Business Cycles

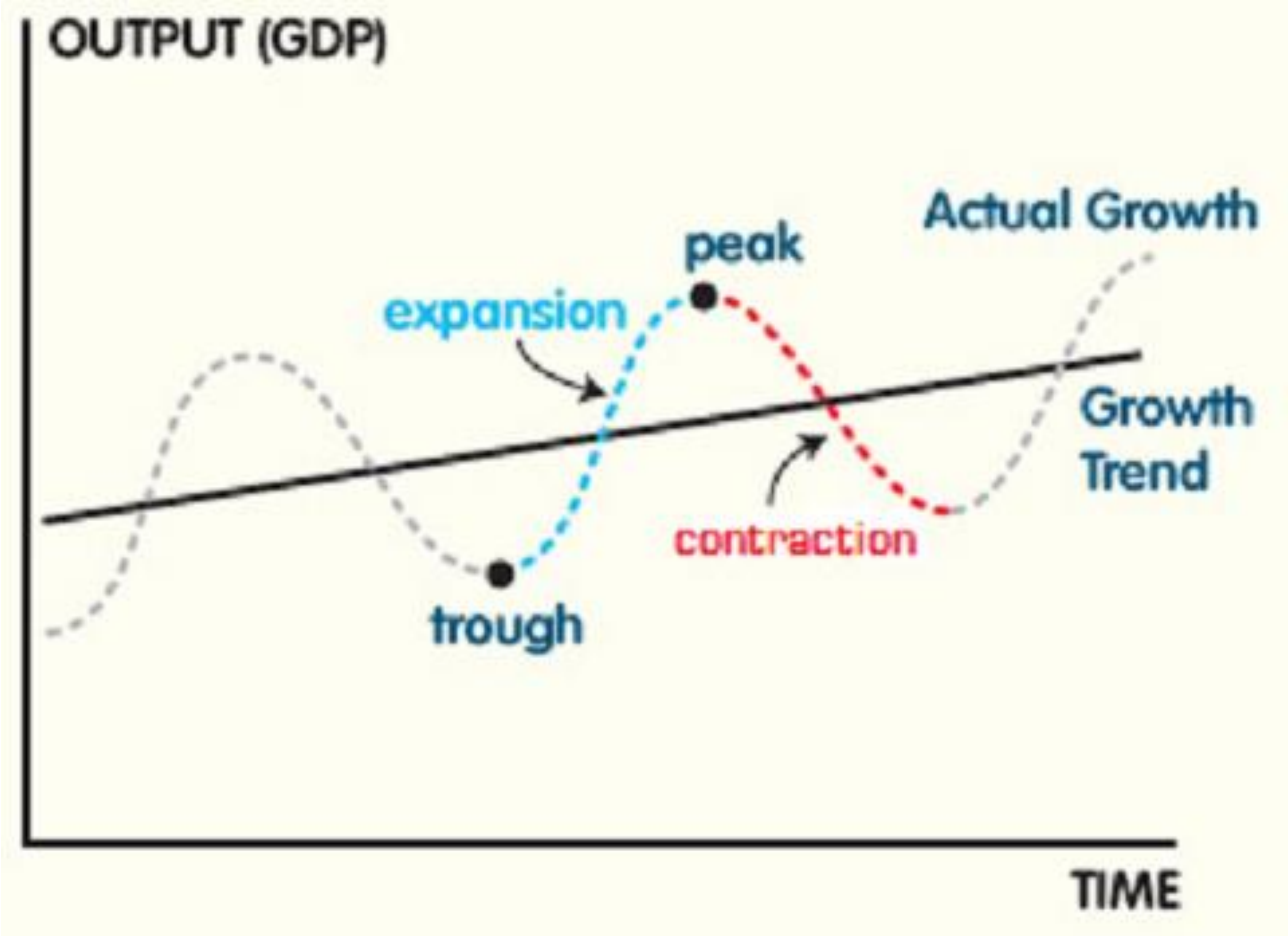
- Business cycle is the regular pattern of expansion and contraction in economic activity around the trend path of GDP growth.
- Trend path of GDP is the path GDP would take if factors of production are fully employed.
- Business cycles are characterised by the following phases:

(1) Expansion (Boom, upswing or prosperity)

(2) Peak (upper turning point)

(3) Contraction (downswing, recession or depression)

(4) Trough (lower turning point)


OUTPUT (GDP)
Actual Growth
peak
expansion
Growth
Trend
contraction
trough
TIME

Reasons for changes in GDP over time

- More resources become available: population size increases, firms acquire new machinery or build plants, land is improved for cultivation, stock of knowledge increases as new goods and new methods of production are invented and introduced. Increased availability of resources allows the economy to produce more goods and services, resulting in a rising trend level of output.
- Factors of production are not fully employed all the time. Employment level fluctuates contributing to fluctuating output.

Output gap

- Output gap measures the gap between actual output and the output the economy could produce at full employment, given the existing resources.
- Full employment output is called *potential output*.

$$output\ gap = actual\ output - potential\ output$$

- Output gap falls during recession as actual output produced falls. During expansion output gap increases.

Business cycle theories

- The theories on business cycles can be broadly classified into (1) Exogenous and (2) Internal.

(1) Exogenous: Due to fluctuation of factors outside the economic system e.g., wars, revolutions, elections, gold discoveries, population migrations, in discoveries of new land and resources, in scientific breakthroughs and technological innovations climate change etc.

(2) Internal: Due to mechanisms within the economic system. Every expansion breeds recession and contraction, and every contraction breeds revival and expansion.