Title:
Market Failures And Business Cycles (Part 1)

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Summary:
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The following is the most comprehensive ever explanation to the most mysterious phenomenon of Capitalism - the Business Cycles. In order to ensure that the article can be read by any well educated reader, I have minimized the economics jargon and have added a short and simple introduction to the structure of the economy. Each and every one of us would be interested to know as to why we cannot have a paradise on earth. Why is it that we are often besieged by such painful downslides of economic activity such as Great Depression or the nerve wracking periods such as Stagflations? Why can’t we all be always happy with hundred percent employment all the time, with each and every one of us employed? The following article provides simple and complete Business Cycle explanations to Depressions before 1930s, Recessions after 1940s, Stagflations of 70s and Continuous Booms of 80s and 90s.

The income that we earn is normally divided into two portions, Consumption and Savings. We normally consume a large portion of the income we earn for our day to day necessities as well as irregular buys. Regular necessities include food, clothing, toothpastes, soaps and other daily necessities. Irregular buys include bikes, cars, books, movies, music and so on. After we spend most of our incomes on Consumption, we save a small portion of our income and invest it in shares, bonds, fixed deposits and other long term investments.

In direct relation to our above mentioned activity, our economy is divided into two sectors - Consumption sector and Investment sector. If we exclude the government spending, Consumption sector constitutes roughly around 80% of the size of economy. It includes everything that we buy - food, clothing, cars, bikes, TVs and other durable goods, books - every thing. And around 20 percent of the size our economy is constituted by the Investment sector. Investment sector mainly includes activities such as installing new plants and capacities, and housing. A three sector model would also include government spending as well. However free markets have more to do with these sectors and less to do with Government Spending, so let us exclude governemnt spending. The figures given above are only approximate and can vary sizeably from economy to economy.

So how are profits made by the Consumption sector manufacturers? In any economy, Consumption sector always produces in excess of its requirements - it produces surplus. Consumption sector capitalists as well as households also save a certain portion of their income. Investors invest these Savings in the Investment sector. So these Savings turn into the earnings of the Investment sector capitalists and workers. The workers and capitalists of the Investment sector then spend their earnings on the consumption goods. So basically the surplus production of the Consumption sector is consumed by the workers and capitalists of the Investment sector. Therefore in a circular flow monetary economy, the income of the Investment sector becomes the profit or surplus of the Consumption sector firms. There is a small assumption that is made here on which I shall allude to at the end of the article.

So there are two things that we have to note here. First the size of the investment sector decides on the size of the profits of the Consumption sector. If there are huge Investments made, the Consumption sector capitalists make huge surpluses or profits and if the size of the Investment sector is on the lower side, the Consumption sector capitalists would make lower surpluses or profits. Also all of the Savings made should always be invested. If Savings are made but are not invested, then it would lead to a lower size of Investments and lower profits. Insufficient profits would force the producers to cut down on their production levels and this would directly lead to rising unemployment and recession! It is a long recognized economic thought that Savings made should be compulsorily invested fully so that the economy can be in equilibrium. If the Savings made are not invested fully, it can lead to disequilibrium between Supply and Demand and can lead to piling up of unsold stocks of inventories and a subsequent recession.

With the above short introduction to the structure of our economy, we are ready for a small journey into the fascinating world of Business Cycles.

Our economies are rarely ever static. They keep growing in size every year. Now in a growing economy Consumption also grows. Year on year more cars are purchased, more televisions are bought, more computers are installed and so on. It is natural that when Consumption grows by say 6%, the suppliers would expect their surplus also to grow by 6% because surplus, which is called profit in the business parlance, is obviously measured in percentage terms. However the surplus production has to be consumed by the workers of the Investment sector which obviously means that even Investment would have to grow by 6%. However this would mean that Savings, which is the fund for Investment, would also have to grow by 6%. What would happen if Consumption grows by 6% but Investment or Savings do not grow by an equivalent percentage? To the extent of the inequality, producers' surplus would remain unsold and the economy would be in disequilibrium. So the equilibrium condition of the economy would be –

Periodic Growth percentage of Consumption = Periodic growth percentage of Investment = Periodic growth percentage of Savings.

Suppose during a particular period, there was a perfect equilibrium in which Consumption was C, Investment was I and Savings was S. Suppose during the next financial period C grows by a certain X percentage points. Then S and I would also have to grow by the same X percentage points. Suppose either I or S does not grow by X percentage points, the economy would be in disequilibrium even if Investment is equal to Savings!

Here in lies a blue print for different types of Business Cycles.

A normal characteristic of any recession is the presence of huge un-invested Savings. Investors hoard money without investing it because of lack of investor confidence. At the trough or the lowest point in a business cycle, Consumption is relatively low and Savings are relatively high, especially un-invested Savings. Then as economic activity picks up, all of the Savings are invested and the producers of the Consumption sector would be able to realize their expected surpluses. The size of Investment sector is equal to the surplus of the Consumption sector. Since Savings are high and are fully invested, the producers of the Consumption sector would be able to realize huge surpluses. Economic activity picks up a roaring speed.

As economic activity picks up, there starts a battle amongst the producers for market shares. For example, each car manufacturer wants to sell as many cars as possible. He would not think – let me produce less cars now, let me save and invest more for later. So as the battle for market share picks up, Consumption accelerates at the expense of Savings i.e. Consumption grows at a faster rate than Savings. Our above mentioned condition tells us that for equilibrium to exist, Consumption and Savings have to grow at an equal pace. So if Consumption grows at a faster pace than Savings, would this lead to disequilibrium immediately? This may not immediately lead to disequilibrium because producers would obviously not keep expecting to earn abnormally high profits the way they earned in the initial stages of the boom. Their expectations are also geared towards comparatively lower profits or what is called as normal profits as the boom progresses and therefore lower growth rate in Savings vis-à-vis Consumption would not immediately damage their expectations of surplus. This way the boom progresses from the trough to the peak for a few years.

After a few years of growth of Consumption at a faster rate than Savings, the percentage of Savings in the income would drop so low that Savings are not sufficient to meet the expectations of surplus of the producers of the Consumption sector. Even if Savings are fully invested, this does not generate the surplus as expected by the Consumption sector because of the lower size of investment and would lead to disequilibrium. Producers see their unsold inventory stock piles rise and their profits dwindle. The situation needs correction. Consumption needs to be cut and Savings need to be raised. As they are not able to sell their goods, the producers of Consumption sector would be more than willing to do so. They cut their production and increase their Savings.

However the required correction might not materialize! The very objective of capitalist economies is Consumption. If Consumption is on the decline, we cannot expect Investment to increase. We cannot have fewer bikes sold as compared to previous year and at the same time have much higher Investment in the bike sector as compared to the previous year. A cut in Consumption might increase Savings but would not raise Investment. Investment follows the path of Consumption and it itself starts in the downward trend. As a result the increased Savings are not invested and the disequilibrium takes on a relatively permanent position and we have a recession! There are no automatic forces to ensure immediate correction. What started with a cut in Consumption to increase Savings leads to a fall in Investment. This drop in Investment leads to a further depletion of aggregate demand which then prompts the producers to cut their production levels even further. Consumption declines even further and the spiral continues until the economy settles at a low output with a lot of unemployment. This sort of downward spirals were recognized by the eminent British economist John Maynard Keynes. Eventually, after a few years of low output, some invention or some enthusiastic entrepreneurs who are attracted by prevalent low interest rates might trigger Investment to reverse its downward path and start the process of expansion all over again. I believe that most recessions in US and Europe after 1940s occurred in this way. I would call these cycles – the Consumption led Business Cycles.