

BUSINESS CYCLES, RECESSIONS AND ECONOMIC BOOMS

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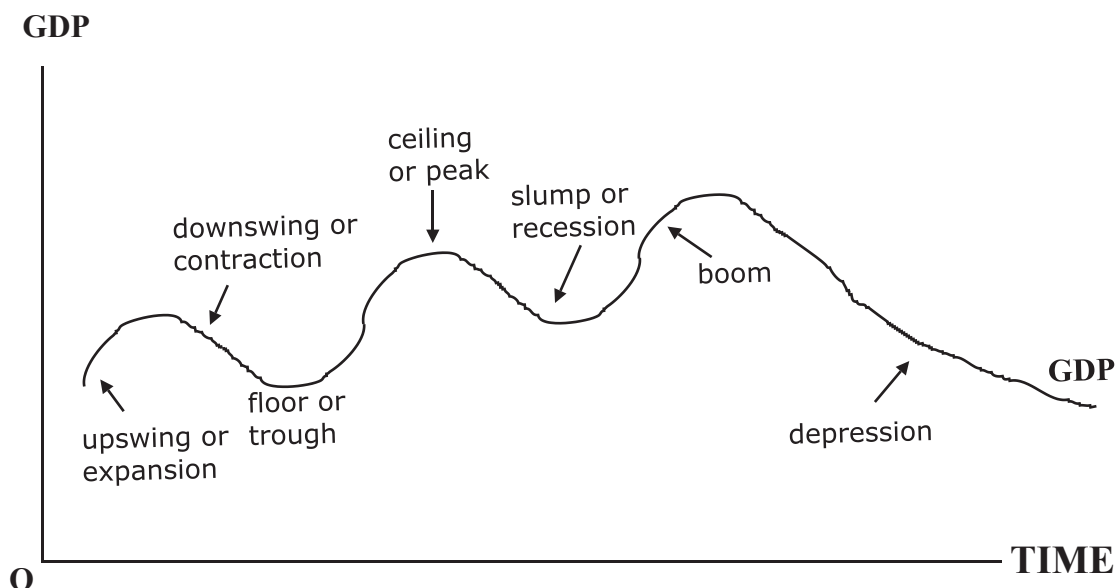
What are business cycles?

They are periodic swings in production, with national income rising and falling rhythmically over time. They may last for months, quarters of the year, or even years, when we see periods of alternating growth and recession. Sometimes the event is called "the economic cycle" or "economic fluctuations".

What does the cycle look like?

Various names are given to parts of the cycle, typically like this:

Diagram 1. The names associated with cycles



One also gets terms like "minor recession" or "major recession"; a "depression" just lasts longer than a recession and might also be lower. As in a lot of countries, in the UK "recession" is defined as two successive quarters of falling output. In 2009 it became fashionable to refer to "The emergence of green shoots" as a phrase to indicate the hoped-for start of an upturn.

Generally we draw the above diagram sloping upwards a bit, to reflect long term economic growth.

What might we expect to see?

In an upswing, prices and profits rise fast, but wages tend to lag.

In a downswing, profits fall rapidly; wages still lag behind events and so by contrast they continue to increase for a short time before levelling off or even falling.

Between 1992 and 2008 Britain was in a continuous upswing – a very long time and indeed it seems to have been the longest period of economic expansion on record. Then in 2008 came the financial crisis or the credit crunch, and the real economy turned down. This was a global event so the UK was not alone in this.

When did the business cycle first appear?

The cycle seems to have appeared about the mid Eighteenth Century, as an industrial economy began to develop; the business cycle was clearly in place and recognised by the mid Nineteenth Century.

During the recent long expansion for much of the 1990s until 2008, some asked if the business cycle had ended and the then Chancellor of the Exchequer, the now Prime Minister Gordon Brown, said it had: he was wrong. It is possible, however, that business cycles may be becoming less common in the long term. Perhaps information technology and rapid restructuring is making it easier to head them off? We simply do not know.

Why are cycles important? There are many reasons.

- 1) In a slump, we lose output that we could have had; unemployment rises, the newly unemployed are worse off and suffer a lower standard of living; and people face increasing uncertainty and worries.
- 2) Average long term growth is lower – and so is the standard of living.
- 3) The more extreme lunacies of a boom may distort resource allocation, e.g., too much went into dot.com and hi tech companies in the late 1990s.
- 4) Slumps may distort resource allocation if the government decides to protect a few groups it favours, e.g., motor-car manufacturers or farmers, and subsidise them or bail them out.
- 5) The cycle interferes with a long-term view of government budgets. In a boom revenue rises from items such as income tax, company tax, and VAT which all increase. At the same time, during a boom, government expenditure on welfare payments and social security falls. With increased revenue and reduced expenditure, the government surplus increases. The reverse happens in a slump: revenue falls and welfare expenses increase, so a deficit develops. The government may have to borrow to cover the deficit – which can interfere with other government targets like the Public Sector Net Borrowing requirement. In the UK, in 2009 government debt increased sharply and it became a major headache for the future. The government policy is, or used to be, to balance its budget over the cycle and it has significantly failed to do so.

- 6) If the government reduces the rate of interest to try to increase the level of aggregate demand, which is likely, then borrowers gain, savers lose, and mortgage repayments fall. In other words, there is a redistribution of income.
- 7) If there is an extended recession or a depression, prices may actually fall, in which case pensioners and other fixed income groups see some gain as their living standards rise. Many pensioners on balance still lose, as they often rely on interest earned on savings to supplement their income - and interest rates are likely to be low.
- 8) In a slump, firms may put off investing, leading to a continuation of the slump which might then turn into a full recession, and lower investment now is likely to lead to slower growth in the future.
- 9) If we could only predict their onset the government could improve its economic policy timing.

Why do cycles occur?

This is the big question! There are lots of different explanations, but certainty eludes us. Someone once said "There are two kinds of business cycle forecasters: those who do not know, and those who know that they do not know!" And that is about right.

1. The Classical School Here it was felt that long term recessions were not possible, as production meant people were working and thus had incomes, so supply created its own demand. Keynes claimed that the Classical School had no theory of cycles and they just felt that cycles were an aberration which time would solve cycles automatically – i.e., the system was self-correcting. The Classical School felt that in a slump, prices and wages would fall and would continue to do so until they wiped out the lack of demand and the economy would start up again. Prices and wages would have a cycle, rather than production. Since we see real output going up and down *the problem must be sticky wages and prices* – it is a problem in the system that prevents prices and wages to fall in a slump and this should be tackled.

2. Karl Marx

He claimed that the nature of the capitalist system is to produce very efficiently because costs are always being squeezed; supply increases rapidly under capitalism, but people do not spend all their income, so demand will be less than supply. In the end there must be a downturn, as supply outruns demand. In the long run, the downturns will constantly get bigger until the people have had enough and there will be a revolution and capitalism collapses. A function of the Communist Party is to hasten this event.

3. J.M. Keynes (and others who pushed it further) explains the downswing.

Aggregate demand *can* be deficient – supply does not create its own demand contrary to what Say's Law maintained. To combat deficient demand the government can increase aggregate demand via fiscal and monetary policies which will wipe out unemployment and in this way prevent a major depression. Wages are sticky and will not fall enough to wipe out unemployment, nor will prices fall enough so the government must step in and act.

The liquidity trap, in which interest rates cannot fall enough to stimulate investment because people simply hold the money, prevents the successful use of monetary policy working, (we saw this in Japan after 1991 and well into the Twenty-first Century, when

interest rates were effectively zero, and some say negative). Fiscal policy and direct government spending has to be the answer.

4. The stock (inventory) cycle explanation of the business cycle

Firms run down stocks then have to reorder them by the nature of marketing and selling. In any one industry, firms tend to do this about the same time, for they all face the same market conditions. If all firms suddenly order large amounts it kicks off an upswing but when they stop it can cause a downturn. These cycles may last for three to five years.

Probably this was once more important than it is now – the development of “just in time” ordering and the use of computers mean that firms can manage with smaller stocks than they could decades ago.

5. The fixed investment cycle (7-11 years)

Firms in an industry have to replace old machinery as it wears out and as better machinery comes onto the market. Again they all tend to do it at roughly the same time, owing to competition.

6. Government can start the swings and also worsen existing ones: the government may cause the cycle

The argument is that a government sees an upswing is underway and fears that inflation will start to increase, so it tightens monetary and/or uses fiscal policy to curb the boom. But there is a serious lag problem:

- *Data lag*: we do not know where we are because the data may be months or even quarters late – and then will get revised again in future as they were incorrect initially! The leading indicators are: unemployment rate, utilisation of productive capacity, commodity prices, changes in business inventories, worker productivity gains.
- *Recognition lag*: do not see we have a problem soon enough.
- *Response lag*: it takes time to decide what to do.
- *Implementation lag*: it takes time for policy to work through and take effect

As a result of such lags, by the time the government acts it may be too late; the economy may have started to turn down already but this is not yet recognised. In this case the government action will inadvertently worsen the cycle.

7. The imported cycle

If other economies abroad boom, we follow suit because of the rapid increase in our exports to them, for these are part of our aggregate demand. Should the other countries later go into recession, our exports will decline as they buy less from abroad. This in turn can force us into a downturn. The USA is particularly important in this respect because it is dominant internationally and imports much.

8. The property or stock market cycles

As people get richer they wish to save or invest their surplus – and generally wish to become wealthier. If the stock market is rising, that is a good place to put any surplus funds in order to achieve long term capital gains as well as short term income. The stock market cycle feeds on itself: when stock market prices start to fall, some people pull out and this worsens the fall in prices. If they put their money into property instead of the stock market, a similar property cycle is observed.

9. Various psychological explanations of the business cycle

A). The feeding frenzy

Once a boom starts, people behave irrationally – a feeding frenzy sets in, as it sometimes does with sharks, with the result that the boom gets too big to sustain, and so it eventually collapses. Then people overreact again and drive the market too low for its fundamentals. So it goes on, with cycles continuing to overshoot.

B). Business confidence

When businesspeople are confident, they invest for the future – and this increases demand and can cause a boom to develop. When they become less confident they cut back on investment and this can push us into a downturn. We have a cycle!

C). Consumer confidence

Similarly, high consumption via credit card purchases seems to have kept the UK economy growing in the last few years. Now that credit is something of a dirty word, spending is being cut back which has helped to push the economy into a downswing.

Consumers may feel confident for other reasons: the stock market gains of the past led to many feeling better off and perhaps this induced them to spend more. Similarly, the steady rise in house prices for the first eight years of the new millennium led to many people feeling richer which again may have led them to be more willing to spend.

There is also a socio-political argument that blames “Thatcher’s children” who following the dictum of Gordon Gecko that “Greed is good”. They then adopted the slogan “What do we want? Everything! When do we want it? Now!” This was the emergence of a new generation that was not prepared to go without, or save up for what was wanted. This accounts in part for the credit card fuelled boom.

10. Schumpeter’s Innovation Cycle

Joseph Schumpeter pointed out that a firm suddenly puts into production a new technical innovation. Initially it gets high profits because the demand is good and of course for a time the firm dominates the entire market (it is the innovator). But subsequently other firms start to enter, compete with the first firm, and bid away the initial high profits. The cycle starts with the successful innovation, continues as other firms join in, but it runs out eventually. Technical change and innovation are therefore at the heart of the business cycle.

The innovation cycle may be getting shorter, because of computers and the ease of communication, particularly as many governments have remove some barriers to competition. This means that new, cheaper, competing goods come on the market more rapidly.

11. The Kondratiev cycle

This was first pointed out by Nikolai Dmitriyevich Kondratiev, hence the name. These are long cycles, perhaps 50-70 years in length. The big discoveries or inventions, like electric power or mass-produced motor vehicles, kick off such a long cycle. This seems like a good explanation of the long historical sweeps in production that we see but has little relevance for the short term business cycle.

12. A natural built-in reason

Through the initial upswing into a full boom, we see unemployment fall; workers thus increase their power, and ask for, and gain wage increases. These higher costs feed through to price increases. This domestic inflation means that exports become harder to make as they are dearer, so aggregate demand falls, and the downswing commences automatically.

13. The multiplier-accelerator event (Paul Samuelson)

Putting the multiplier (increase in consumption or investment multiplies the effect on income, as people spend most of what they receive). Along with the "accelerator" (a change in consumption demand of a given percentage causes a much greater change in the demand for machines to make those extra needed consumer goods) can generate a cycle.

14. Shocks to the system

Any shock can have an impact – e.g., the New York bombing on Sept. 11 2001 ("9/11") hit a lot of tourist-related industries; this was not only in the United States but as many Americans refused to fly or travel abroad, other countries too saw a fall in aggregate demand.

The "sunspot theory" of the Nineteenth Century was once popular: after sunspots occur on the sun, which tended to happen on roughly an eleven year cycle, crops failed, causing an economic recession. This was once laughed at but it now seems that it may have had some validity. This was a specific kind of shock explanation.

The Schumpeter and Kondratiev cycles are examples of specific shocks.

The business cycle and the SAS/AD model

Many sudden changes in events, for the better or for the worse, can affect either the short-run aggregate supply (SAS) curve or the aggregate demand (AD) curve.

Many of the destructive "shock" explanations, e.g., "9/11", sunspots, or sudden weather change, can reduce the AS curve – they move it to the left and reduce the level of gross domestic product (GDP) - see Diagram 2. Announcements of bad news by governments, sudden sharp increases in the rate of interest, or perhaps fear of war might induce people to save more and spend less, thereby shifting the AD curve leftward and reducing the level of GDP.

By contrast, all "furthering" shocks, such as a sudden boost in consumer or producer confidence or the announcement of good financial news, can push the AD curve to the right (demand increases when people buy more or businesses invest more). This means the start or continuation of an upswing in the cycle (see Diagram 3).

Diagram 2. A fall in aggregate supply caused by some destructive shock

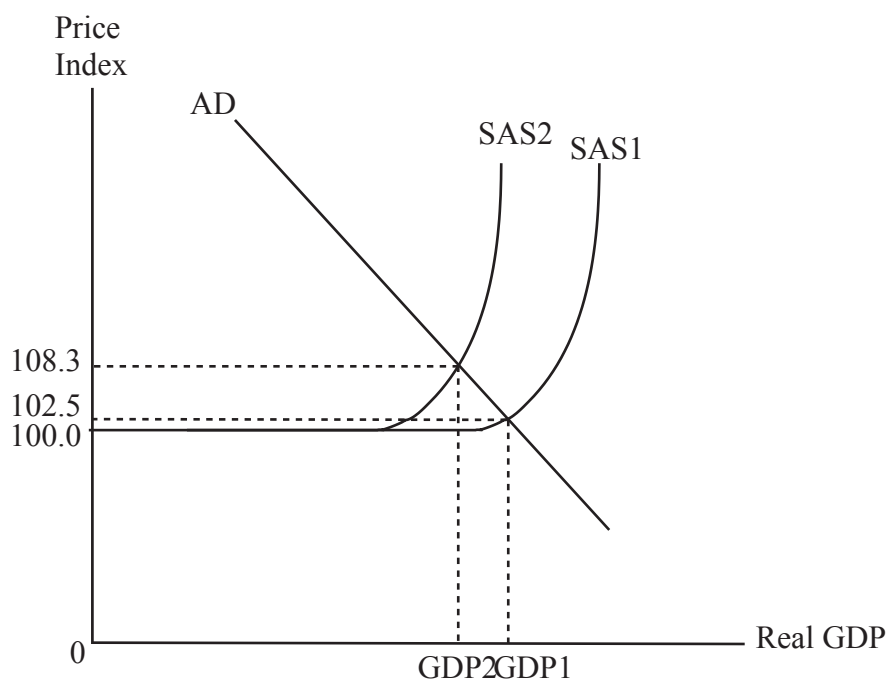
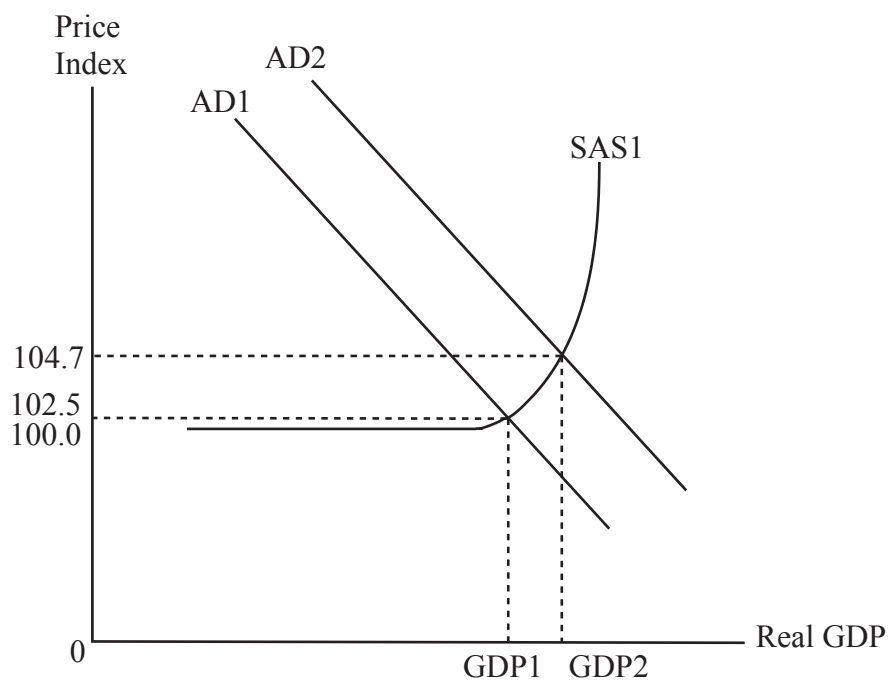


Diagram 3. An increase in aggregate demand caused by an expansionary event



Conclusion

The business cycle is not new, and cycles seem to be inherent in the economic system. They are not regular and are unpredictable, although after the event some may claim to have predicted them. A few economic commentators regularly predict an imminent downswing or upswing. Bear in mind that if one predicts something in this way, *eventually* one must turn out to be right! Success may then be claimed - as long as one ignores the preceding continuous failures.

There are a lot of explanations of the cause of business cycles. We know why some cycles occur but we do not really know for certain why they all occur. It is possible that many of the explanations are valid for some cycles at some times. It is also possible that any individual cycle can have a single cause - or perhaps several causes all coming together at once.

With globalisation, which means more interlinked economics and faster transmission belts, it seems likely that cycles may get larger and more world-wide than they once were but even this is not certain. We still have a lot to learn.

The author's latest book is *Going to University: the Secrets of Success*, Second Edition revised and expanded. It has a 5-Star Amazon review. The book aims to help students to improve their results in essays and exams, and to make the transition from high-school to university both easier and more enjoyable.

It can be obtained directly from the publisher www.keweipress.com for £9.95 (including postage within the UK) in which case you get a free bonus CD with 19 articles covering things such as how to study more easily and get better results as well as more economics-related items. This site also contains a free book *An Introduction to Economics* which you can download. Alternatively, *Going to University: the Secrets of Success* can be obtained from Amazon and elsewhere, including UCAS, but you will not then get the free CD or a signed copy of the book.

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