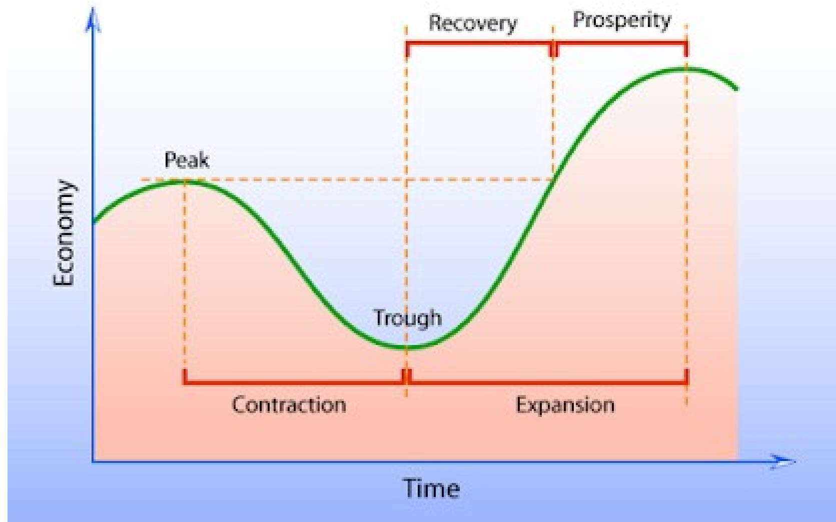
Trade Cycle

What is Trade Cycle? Meaning

The alternating periods of expansion and contraction in the economic activity has been called business cycles or trade cycles.



The period of high income, high output and high employment is called as the Period of Expansion, Upswing or Prosperity.

The period of low income, low output and low employment is called as the Period of Contraction, Recession, Downswing or Depression.

Definition of Trade Cycle:

According to Keynes,

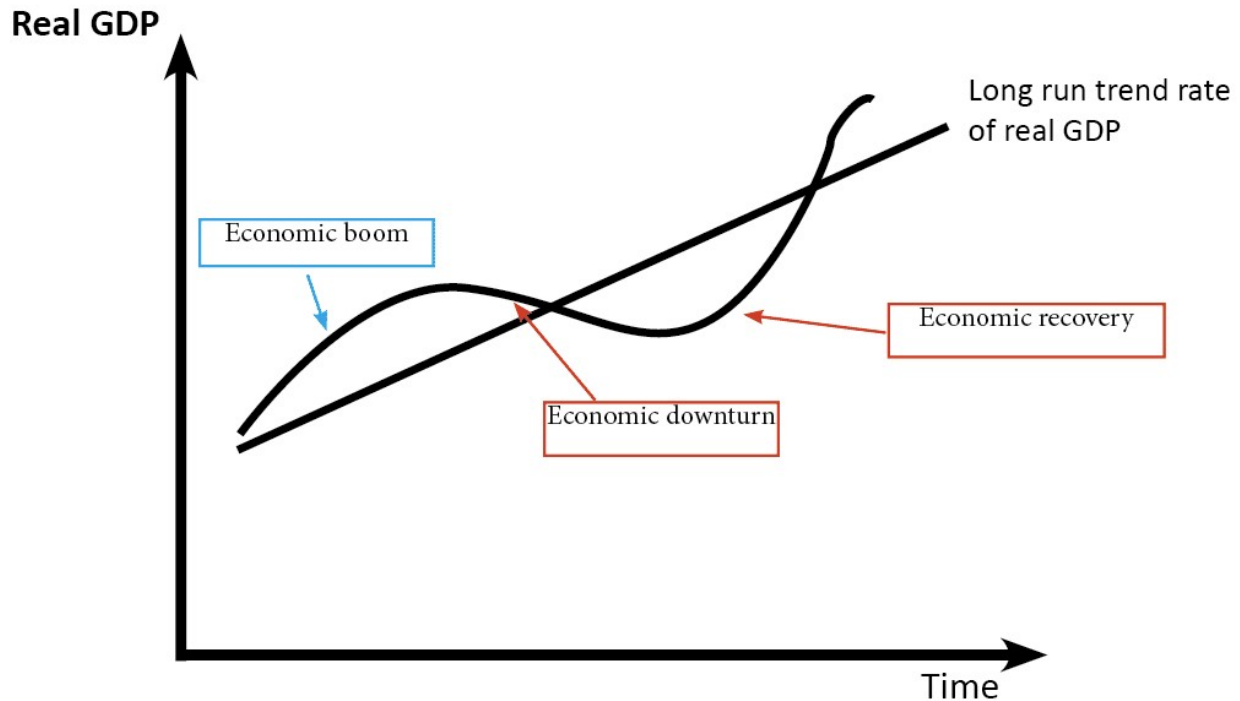
"A trade cycle is composed of periods of Good Trade, characterized by rising prices and low unemployment percentages, shifting with periods of bad trade characterized by falling prices and high unemployment percentages."

Economic Trade Cycle

The economic trade cycle shows how economic growth can fluctuate within different phases, for example:

- Boom (which is a period of high economic growth possibly causing inflation)
- Peak (top of trade cycle, where growth rates may start to fall)

- Economic downturn/Recession (where the growth rate falls and may become negative – leading to a fall in national output)
- Economic recovery (economic growth becomes positive and growth rates pick up.)



Causes of economic trade cycle

1. **Momentum effect**. When there is positive economic growth, this tends to cause:

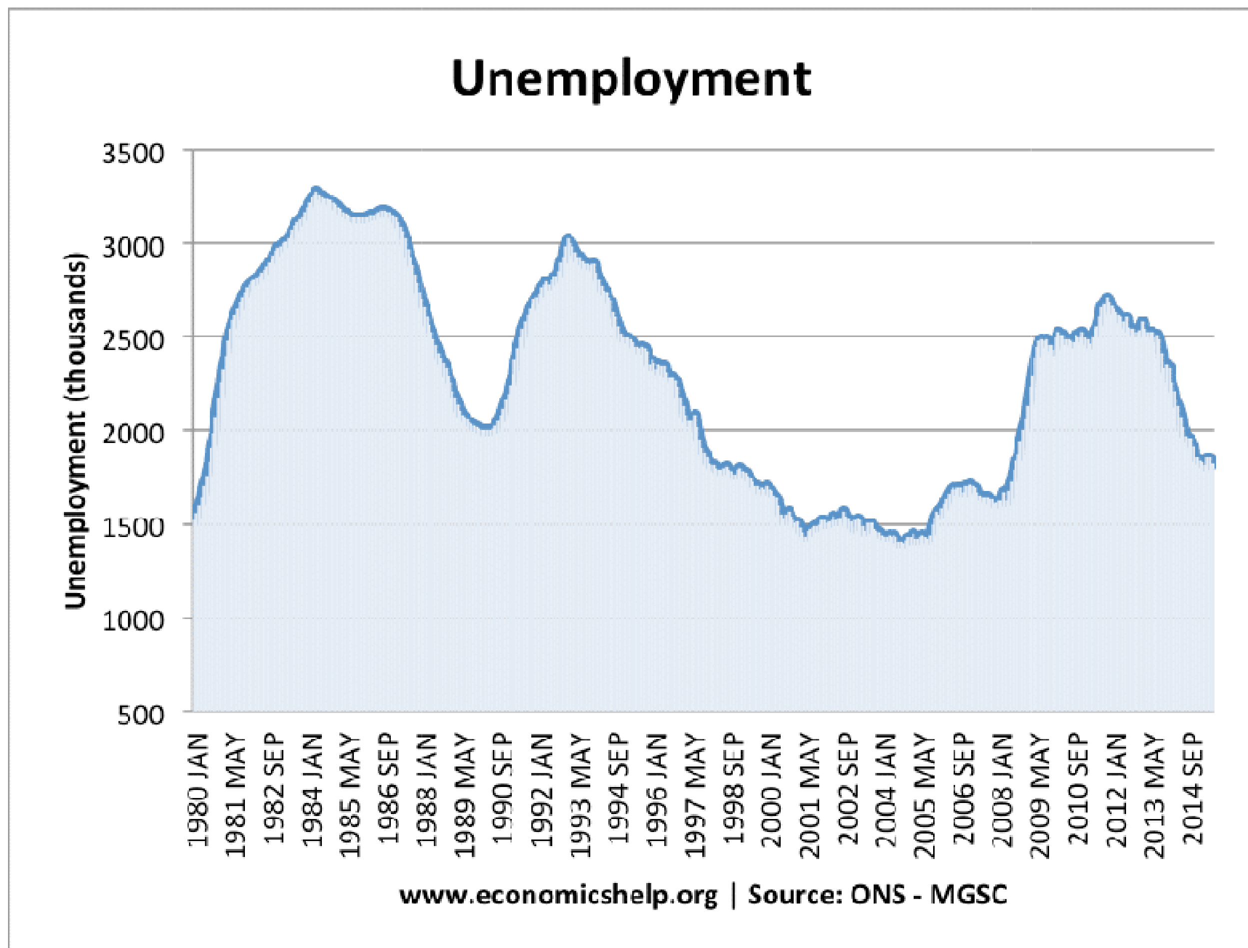
- A rise in consumer and business confidence
- With economic growth, banks are more willing to lend, increasing investment.
- Rising asset prices such as houses; this causes a rise in wealth and consumer spending. The higher economic growth increases incomes and causes more demand for housing
- Accelerator theory of investment. This suggests investment depends on the rate of change of economic growth. An improved growth rate leads to higher investment.

2. **Interest rate changes**. When there is higher economic growth, inflation tends to rise. In response, Central Banks tend to increase interest rates to reduce growth and inflation. High-interest rates in 1990-92 were an important cause of bringing the economic downturn. High-interest rates made mortgages expensive, reducing disposable income and causing a rise in home-repossession rates.
3. **Technology**. Improvements in technology may cause a boost in economic growth. A lull in technological innovation may cause slower growth.

4. **Political Business cycle**. Some economists suggest that there is a political business cycle. This is when politicians try to have a boom (high economic growth) before an election to help win the election. Since 1997, UK monetary policy has been given to the independent Bank of England with a remit of keeping inflation at 2%
5. **Global Trade Cycle**. A global economic downturn will tend to affect individual economies. The recession of 2008/09 occurred in all major global economies.

Impact of the trade cycle

Fluctuations in economic growth have an important influence on other macroeconomic variables.



Inflation

– In a recession, the inflation rate tends to fall. With rapid economic growth, we tend to get demand-pull inflation

– In a period of rapid economic growth and rising consumer spending, we tend to get a rise in imports which causes a deterioration in the current account.

This is because in a recession:

- **Tax revenues fall**. Less spending – less VAT. Lower incomes – lower income tax.
- **Higher welfare spending**, e.g. unemployment benefits**.**

Influencing the Trade Cycle

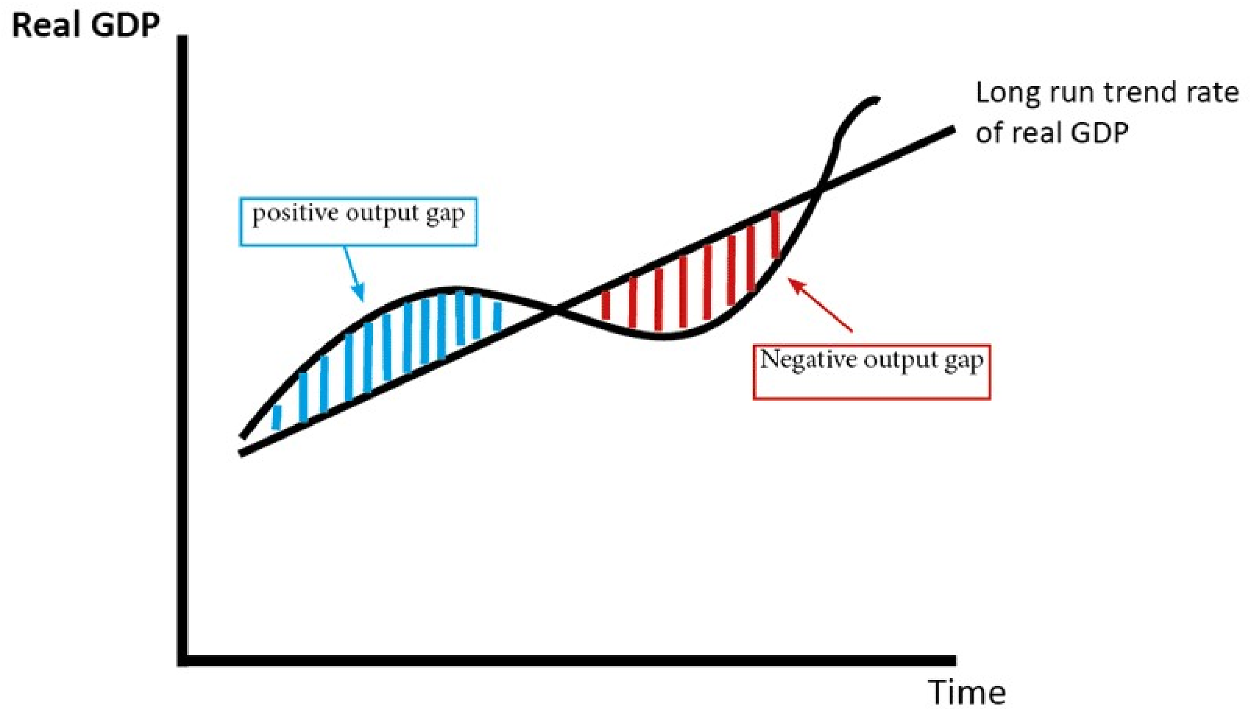
Some economists feel that there is an inevitability of a trade cycle and the government cannot influence and prevent recessions. However, other economists (such as Keynesians) argue that government intervention can help overcome recessions.

For example, in an economic downturn, the government can pursue

- Expansionary fiscal policy -Higher government spending and/or lower taxes financed by borrowing. This should provide an economic stimulus.
- Also, the Central Bank can provide monetary easing – lower interest rates and/or increasing the money supply.

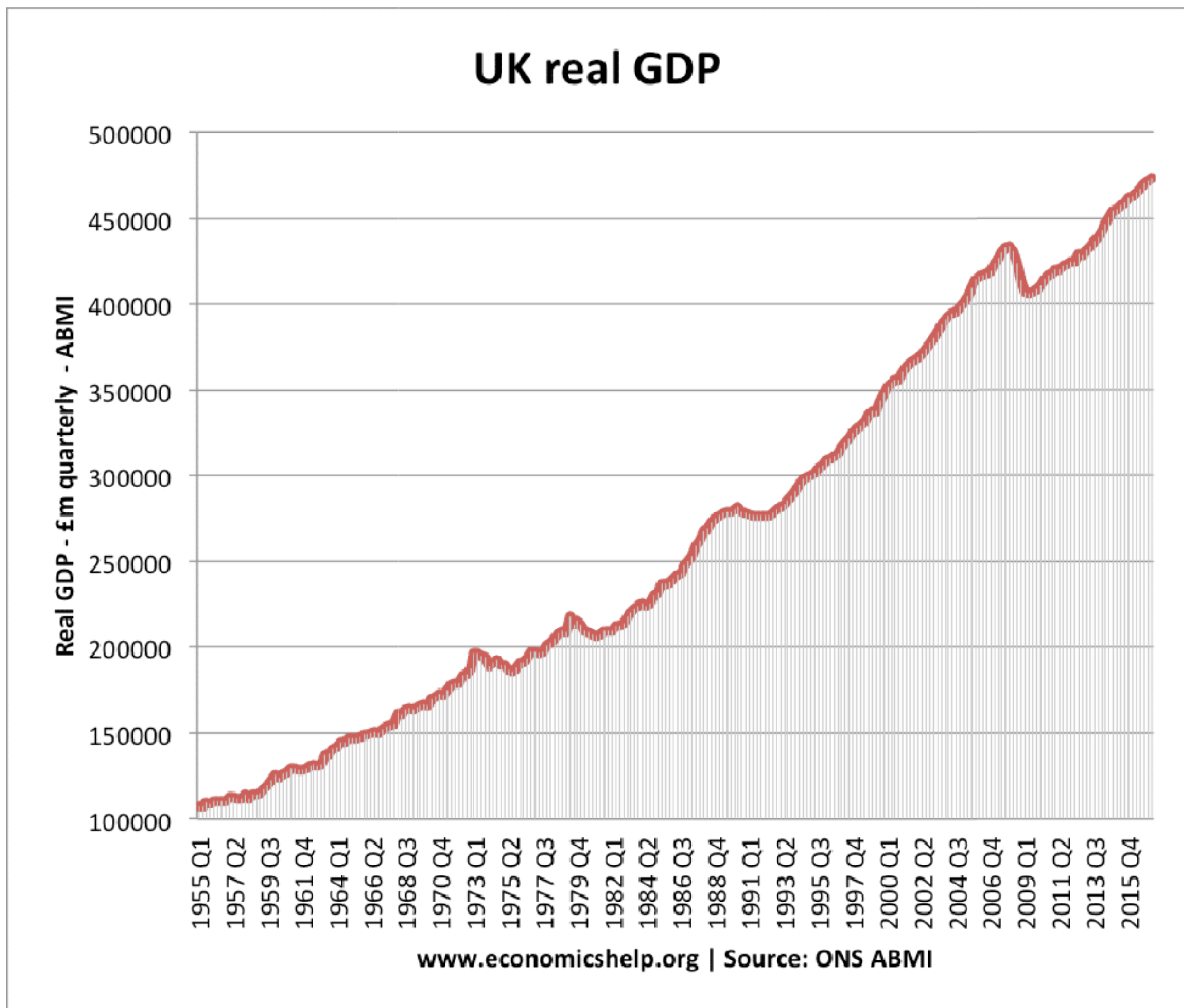
Between 1997 and 2007 the trade cycle was more stable in the UK. However, the global financial crisis pushed the UK economy into recession during 2008/09.

Output Gap



- If economic growth is slow and actual output grows slower than potential – there will be an increase in spare capacity. This will cause a negative output gap.
- With fast economic growth and increases in AD then the output gap gets smaller and can become a positive output gap.

The Long Run Trend Rate of Economic Growth



The long-run trend rate refers to the average sustainable rate of economic growth in an economy. For example, in the UK this is about 2.5%. This depends on the growth of AS and productive capacity.

Features of Trade Cycle

The characteristics or features of trade cycle are :-

Movement in Economic Activity :A trade cycle is a wave-like movement in economic activity showing an upward trend and a downward trend in the economy.

Periodical : Trade cycles occur periodically but they do not show the same regularity.

Different Phases : Trade cycles have different phases such as Prosperity, Recession, Depression and Recovery.

Different Types : There are minor and major trade cycles. Minor trade cycles operate for 3-4 years, while major trade cycles operate for 4-8 years or more. Though trade cycles differ in timing, they have a common pattern of sequential phases.

Duration : The duration of trade cycles may vary from a minimum of 2 years to a maximum of 12 years.

Dynamic : Business cycles cause changes in all sectors of the economy. Fluctuations occur not only in production and income but also in other variables like employment, investment, consumption, rate of interest, price level, etc.

Phases are Cumulative : Expansion and contraction in a trade cycle are cumulative, in effect, i.e. increasing or decreasing progressively.

Uncertainty to businessmen : There is uncertainty in the economy, especially for the businessmen as profits fluctuate more than any other type of income.

International Nature : Trade Cycles are international in character. For e.g. Great Depression of 1930s.

Types of Trade Cycle

Dynamic forces operating in a capitalist economy create various kinds of economic fluctuations. These fluctuations can be classified as follows :-

Short-Time Cycle : This trade cycle occur for a short period of time. It is also known as minor cycles. It lasts for about 3-4 years.

Secular Trends : This trade cycle occurs for a long period of time and is known as Long term cycle. It lasts for about 4-8 years or more. It is also known as major cycle.

Seasonal Fluctuations : This refers to trade cycles, which take place due to seasonal changes in the economy. For e.g. failure of monsoon can cause a downtrend in the economy which may be followed by a good monsoon and up to trend.

Irregular or Random Fluctuations: These trade cycles are unpredictable and occur during a period of strikes, war, etc., causing a shock to the economic system.

Cyclic Fluctuation: These fluctuations are wave-like changes in economic activity caused by recurring phases of expansion and contraction. There is an upswing from a trough (low point) to peak and downswing from the peak to trough caused due to economic changes in demand, or supply or various other factors.

The Keynes' Theory of Business Cycles

According to Keynes, business cycle is caused by variations in the rate of investment caused by fluctuations in the Marginal Efficiency of Capital. The term 'marginal efficiency of capital' means the expected profits from new investments. Entrepreneurial activity depends upon profit expectations. In his business cycle theory, Keynes assigns the major role to expectations.

Business cycles are periodic fluctuations of employment, income and output. According to Keynes, income and output depend upon the volume of employment. The volume of employment is determined by three variables: the marginal efficiency of capital, the rate of interest and the propensity to consume.

In the short period the rate of interest and the propensity to consume are more or less stable. Therefore, fluctuations in the volume of employment are caused by fluctuations in the marginal efficiency of capital.

The Phases:
The course of a business cycle, according to the Keynesian theory, runs as follows. During the period of expansion the marginal efficiency of capital is high. Businessmen are optimistic; investment goes on at a rapid pace; employment is high; and incomes are rising, each increment of investment causing a multiple increase of income.

Towards the end of the period, the high marginal efficiency of capital receives a setback from two directions:
(i) The cost of production of new capital assets increases as shortages and bottlenecks of materials and of labour arise, and

(ii) Owing to the abundance of output, profits are lowered below expectation.

Soon business optimism gives way to scepticism and then to pessimism. The marginal efficiency of capital collapses with catastrophic suddenness. When businessmen find the investment expected to yield 10% yield only 3%, reducing incomes still further.

The downward movement proceeds cumulatively, because every decrement of investment causes a multiple decrement in income. The economy proceeds towards a crisis and depression. Recovery begins when confidence revives, that is, when the marginal efficiency of capital again increases.

This will happen after the period of time necessary for (i) the wearing out and obsolescence of part of the durable capital and (ii) the exhaustion of excess stock of consumer goods accumulated during the depression. Gradually the growing scarcity of capital goods and consumer goods increases profits and expectation of profits.

The marginal efficiency of capital revives and expansion commences. The time period of a cycle is fairly regular because the average time required for the wearing out, obsolescence and exhaustion of capital and consumer goods is more or less the same in every epoch.

Criticisms:

However, Keynes' theory is not free from defects. Its main weaknesses are listed below:

1. Keynes based his theory only on internal causes of a trade cycle. Moreover, he has developed his explanation with the help of multiplier principle alone. He has ignored induced investment and the acceleration effect. A complete explanation of a trade cycle must consider external causes of a trade cycle and the role of the accelerator in causing investment and income fluctuations.

2. Keynes has not explained clearly the determinants of 'marginal efficiency of capital' which influence the investment decisions of entrepreneurs.

3. Keynes does not attach due importance to the rate of interest. He considers the rate of interest only as an item of the cost of production of goods. He, on the other hand, holds that rate of interest does not exercise any influence on investment decisions.

4. The periodical aspect or the phases of the business cycle is left in darkness in Keynes' theory. Keynes has mainly discussed the problems of economic depression, with which he was primarily concerned.