Chapter - 10

Business Cycle

Meaning:

The business in an economy sometimes grows well and enlarges, at the other time business slows down, contrasts and declines. If the overall business phenomenon reveals sometimes contraction and sometimes expansion regularly in an economy, it is called trade cycle. In other words, business cycles are those fluctuations which recur in the aggregate economic activity with a certain degree of regularity following a pendulum like oscillation. Trade or business cycle as a tendency of recurring rise and fall in the aggregate level of output, income, employment, price and aggregate demand.

Business cycle is a part of capitalist economic system. It is because there is the free environment to play by private sector which has the crucial role in the economy. Business sector become more optimistic during boom and it becomes pessimistic during recession.

Types of Business Cycle:

1. **Short Run Kitchin Cycle:** It is also known as a minor cycle which is of approximately 40 months duration. The British economist Joseph Kitchin propounded this cycle.
2. **Long Jugler Cycle:** This cycle was named after the French economist Clement Jugler in 19^{th} century. It is defined as fluctuations in business activities between successive crises. The time period of Jugler cycle is around 10 years.
3. **Very Long Kondratieff cycle:** This cycle was propounded by Russian economist N.D. Kondratieff in 1925 A.D. He said that there are longer waves of cycles of more than 50 or up to 60 years duration.
4. **Building Cycle:** This cycle, which is relates to the construction of building, is of fairly regular duration. The duration of this cycle is about 18 years.
5. **Kuznets Cycle:** This cycle was propounded by American economist Simon Kuznets. The time period of this cycle is from 16 to 22 years.

Causes:

Business Cycle occurs due to numbers of factors and causes, these causes are classified into:

1. External Factors of Business Cycle:

a. Wars:

In war days all the available resources are utilized for the production of weapons which greatly affect the product of both capital and consumer goods. This fall in production decreases income, profits which further create unemployment. These create contraction in the economic activity.

b. Postwar Period:

In the post war period the level of consumption and investment goes upward. Both the government and individuals involve the construction (houses, roads, bridges etc.). All these activities increases the effective due to which the economic variables, output, income and employment goes upward.

c. Scientific Development:

Another cause of business cycle is scientific development. Every day new products come to the markets like mobile phone, laptops etc. These products require huge amount of investment through which new technology of production is adopted. All this increases income, employment and profit etc. and plays an important part in the revival of economy.

d. Gold Discoveries:

The discoveries of gold and mines stimulate the volume of international trade and help in adjusting trade deficit, loans etc. the rising income lead to expansion in economic activity.

e. Surplus, Exports and Foreign Aid:

Surplus, exports and foreign aid raises the level of consumption and investment spending which helps in increasing output, income and employment level.

f. Weather:

Weather is one of the causes of business cycle. It is an important factor which can cause economic activities. If in any year, weather is good the output of agricultural sector will goes upward.

g. Population Growth Rate:

Population growth rate is one the factors of business cycle. If the population growth rate is higher than the economic growth rate, income level and consumption expenditure and savings will be low.

2. Internal Factors of Business Cycle

Internal causes of business cycle are those, which are built in within economic system. These are the internal factors of business cycle:

a. Psychological Factors:

According to Pigou business cycle appears because of the optimistic and pessimistic mood of the entrepreneur. When entrepreneurs are in optimistic about future market conditions they take up investment. Here the expanses phase of business cycle starts which ultimately ends in a boom. On the contrary, the pessimism reduces investment, production, employment and shifts to downward trend in business activity.

b. Money Supply:

Hawtrey and Friendman relate trade cycle to fluctuation in money and credit supply. If there is expansion in money and credit supply, there will be raise in economic activity. If there is contraction there will be down fall in economic activity.

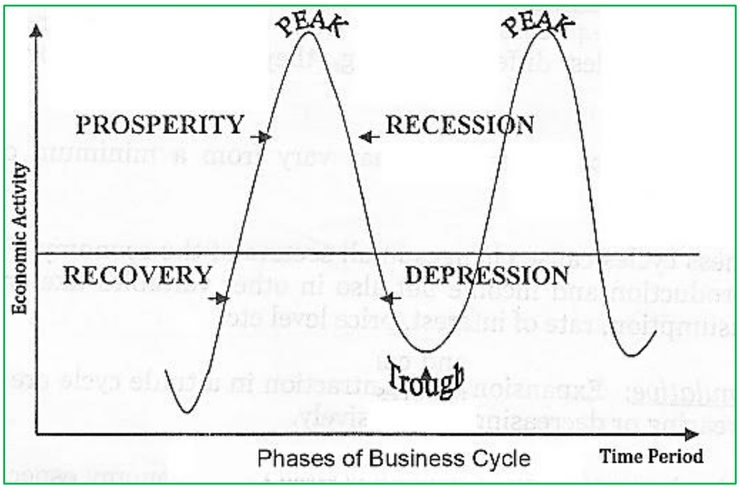
c. **Over Investment:**

Hayek relates business cycle to variation in capital goods industries. Excessive investment in capital goods industries brings upswing and downswing when there is a fall in investment.

d. **Marginal Efficiency of Capital (MEC):**

According to Keynes changes in the rate of marginal efficiency of capital are responsible for business cycle. When the rate of marginal efficiency of capital gets higher the expansion phase of trade cycle commences. There is a contraction phase when the rate of marginal efficiency of capital is lower.

Phases of Business Cycle



1. **Depression Phase:**

There is considerable reduction in the production of goods and services, employment, income, demand and prices. The general reduction in economics activities leads to a fall in bank deposits. Credit expansion stops because the business community is not willing to borrow. Depression is characterized by mass unemployment, general fall in prices, profits, wages, interest rates, consumption, expenditure, investment, bank deposits and loans, factories closedown and construction of all types of capital goods, building etc.

2. **Trough:**

It is defined as the lowest point of depression or lower turning point of aggregate economic activities. Various economic activities are very low at the bottom of the cycle. There exists mass unemployment in the economy so that consumption investment and imports will be very low.

3. **Recovery Phase:**

It implies the increase in business activities after the lowest point of depression or trough has been reached. When depression has ended and the lower turning point starts, it is called recovery phase of trade cycle. In the early stages of the phase, there is considerable excess or idle capacity in the economy so that output increases without proportionate increase in total costs. The cumulative process of increase in investment and employment, output, income and prices will feed upon itself and becomes self-reinforcing. Ultimately it enters into the prosperity phase.

4. **Prosperity Phase:**

In the prosperity phase, demand, output, employment and income are at the 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 in profit and prospect of its continuance commonly cause a rapid rise in stock market values. The outstanding change is in stocks, that reflecting the capitalized values of prospective earnings register in an exaggerate form the rising profits of enterprise. They lead to considerable expansion in the economic activities by the increasing the demand for consumer goods and further raising the price level. This encourages retailers, wholesalers and manufacturers to add the inventories which create the situation of near to full employment.

5. **Boom or Peak Phase:**

It is called the upper turning point of the trade cycle. When the economy is in boom, national income is the highest point. It is likely that the economy will be working at beyond full employment. It is the stage of rapid expansion in business activities with new heights, resulting in high stocks and prices, high profits and overall employment. In this stage,

a. There is scarcity of labor, raw materials, leading to rise in costs relative to prices.
b. Rise in rate of interest due to scarcity of capital
c. Additional pressure on factors of production, which are fully employed, causing a sharp rise in factor prices.
d. The number of jobs exceeds the number of workers which is the situation of over full employment.

6. **Recession Phase:**

Recession phase starts when there is a downturn from the peak or boom which is of a short duration. It makes the turning period during which the forces that make for contraction finally win over the forces of expansion. In this stage, there is:

a. Real output is decreasing
b. Unemployment rate is rising.
c. As contraction continues, inflation pressure fades.
d. If the recession is prolonged, price may decline (deflation)
e. The government determinant for a recession is two consecutive quarters of declining output.

Measures to control Trade Cycle

Government uses two polices to control trade cycle: They are

1. **Monetary Policy Measures:**

It is one of the macroeconomic policies of the government. This policy is implemented by the central bank on behalf of the government. It means the policy action taken by central bank to influence the economic activities. So, the policy of the central bank to influence money supply and credit to achieve specific objectives like growth, stability, employment, low inflation etc. is called monetary policy. There are two types of monetary policies i.e. expansionary and deflationary monetary policy.

When the economy is passing through prosperity phase with high rate of inflation, then central bank uses deflationary monetary policy to control high rate of inflation and other effects. The following policies are used by central bank to control inflation and unexpected economic activities;

a. Increase in bank rate
b. Increase in cash reserve ratio(CRR)
c. Sell securities in open market operation
d. Decrease in money supply and increase in rate of interest in the market

But, if the economy is passing through depression phase with decrease in economic activities and deflation is existing, then central bank uses expansionary monetary policy to stimulate economic activities.

a. Decrease in bank rate
b. Decrease in cash reserve ratio(CRR)
c. Purchase securities in open market operation
d. Increase in money supply and increase in rate of interest in the market

Objectives of Monetary Policy:

a. To promote higher economic growth
b. To increase higher level of employment opportunities
c. To stabilize domestic price and interest rates
d. To stabilize financial markets
e. To stabilize external sector (BOP, Foreign exchange reserves and exchange rates)

2. **Fiscal Policy Measures:**

A policy in which government uses its expenditure and revenue programs to produce desirable effects and avoid undesirable effects on the income, production and employment is called fiscal policy. Fiscal policy is implemented by the government. The major instruments of fiscal policy are government budget, government expenditure including taxation, subsidies, transfer payment and public borrowing.

Fiscal policy may be expansionary and deflationary. Government uses appropriate fiscal policy to control undesirable effects of business cycle.

When the economy is passing through prosperity phase with high rate of inflation, then the government uses deflationary fiscal policy to control high rate of inflation and other effects. It includes following policies;

a. Surplus budget
b. Increase in Tax rates
c. Decrease in government spending
d. Reduction in Public borrowing

On the other hand, when the economy is passing through depression phase, then the government uses expansionary fiscal policy. It includes following policies;

a. Deficit budget
b. Decrease in Tax rates
c. Increase in government spending
d. Increase in Public borrowing

<u>Objectives of Fiscal Policy:</u>

a. Attainment of higher economic growth
b. Achieving higher level of employment opportunities
c. Reducing inequality of income and wealth
d. Maintenance of economic stability
e. Optimum Allocation of resources