Business Cycles: Meaning, Characteristics and Control

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In this article we will discuss about:- 1. Meaning of Business Cycles 2. Characteristics or Business Cycles 3. Phases 4. Causes 5. Effects 6. Control Measures.

Meaning of Business Cycles:

Business cycle or trade cycle is a part of the capitalist system. It refers to the phenomenon of cyclical booms and depressions. In a business cycle, there are wave-like fluctuations in aggregate employment, income, output and price level. The term business cycle has been defined in various ways by different economists.

Prof. Haberler's definition is very simple – "The business cycle in the general sense may be defined as an alternation of periods of prosperity and depression of good and bad trade." Keynes' definition in his Treatise of Money is more explicit – **"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."**

Gordon's definition is precise:

"Business cycles consist of recurring alternation of expansion and contraction in aggregate economic activity, the alternating movements in each direction being self-reinforcing and pervading virtually, all parts of the economy."

The most acceptable definition is by Estey:

"Cyclical fluctuations are characterised by alternating waves of expansion and contraction. They do not have a fixed rhythm, but they are cycles in that the phases of contraction and expansion recur frequently and in fairly similar patterns."

Characteristics or Business Cycles:

Business cycles possess the following characteristics:

1. Cyclical fluctuations are wave-like movements.

2. Fluctuations are recurrent in nature.

3. They are non-periodic or irregular. In other words, the peaks and troughs do not occur at regular intervals.

4. They occur in such aggregate variables as output, income, employment and prices.

5. These variables move at about the same time in the same direction but at different rates.

6. The durable goods industries experience relatively wide fluctuations in output a employment but relatively small fluctuations in prices. On the other hand, nondur

goods industries experience relatively wide fluctuations in prices but relatively small fluctuations in output and employment.

7. Business cycles are not seasonal fluctuations such as upswings in retail trade during Diwali or Christmas.

8. They are not secular trends such as long-run growth or decline in economic activity.

9. Upswings and downswings are cumulative in their effects.

Thus business cycles are recurrent fluctuations in aggregate employment, income, output and price level.

Phases of a Business Cycle:

A typical cycle is generally divided into four phases:

(1) Expansion or prosperity or the upswing;

(2) Recession or upper-turning point;

(3) Contraction or depression or downswing; and

(4) Revival or recovery or lower-turning point.

These phases are recurrent and uniform in the case of different cycles. But no phase has definite periodicity or time interval. As pointed out by Pigou, cycles may not be twins but they are of the same family. Like families they have common characteristics that are capable of description.

Starting at the trough or low point, a cycle passes through a recovery and prosperity phase, rises to a peak, declines through a recession and depression phase and reaches a trough. This is shown in Figure 1 where E is the equilibrium position.

We describe below these characteristics of a business cycle:

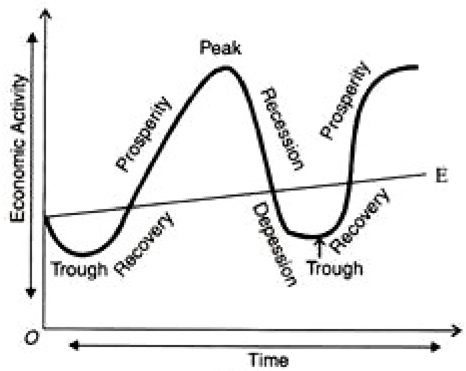

Fig. 1

Recovery:

We start from a situation when depression has lasted for some time and the revival phase or the lower-turning point starts. The “originating forces” or “starters” may be exogenous or endogenous forces. Suppose the semi-durable goods wear out which necessitate their replacement in the economy.

It leads to increased demand. To meet this increased demand, investment and employment increase. Industry begins to revive. Revival also starts in related capital goods industries. Once begun, the process of revival becomes cumulative.

As a result, the levels of employment, income and output rise steadily in the economy. In the early stages of the revival phase, there is considerable excess or idle capacity in the economy so that output increases without a proportionate increase in total costs. But as time goes on, output becomes less elastic; bottlenecks appear with rising costs, deliveries are more difficult and plants may have to be expanded.

Under these conditions, prices rise. Profits increase. Business expectations improve. Optimism prevails. Investment is encouraged which tends to raise the demand for bank loans. It leads to credit expansion. Thus the cumulative process of increase in investment, employment, output, income and prices feeds upon itself and becomes self-reinforcing. Ultimately, revival enters the prosperity phase.

Prosperity:

In the prosperity phase, demand, output, employment and income are at a high level. They tend to raise prices. But wages, salaries, interest rates, rentals and taxes do not rise in proportion to the rise in prices. The gap between prices and costs increases the margin of profit. The increase of profit and the prospect of its continuance commonly cause a rapid rise in stock market values.

The economy is engulfed in waves of optimism. Larger profit expectations further increase investment which is helped by liberal bank credit. Such investments are mostly in fixed capital, plant, equipment and machinery. They lead to considerable expansion in economic activity by increasing the demand for consumer goods and further raising the price level. This encourages retailers, wholesalers and manufacturers to add to inventories. In this way, the expansionary process becomes cumulative and self-reinforcing until the economy reaches a very high level of production, known as the peak or boom.

The peak or prosperity may lead the economy to over full employment and to inflationary rise in prices. It is a symptom of the end of the prosperity phase and the beginning of the recession. The seeds of recession are contained in the boom in the form of strains in the economic structure which act as brakes to the expansionary path.

They are:

(i) Scarcities of labour, raw materials, etc. leading to rise in costs relative to prices;

(ii) Rise in the rate of interest due to scarcity of capital; and

(iii) Failure of consumption to rise due to rising prices and stable propensity to consume when incomes increase.

The first factor brings a decline in profit margins. The second makes investments costly and along with the first, lowers business expectations. The third factor leads to the piling up of inventories indicating that sales (or consumption) lag behind production. These forces become cumulative and self-reinforcing. Entrepreneurs, businessmen and traders become over cautious and over optimism gives way to pessimism. This is the beginning of the upper turning point.

Recession:

Recession starts when there is a downward descend from the 'peak' which is of a short duration. It marks the turning period during which the forces that make for contraction finally win over the forces of expansion. Its outward signs are liquidation in the stock market, strain in the banking system and some liquidation of bank loans, and the beginning of the decline of prices.

As a result, profit margins decline further because costs start overtaking prices. Some firms close down. Others reduce production and try to sell out accumulated stocks. Investment, employment, income and demand decline. This process becomes cumulative.

Recession may be mild or severe. The latter might lead to a sudden explosive situation emanating from the banking system or the stock exchange, and a panic or crisis occurs. "When a crisis, and more particularly a panic, does occur, it seems to be associated with a collapse of confidence and sudden demands for liquidity.

This crisis of nerves may itself be occasioned by some spectacular and unexpected failure. A firm or a bank, or a corporation announces its inability to meet its debts. This announcement weakens other firms and banks at a time when ominous signs of distress are appearing in the economic structure; moreover, it sets off a wave of fright that culminates in a general run on financial institutions"…Such was the experience of the United States in 1873, in 1893, in 1907 and recently in 2008. In the words of M.W. Lee, "A recession, once started, tends to build upon itself much as forest fire, once under way, tends to create its own draft and give internal impetus to its destructive ability."

Depression:

Recession merges into depression when there is a general decline in economic activity. There is considerable reduction in the production of goods and services, employment, income, demand and prices. The general decline in economic activity leads to a fall in bank deposits.

Credit expansion stops because the business community is not willing to borrow. Bank rate falls considerably. According to Professor Estey, "This fall in active purchasing power is the fundamental background of the fall in prices, that despite the general reduction of output, characterizes the depression." Thus a depression is characterised by mass unemployment; general fall in prices, profits, wages, interest rate, consumption, expenditure, investment, bank deposits and loans; factories close down; and construction of all types of capital goods, buildings, etc. comes to a standstill. These forces are cumulative and self-reinforcing and the economy is at the trough.

The trough or depression may be short-lived or it may continue at the bottom for considerable time. But sooner or later limiting forces are set in motion which ultimately tend to bring the contraction phase to end and pave the way for the revival. A cycle is thus complete.

Causes of Business Cycles:

During the last several hundred years, philosophers, economists, stock brokers and men in the street have tried to give various causes of business cycles. Some attribute them to monetary and non-monetary factors while others to psychological factors. Samuelson attributes business cycles to external and internal factors which we explain below.

External Factors:

The external factors emphasise the causes of business cycles in the fluctuations of something outside the economic system. Such external factors are sunspots, wars, revolutions, political events, gold discoveries, growth rate of population, migrations, discoveries and innovations.

These outside factors change the level of national income by affecting either the investment or consumption component of aggregate demand. For example, a drought that destroys many crops due to sunspots may reduce the quantity of goods produced in the country and adversely affect both consumption and investment.

An innovation by opening the door to new markets, raw materials, products and production processes encourages new investments in plant and equipment. Inventions of railroads, electricity, telephone, automobiles, TVs, computers, etc. have led to the burst of investments in both capital and consumer goods from time to time.

Discoveries of gold, oil and natural resources have led to large scale investments. Similarly, population expansion and migrations are the causes of huge investments in both housing and other infrastructure and consumer durables. All the above noted external factors have been responsible for booms in business cycles from time to time.

Internal Factors:

The internal factors relate to "mechanisms within the economic system itself which will give rise to self-generating business cycles, so that every expansion will breed rece

and contraction, and every contraction will in turn breed revival and expansion, in regular, repeating, never-ending chain." Haberler divides the internal factors into monetary and non-monetary which we briefly explain.

1. Bank Credit:

Hawtrey, Friedman and other monetarists regard business cycles as "a purely monetary phenomenon". According to Hawtrey, cyclical fluctuations are caused by expansion and contraction of bank credit. These in, turn, lead to changes in the demand for money on the part of producers and traders. Bank credit is the principal means of payment. Credit is expanded or reduced by the banks by lowering or raising the rate of interest or by purchasing and selling of securities to traders. This increases or decreases the supply of money in the economy. An increase in the money supply brings about prosperity and a decrease in the money supply leads to depression.

2. Over-Saving or Under Consumption:

According to economists like Hobson, Foster and Douglas, business cycles are caused by over saving or under-consumption. They argue that wide disparities of income and wealth lead to depression in the country. The rich people are not able to spend their entire income. So they save more and invest more in producing consumer goods. On the other hand, the poor people have low incomes or wages.

As a result, their demand for consumer goods is low which means that there is under-consumption. According to Hobson, over saving leads to production of consumer goods in large quantities and to a boom. But under-consumption on the part of the workers due to low wages brings a fall in the demand for consumer goods. Stocks pule up at the current level of prices. These, in turn, lead to a fall in the prices of consumer goods and in the income of the producers. As a result, depression sets in.

3. Over-Investment:

Hayek Spiethoff, Cassel and Robertson find the root cause of business cycles in over-investment. According to Hayek, it is bank loans which lead to over-investment in capital goods industries relative to consumer goods industries that ultimately brings depression in the economy.

When the total money supply exceeds the amount of voluntary savings, it leads to increase in the investment activity and ultimately to a boom. But banks cannot continue to give credit for long due to the shortage of voluntary savings. As a result, production will decline which will bring about a depression. Thus it is over-investment in the capital goods industries which is the cause of a boom and a depression.

4. Competition:

According to Chapman, the main cause of business cycles is the existence of competition in an economy which leads to over-production and ultimately to a crisis (depression). Under competitive conditions, firms produce in anticipation of demand.

The profit motive attracts new firms. Production increases and boom starts. Competition and profits lead to overproduction and glut of commodities in the market and to fall in prices. On the other hand, the race to produce more and profit more on the part of producers increases the demand for factors of production. Competition among producers to hire more factors raises their prices. Thus costs rise which raise the prices of products. Demand falls and there is glut of commodities which eventually leads to fall in prices and to a depression.

5. Psychological Causes:

According to Pigou, the alternating waves of "over optimism" and "over pessimism" are the sole causes of the industrial fluctuations. He traces cyclical fluctuations to the tendency of businessmen to react excessively to the changing conditions of the economy. It is this tendency that causes alternating periods of over-production and under-production.

Errors of optimism and pessimism are interacting forces. As soon as the business community discovers that it has made an error of optimism, it tries to correct it by making errors of pessimism. Each phase of the cycle produces a state of psychology which produces forces that bring about reversal of that psychology and in turn another reversal. These alternating waves of over- optimism (over-production) and over-pessimism (under-production), as a result of these reversals, are the main causes of business cycles.

6. Innovations:

According to Schumpeter, innovations in the structure of an economy are the source of economic fluctuations. To him, "the cause of depression is prosperity." The boom consists in the carrying out of innovations in the industrial and commercial fields. The cyclical upswing is set in motion when an innovator starts making investment in his innovation of a new product.

This enables him to make profit soon other entrepreneurs adopt this new product in "swarm-like clusters". Innovations in one field induce innovations in related fields. There is large increase in the output of new products. Consequently, money incomes and prices rise and help to create a cumulative expansion in the economy. Over optimism adds further to the boom.

When there is glut of new products in the market, their prices fall, and profit margins of entrepreneurs are reduced. Banks ask for repayment of loans. The quantity of money is reduced and prices fall further. Some entrepreneurs cut down production and others are forced into liquidation. Thus the economy enters into depression.

7. Marginal Efficiency of Capital (MEC):

According to Keynes, the cycle consists primarily of fluctuations in the rate of investment. And fluctuations in the rate of investment are caused mainly by fluctuations in the MEC. The MEC depends on the supply price of capital assets and their prospective yield.

The supply price of capital assets being stable in the short-run, the MEC is determined by the prospective yield of capital assets. The prospective yield, in turn, depends on business expectations. Fluctuations in the rate of investment are also caused by fluctuations in the rate of interest. But it is fluctuations in the MEC which are the principal cause of cyclical fluctuations.

Conclusion:

To conclude with Samuelson, business cycles are caused both by external and internal factors. The economic system responds to fluctuations in external factors according to its internal factors, and vice versa.

Effects of Business Cycles:

Business cycles have both good and bad effects depending upon whether the economy is passing through a phase of prosperity or depression. In the prosperity phase, "the real income consumed, real income produced and the level of employment are high or rising and there are no idle or unemployed workers or very few of either."

There is general increase in economic activity: aggregate output, demand, employment and income are at a high level. Prices are rising. Profits are increasing. Stock markets are rapidly reaching new heights. Investments are increasing with liberal bank credit. This entire process is cumulative and self-reinforcing.

But different sections of the society are affected differently during the prosperity phase. The landless, factory and agricultural workers and middle classes suffer because th wages and salaries are more or less fixed but the prices of commodities rise continuously. They become more poor.

On the other hand, businessmen, traders, industrialists, real estate holders, speculators, landlords, shareholders and others with variable incomes gain. Thus the rich become richer and the poor poorer.

The social effects are also bad. Lured by profit, there is hoarding black-marketing, adulteration, production of substandard goods, speculation, etc. Corruption spreads in every walk of life. When the economy is nearing the full employment level of resources, the ill-effects on production start appearing. Rising prices of raw materials and increase in wages raise costs of production. As a result, profit margins decline. There is rise in interest rates due to scarcity of capital which makes investment costly.

These two factors lower business expectations. Lastly, the demand for consumer goods does not rise due to inflationary rise in prices. This leads to piling up of inventories (stocks) with producers and traders. Thus sales lag behind production. There is decline is prices. Producers, businessmen and traders become pessimists and the recession starts.

During recession, profit margins decline further because costs start rising more than prices. Some firms close down. Others reduce production and try to sell accumulated stocks. Investment, output, employment, income, demand and prices decline further. This process becomes cumulative and recession merges into depression.

During a depression, there is mass unemployment. Prices, profits and wages are at their lowest levels. Demand for goods and services is the minimum. Investment, bank deposits and bank loans are negligible. Construction of all types of capital goods, buildings, etc. is at a standstill. There is mass unemployment in the economy. The government revenues from direct and indirect taxes decline. The real burden of the debt increases. The econo development of the country suffers.

Measures to Control Business Cycles or Stabilisation Policies:

Various measures have been suggested and put into practice from time to time to control fluctuations in an economy. They aim at stabilising economic activity so as to avoid the ill-effects of a boom and a depression. The following three measures are adopted for this purpose.

1. Monetary Policy:

Monetary policy as a method to control business fluctuations is operated by the central bank of a country. The central bank adopts a number of methods to control the quantity and quality of credit. To control the expansion of money supply during a boom, it raises its bank rate, sells securities in the open market, raises the reserve ratio, and adopts a number of selective credit control measures such as raising margin requirements and regulating consumer credit. Thus the central bank adopts a dear money policy. Borrowings by business and trade become dearer, difficult and selective. Efforts are made to control excess money supply in the economy.

To control a recession or depression, the central bank follows an easy or cheap monetary policy by increasing the reserves of commercial banks. It reduces the bank rate and interest rates of banks. It buys securities in the open market. It lowers margin requirements on loans and encourages banks to lend more to consumers, businessmen, traders, etc.

Limitations of Monetary Policy:

But monetary policy is not so effective as to control a boom and a depression. If the boom is due to cost- push factors, it may not be effective in controlling inflation, aggregate demand, output, income and employment. So far as depression is concerned, the experience of the Great Depression of 1930s tells us that when there is pessimism among businessmen, the success of monetary policy is practically nil.

In such a situation, they do not have any inclination to borrow even when the interest rate is very low. Similarly, consumers who are faced with reduced incomes and unemployment cut down their consumption expenditure. Neither the central bank nor the commercial banks are able to induce businessmen and consumers to raise the aggregate demand. Thus the success of monetary policy to control economic fluctuations is severely limited.

2. Fiscal Policy:

Monetary policy alone is not capable of controlling business cycles. It should, therefore, be supplemented by compensatory fiscal policy. Fiscal measures are highly effective for controlling excessive government expenditure, personal consumption expenditure, and private and public investment during a boom. On the other hand, they help in increasing government expenditure, personal consumption expenditure and private and public investment during a depression.

Policy during Boom:

The following measures are adopted during a boom. During a boom, the government tries to reduce unnecessary expenditure on non-development activities in order to reduce its demand for goods and services. This also puts a check on private expenditure which is dependent on the government demand for goods and services. But it is difficult to cut government expenditure. Moreover, it is not possible to distinguish between essential and non-essential government expenditure. Therefore, this measure is supplemented by taxation.

To cut personal expenditure, the government raises the rates of personal, corporate and commodity taxes.

The government also follows the policy of having a surplus budget when the government revenues exceed expenditures. This is done by increasing the tax rates or reductio government expenditure or both. This tends to reduce income and aggregate demand through the reverse operation of the multipher.

Another fiscal measure which is usually adopted is to borrow more from the public which has the effect of reducing the money supply with the public. Further, the repayment of public debt should be stopped and postponed to some future date when the economy stabilises.

Policy during Depression:

During a depression, the government increases public expenditure, reduces taxes and adopts a budget deficit policy. These measures tend to raise aggregate demand, output, income, employment and prices. An increase in public expenditure increases the aggregate demand for goods and services and leads to increase in income via the multipher. The public expenditure is made on such public works as roads, canals, dams, parks, schools, hospitals and other construction works.

They create demand for labour and the products of private construction industries and helps in reviving them. The government also increases its expenditure on such relief measures as unemployment insurance, and other social security measures in order to stimulate the demand for consumer goods industries. Borrowing by the government to finance budget deficits utilizes idle money lying with the banks and financial institutions for investment purposes.

Conclusion:

The effectiveness of anti-cyclical fiscal policy depends upon proper timing of policy action and the nature and volume of public works and their planning.

3. Direct Controls:

The aim of direct controls is to ensure proper allocation of resources for the purpose of price stability. They are meant to affect strategic points of the economy. They affect particular consumers and producers. They are in the form of rationing licensing, price and wage controls, export duties, exchange controls, quotas, monopoly control, etc.

They are more effective in overcoming bottlenecks and shortages arising from inflationary pressures. Their success depends on the existence of an efficient and honest administration. Otherwise, they lead to black marketing, corruption, long queues, speculation, etc. Therefore, they should be resorted to only in emergencies like war, crop failures and hyper-inflation.

Conclusions:

Of the various instruments of stabilizations policy, no single method is sufficient to control cyclical fluctuations. Therefore, all methods should be used simultaneously. This is because monetary policy is easy to apply but less effective while fiscal measures and direct controls are difficult to operate but are more effective.

Since cyclical fluctuations are inherent in the capitalist system, they cannot be eliminated completely. Some fluctuations may be beneficial for economic growth and others may be undesirable. Stabilisation policy should, therefore, control undesirable fluctuations.

We conclude with Keynes, "The right remedy for the trade cycles is not to be found in abolishing booms and thus keeping us permanently in a semi-slump; but in abolishing slumps and thus keeping us permanently in a quasi-boom."

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