JAYOTI VIDYAPEETH WOMEN'S UNIVERSITY, JAIPUR

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Faculty of Education and Methodology

Faculty Name- JV'n Dr. Md Meraj Alam

Program- BA (Hons) Economics 2nd Semester

Course – Macroeconomics II

Digital session name – Phases of Business Cycles:

Introduction

Business cycles have shown distinct phases the study of which is useful to understand their underlying causes. These phases have been called by different names by different economists.

Generally, the following phases of business cycles have been distinguished:

1. Expansion (Boom, Upswing or Prosperity)

2. Peak (upper turning point)

3. Contraction (Downswing, Recession or Depression)

4. Trough (lower turning point)

The four phases of business cycles have been shown in Fig. 13.1 where we start from trough or depression when the level of economic activity i.e., level of production and employment is at the lowest level.

With the revival of economic activity the economy moves into the expansion phase, but due to the causes explained below, the expansion cannot continue indefinitely, and after reaching peak, contraction or downswing starts. When the contraction gathers momentum, we have a depression. The downswing continues till the lowest turning point which is also called trough is reached.

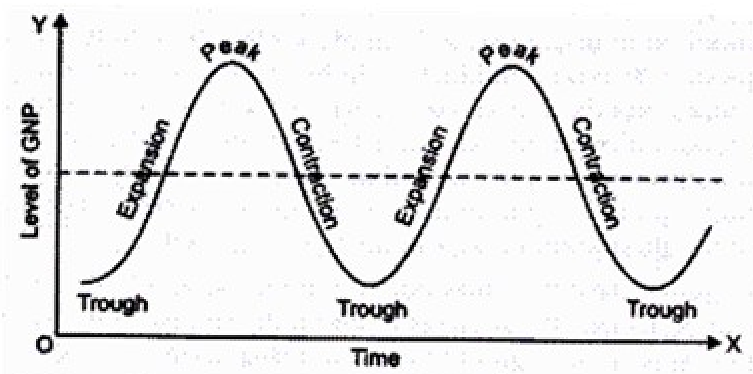

Fig. 13.1. *Four Phases of Business Cycles without Growth Trend*

Source: Internet

In this way cycle is complete. However, after remaining at the trough for some time the economy revives and again the new cycle starts.

Haberler in his important work on business cycles has named the four phases of business cycles as:

(1) Upswing,

(2) Upper turning point,

(3) Downswing, and

(4) Lower turning point.

There are two types of patterns of cyclic changes. One pattern is shown in Fig. 13.1 where fluctuations occur around a stable equilibrium position as shown by the horizontal line. It is a case of dynamic stability which depicts change but without growth or trend.

The second pattern of cyclical fluctuations is shown in Fig. 13.2 where cyclical changes in economic activity take place around a growth path (i.e., rising trend). J.R. Hicks in his model of business cycles explains such a pattern of fluctuations with long-run rising trend in economic activity by imposing factors such as autonomous investment due to population growth and technological progress causing economic growth on the otherwise stationary state. We briefly explain below various phases of business cycles.

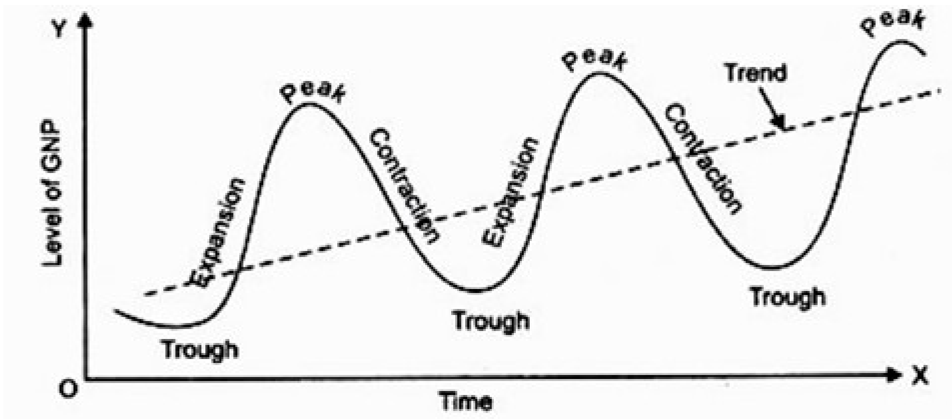

Fig. 13.2. *Cycles with Trend (i.e., Growth)*

Source: Internet

Expansion and Prosperity:

In its expansion phase, both output and employment increase till we have full employment of resources and production is at the highest possible level with the given productive resources. There is no involuntary unemployment and whatever unemployment prevails is only of frictional and structural types.

Thus, when expansion gathers momentum and we have prosperity, the gap between potential GNP and actual GNP is zero, that is, the level of production is at the maximum production level. A good amount of net investment is occurring and demand for durable consumer goods is also high. Prices also generally rise during the expansion phase but due to high level of economic activity people enjoy a high standard of living.

Then something may occur, whether banks start reducing credit or profit expectations change adversely and businessmen become pessimistic about future state of the economy that brings an end to the expansion or prosperity phase. Economists differ regarding the possible causes of the end of prosperity and start of downswing in economic activity.

Monetarists have argued that contraction in bank credit may cause downswing. Keynes has argued that sudden collapse of expected rate of profit (which he calls marginal efficiency of capital, MEC) caused by adverse changes in expectations of entrepreneurs lowers investment in the economy. This fall in investment, according to him, causes downswing in economic activity.

Contraction and Depression:

As stated above, expansion or prosperity is followed by contraction or depression. During contraction, not only there is a fall in GNP but also level of employment is reduced. As a result, involuntary unemployment appears on a large scale. Investment also decreases causing further fall in consumption of goods and services.

At times of contraction or depression prices also generally fall due to fall in aggregate demand. A significant feature of depression phase is the fall in rate of interest. With lower rate of interest people's demand for money holdings increases. There is a lot of excess capacity as industries producing capital goods and consumer goods work much below their capacity due to lack of demand.

Capital goods and durable consumer goods industries are especially hit hard during depression. Depression, it may be noted, occurs when there is a severe contraction or recession of economic activities. The depression of 1929-33 is still remembered because of its great intensity which caused a lot of human suffering.

Trough and Revival:

There is a limit to which level of economic activity can fall. The lowest level of economic activity, generally called trough, lasts for some time. Capital stock is allowed to depreciate without replacement. The progress in technology makes the existing capital stock obsolete. If the banking system starts expanding credit or there is a spurt in investment activity due to the emergence of scarcity of capital as a result of non-replacement of depreciated capital and also because of new technology coming into existence requiring new types of machines and other capital goods.

The stimulation of investment brings about the revival or recovery of the economy. The recovery is the turning point from depression into expansion. As investment rises, this causes induced increase in consumption. As a result industries start producing more and excess capacity is now put into full use due to the revival of aggregate demand. Employment of labour increases and rate of unemployment falls. With this the cycle is complete.

Course Outcome: The goal of this paper will be to expose the students to the basic principles of macroeconomics. The emphasis will be on thinking like an economist and course will illustrate how economic concepts can be applied to analyse real-life situations. In this course, the students are introduced to money and interest, theories of inflation, rate of interest, trade cycle and growth models.