Cyclical Fluctuations

The following features in a trade cycle are worth noting:

(i) A trade cycle is a wave-like movement.

(ii) Cyclical fluctuations are recurrent in nature.

(iii) Expansion and contraction in a trade cycle are cumulative in effect.

(iv) Trade cycles are all-pervading in their impact.

(v) A trade cycle is characterised by the presence of a crisis, *i.e.*, the peak and the trough are not symmetrical, that is to say, the downward movement is more sudden and violent than the change from downward to upward.

(vi) Though cycles differ in timing and amplitude, they have a common pattern of phases which are sequential in nature.

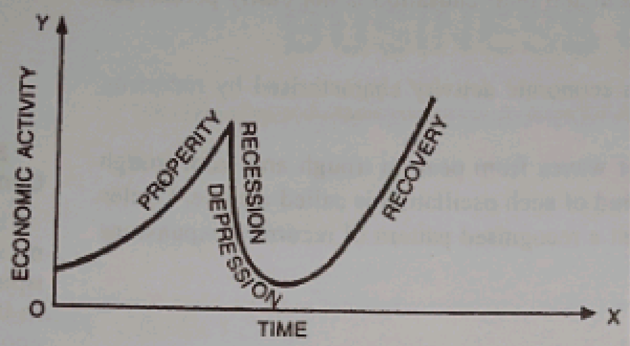
28.3 Phases of a Trade Cycle

A trade cycle is commonly divided into four well-defined and inter-related recurring phases:

- Prosperity phase — expansion or the upswing.
- Recessionary phase — a turn from prosperity to depression (or upper turning point).
- Depressionary phase — contraction or downswing.
- Revival or recovery phase — the turn from depression to prosperity (or lower turning point).

The above four phases of a trade cycle are shown in Fig. 28.2. These phases are recurrent and follow a regular sequence. This means that when prosperity ends, recession starts; depression follows recession; recovery follows depression; prosperity comes after recovery and in turn gives way to recession. Thus, each phase always appears when the immediately preceding phase has run its course. It should be remembered that no phase has any definite periodicity or time interval.

Fig. 28.2.



The Phases of a Trade Cycle

28.3.1 Prosperity Phase

Haberler defines prosperity as "a state of affairs in which the real income consumed, real income produced and level of employment are high or rising and there are no idle resources or unemployed workers or very few of either."

As Haberler points out, the characteristic features of prosperity are *(i)* a high level of output and trade, *(ii)* a high level of effective demand; *(iii)* a high level of employment and income; *(iv)* a high marginal efficiency of capital; *(v)* a price inflation; *(vi)* arising structure of interest rate; *(vii)* a large expansion of bank credit; *(viii)* overall business optimism, and *(ix)* tendency of the economy to operate at almost full capacity along its production possibility frontier.

Prosperity

A prolonged period of growing business and economic activity.

In the expansionary phase of the business cycle, following events occur:

- Income level tends to rise.
- Unemployment rate declines.
- Industrial growth rate accelerates.
- Actual output level exceeds the potential output level.
- Investment increases.
- Investors become optimistic and more enthusiastic.
- Consumption tends to rise.
- Consumer demand for goods and services in the market tend to increase, even at the rising prices.
- Prices tend to rise and provide greater incentives for business expansion.
- Interest rates rise.
- Share price index tends to rise.
- Bullish tendency spreads.
- Foreign portfolio as well as direct investments (FD) capital inflows — tend to increase in an open economy.

- Money supply increases.
- There is a risk of 'over-heating' of the economy.

In Indian context, cyclical variations essentially refer to the growth rates of economic activity and not so to the level of economic activity. That is to say, the growth rates fluctuate even through the Indian economy in growing continuously. [see the *Economics Times*, 2003]*

The prosperity phase comes to an end when the forces favouring expansion become progressively weak. Bottlenecks begin to appear at the peak of prosperity. In fact, the profit-inflation and over-optimism which increase the tempo, carry with them the seeds of self-destruction. In view of high profits and business optimism, entrepreneurs invest more and expand further. But scarcity of resources, particularly, the shortage of raw materials and labour, causes bottlenecks and business calculations go wrong. Hence, entrepreneurs become over-cautious and the peak of prosperity and their over-optimism pave the way to over-pessimism. Thus, prosperity digs its own grave.

28.3.2 Recessionary Phase

Recession

A deep widespread downward movement of the business and economic activity.

When prosperity ends, the recession begins. Recession relates to a turning point rather than a phase. It lasts relatively for a shorter period of time. It marks the point at which the forces that make for contraction finally win over the forces of expansion. Liquidation in the stock market, repayment of bank loans and the decline of prices are its outward symptoms. The stock market is the first to experience the downfall as there will be sudden and violent changes in the prevailing atmosphere. During a recession, businessmen lose confidence. Everyone feels pessimistic about the future profitability of investment. Hence, investment will be drastically curtailed and production of capital goods industries will fall.

During the recessionary phase, the banking system and the people in general try to attain greater liquidity. Therefore, credit sharply contracts. Business expansion stops, orders are cancelled and workers are laid off. There is a general drive to contract the scale of operations, leading to increase in unemployment; thus, income throughout the economy falls. Reduced income causes a decrease in aggregate expenditure and thus, the general demand falls, in turn, prices, profit and business decline.

28.3.3 Depressionary Phase

Depression

A prolonged period of declining business and economic activity.

During a depression, the most deplorable conditions prevail in the economy. Real income consumed, real income produced and the rate of employment fall or reach subnormal levels due to idle resources and capacity.

As Haberler points out, the characteristic features of a depression are the reverse of prosperity: *(i)* shrinkage in the volume of output, trade and transactions; *(ii)* rise in the level of unemployment; *(iii)* price deflation; *(iv)* fall in the aggregate income of the community (especially wages and profits); *(v)* fall in the structure of interest rates; *(vi)* curtailment in consumption expenditure and reduction in the level of effective demand; *(vii)* collapse of the marginal efficiency of capital and decline in the investment demand function; *(viii)* contraction of bank credit, etc.

In short, a depressionary period is characterised by an overall curtailment of aggregate economic activity and its bottom. Thus, depression and prosperity differ in degree rather than in kind. In the former economic activity is at its trough, while in the latter, economic activity is at its peak.

However, a depression cannot be regarded as a permanent feature of an economy. In fact, the very forces which cause the depression are themselves self-defeating. For during a depression, businessmen postpone replacement of their plant and machinery and consumers postpone the purchase

* Economic Times (2003): Economics for Managers, CD Rom, Times Multimedia India, Mumbai. In India the Economic Times (ET), in collaboration with the National Council for Applied Economic Research (NCAER), constructs a business confidence index (BCI) for the country, on the basis of a survey of the business sentiment and publishes on a quarterly basis in the *Economic Times*.

of durable goods. Hence the need for replacement and the purchase of durable goods gradually accumulate. Hence, after a period of time, there will be a moderate increase in the purchase of durable goods on the consumer's part and replacement of plant and machinery on the part of producers. This will call for an increase in production, in turn leading to an increase in employment, income and aggregate effective demand. Banks will be anxious to expand credit by reducing the rate of interest. Gradually, pessimism vanishes and optimism develops and economic activity once again gathers momentum thus, a stage of recovery sets in.

28.3.4 Recovery Phase

The revival or recovery phase refers to the lower turning point at which an economy undergoes change from depression to prosperity. With an improvement in demand for capital goods, recovery sets in. When the demand for consumption goods rises or when the capital stock increases, the demand for capital goods will rise and new investment will be induced. Such induced investment will cause a rise in employment and income. The increased income in turn will lead to a rise in consumption which will push up the demand further which in turns leads to a rise in prices, profits, further investment, employment and income. Once the expansionary movement starts, this is how it gathers momentum. During the revival period, level of employment output and income slowly and steadily improve. Stock markets become more sensitive during this period. A bullish atmosphere will prevail on the stock exchanges. An increase in stock prices favours expansion and hastens revival. The expectations of the entrepreneurs improve and business optimism leads to the stimulation of development investment. The wave of recovery, once initiated, begins to feed upon itself. Thus, during a recessionary period, the expansionary process will be self-reinforcing and if it is continued for some time, the economy will find itself in a position of rising level income output and employment. When this happens, revival slowly emerges into prosperity and the cycle repeats itself.

A business cycle is a complex phenomenon which embraces the entire economic system. It can scarcely be traced to any single cause. Normally, a business cycle is caused and conditioned by a number of factors, both exogenous and endogenous. A brief review of important trade cycle theories has been attempted in the following sections.

28.4 Important Business Cycle Theories

A business cycle is a complex phenomenon which embraces the entire economic system. It can scarcely be traced to any single cause. Normally, a business cycle is caused and conditioned by a number of factors, both exogenous and endogenous.*

Various theories have been expounded by different economists to explain the causes of a trade cycle, the symptoms of which are alternating periods of prosperity and depression. Different explanations have been advanced stressing one or a few factors at a time.

Thus, in order to get a comprehensive idea of such a complex phenomenon, it becomes necessary for us to review certain important explanations provided by eminent trade cycle theorists.

The nineteenth century classical economists could not correctly analyse the causes of economic fluctuations, though throughout the century, alternating periods of inflation and depression were carrying the economy to extremes of disequilibrium which could hardly be ignored. In fact, the classical economists blindly following Say's Law of Market — behind the veil of money under

---

* Exogenous forces are those which are external to the economic system, *e.g.*, war, innovation, population movement, territorial development, etc. These are temporary shocks.
Endogenous factors are integral to the economic structure. They are the forces which operate from within the economic system. As such, they include economic variables like the volume of bank credit, liquidity preference behaviour, the price level, interest rate, the elasticity of supply of production factors, marginal propensity to consume, marginal efficiency of capital, etc. These factors are primarily responsible for the periodic wave-like movements — the cycles. (Hamberg, D.: *Business Cycles.*)