**Trade Cycles**

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**1. Introduction to Trade Cycle:**

The phenomenon of a trade cycle was first recognized in **1819 by Jean Charles Leonard** in his essay entitled **Over Production and Under Consumption**.

The classical economists, however, did not accept the existence of trade cycle since they have long run perspective in view. In the long run, an economy will find its equilibrium at full employment. But, the great depression of the thirties has proved that it is the short run that matters most and in the short run existence of trade cycle is beyond any doubt.

A trade cycle is basically a cyclic form of fluctuation in the economy. However, all the fluctuations are not cyclic in nature. For example, sea­sonal fluctuations, random fluctuations, secular trends do not produce a trade cycle. It is only the cyclic fluctuations in the economic activities that will produce a trade cycle in an economy.

**2. What are the Cyclic Fluctuations?**

The economic activities in a market driven economy does not follow a uniform pattern. They sometime show a continuous improving perfor­mance while at other times a continuous deteriorating one. Former may be termed as a period of good trade and the latter as a period of bad trade.

In the **period of good trade** the economy witnesses following characteristics:

i. Product prices & output levels to increase,

ii. Wages and employment levels to go up,

iii. Rate of interest and use of capital to enhance,

iv. Profit margins of the sellers to rise, and, hence,

v. Standard of living of majority of population to improve.

The reverse will happen in the **period of bad trade**. Thus in a period of bad trade the same economic parameters, product prices & output levels, wages and employment levels, interest rates and use of capital, sales and profit margins, will show downward trends.

Such changes in an economy have a cyclic occurrence, i.e. the two kinds of periods will follow each other. A period of good trade will be followed by a period of bad trade and a period of bad trade will be followed by a period of good trade. Hence, such a movement of economic activities is known as cyclic movements.

**3. Meaning and Definition of Trade Cycle:**

The cyclic movements in an economy around its long term growth trend give rise to a phenomenon which is termed as a trade cycle or a business cycle. Thus, a trade cycle, or a business cycle, will be characterized by upward and downward swings alternatively in the economy in terms of aggregate income, output, employment, productivity, prices, sales, profit margins and so on. The fluctuations are commonly measured in terms of real national income.

According to Keynes, “A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentages altering with periods of bad trade characterised by falling prices and high unemployment percentages”.

According to Mitchell, “Business cycles are of fluctuations in the economic activities of organized communities. The adjective ‘business’ restricts the concept of fluctuations in activities which are systematically conducted on commercial basis.

The following are features of Trade Cycle:

1. In a trade cycle, a period of prosperity is followed by a period of depression. Hence trade cycle is a wave like movement.

2. Business cycle is recurrent and rhythmic; prosperity is followed by depression and vice versa.

3. A trade cycle is cumulative and self-reinforcing. Each phase feeds on itself and creates further movement in the same direction.

4. A trade cycle is asymmetrical. The prosperity phase is slow and gradual and the phase of depression is rapid.

5. The business cycle is not periodical. Some trade cycles last for three or four years, while others last for six or eight or even more years.

6. The impact of a trade cycle is differential. It affects different industries in different ways.

7. A trade cycle is international in character. Through international trade, booms and depressions in one country are passed to other countries.

**4. Periodicity of a Trade Cycle:**

Duration of a cyclic movement or trade cycle in an economy may not be same for all kinds of economic activities. It may vary considerably from a cycle of just 3 years to a cycle of as many as 50 years. Different economists have found varying duration of trade cycle in different economic activities. Some of them are summarized below:

i. Juglar cycle, identified by Clement Juglar in 1860, is of an 8 to 11 years duration.

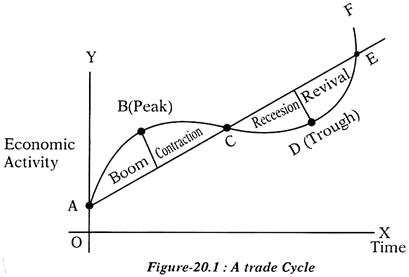
ii. Kitchin inventory cycle, identified by Joseph Kitchin, has duration of just 3-5 years. It is also termed as a minor cycle.

iii. Kuznets infrastructural investment cycle, identified by Simon Kuznets, is of 7-11 years duration and often called as business cycle

iv. The Kondratiev wave or technological cycle of 45-60 years duration was identified by Nikolai Kondratiev. It is a very long or a major cycle.

**5. Phases of a Trade Cycle and their Features:**

A trade cycle, an outcome of cyclic movement of economic activities, passes through different phases from conditions of slump to conditions of boom. Modern economist Schumpeter identified four stages/phases of a business cycle. They are — Expansion/Boom, Contraction, recession and recovery. The Figure-shows all the four phases of a trade cycle.



**1. Boom:**

The Boom is a phase of trade cycle which is marked by a feel good factor in the economy. The economy will continue to witness an increase in economic activities which will be reflected in a continu­ously rising real income, production, employment and prices.

This will facilitate a fuller utilization of resources and will take the economy to a highest possible level of prosperity which can be termed as a peak. The stage will also register a high inflation rate, which will become a matter of concern at some stage.

**Important features of this phase can be listed out as follows:**

a. A continuous increase in real income and output.

b. Fuller utilization of resources and full employment.

c. Factor productivity to reach its maximum.

d. Product and factor prices will be on the rise. Thus, wages, interest rates and various kinds of rents in the economy will increase as the time passes by.

e. Profit margin will grow.

f.As such, consumption and investment expenditures in the economy will rise and more credit creation will be attempted by the financial institutions.

g. The economy will witness a high inflationary pressure causing a concern among the policy makers and operators of the economy.

This phase can also be termed as a phase of prosperity or growth or expansion.

**2. Contraction:**

This phase is marked by a deceleration in economic activities. The economy having peaked out and inflation being on the rise, the profit margins will be increasingly under pressure, factor prices will be rising more than their respective productivities and new investments will be less productive.

To counter strong inflation­ary tendencies, today’s governments may introduce anti-inflationary policies. As a result of all these, a phase of slowing down of economic activities will begin.

**This will result into following important features:**

a. Real income and output will fall.

b. Employment and factor productivities will decline resulting into a downward trend in wages and other factor payments.

c. Borrowings and credit creation will show a sluggish perfor­mance.

d. Profit margins will be lowered.

e. Prices will start becoming normal.

f.Aggregate expenditure, on consumption as well as on invest­ment, in the economy will fall.

As a result, output level will settle around the long term equilibrium level from the peak achieved earlier under the phase of boom.

**3. Recession or Depression:**

The process of contraction will, however, not stop at the long term equilibrium income level and the economy will continue to decelerate. It will result into a further fall, rather sharper, in output, income and employment. Factor payments and general prices will also decline sharply. The market will witness a significant fall in demand and excess supply scenario will be wit­nessed everywhere. Ultimately, the economy will reach to its bottom which can be termed as a trough.

**Major features of this phase can be highlighted as follows:**

a. Output, income and employment will continue to travel down­ward and will bottom out.

b. Mounting unemployment in the economy.

c. Factor prices and factor productivities will reach to their respective lowest levels.

d. Demand of both consumer and capital goods will fall and producers’ profit margins will dip. Excess supply situations will rule the market.

e. No investment, new or replacement will be taken up by the producers. No significant credit off takes. Financial institu­tions will be flushed with surplus funds.

f. All round pessimism in the economy.

All these will again be a matter of serious concern.

Such a situation was witnessed during the great depression of the thirties and the classical economics failed to provide a solution to it. It was a rather failure of market mechanism. The market correction had dragged the economies deeper into the recession rather than bringing them out of it. It is in this background that Keynes advo­cated government intervention to facilitate a recovery from recession through stepping up of effective demand.

**4. Revival or Recovery:**

When the government intervenes in the market by way of enhancing expenditure or reducing taxes, the process of economic revival will start. It will lead effective demand to increase, production and employment to rise and, factor demand to grow.

In nutshell, there will be an all round gradual recovery from the falling tendencies. Consumers will start returning to market for purchasing goods as their income will start rising. Market prices and demand will also begin to pick-up. Employment opportunities will also grow.

**In short, the recovery phase can be marked by following changes:**

a. Output, income and employment to grow.

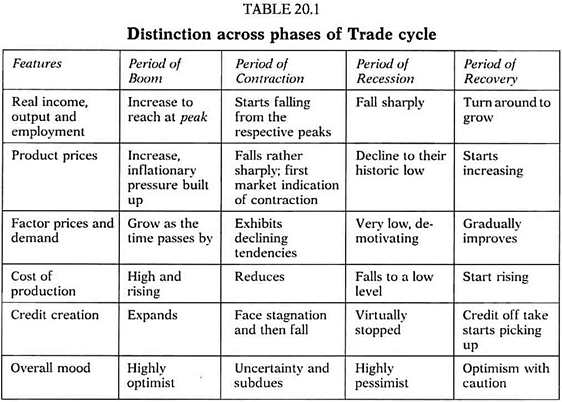
b. Unemployment to fall.

c. Product demand and, in turn, the factor demand to pick-up.

d. Prices of both products and factors to rise.

e. Investment will also grow.

All the above explained four phases of a trade cycle can be summarized as in following Table-20.1.



**6. Causes of Trade Cycle:**

The phenomenon of a business cycle is so complex that it directly or indirectly depends upon not only the entire economic system of a country but also on the performance of global market, in addition to many non-economic and psychological factors.

Different economists have identified different factors contributing to the occurrence of a trade cycle. This has been covered under different theories on causation of a trade cycle. One may further note that the large number of factors on which a trade cycle depends include both **exogenous as well as indigenous factors**.

The exogenous factors are those which are outside the economic system but causes economic instability within the system. They may be economic or non-economic in nature. The non-economic exogenous factors include, war, political instability in the country, and revolution, new discoveries of technologies or land, change in population size, global recession, and so on.

In contrast, the indigenous factors emerge out of the economic system itself. Important among them are presented as theories of trade cycle explained below**:**

1. Climate Theory

2. Psychological Theory

3. Theory of under-consumption or over-saving

4. Monetary explanation of trade cycle

5. Innovation theory

6. Saving and investment theory

7. Theory of over production or competition

**1. Climate Theory:**

It is also known as Sunspot theory. Supporters of this theory, considered trade cycle as a natural phenomenon which occurs due to meteorological factors. This theory argue that changes in atmosphere of sun, which occur at an interval of 10-11 years, cause an impact on the atmosphere of earth and its rainfall.

Its direct impact is felt on agricultural and through agriculture to other sectors of the economy, if such effects are adverse, they will cause depression and, if they are beneficial then boom. Length of such a trade cycle is of 7-8 years.

It is more of a logical expression than a theory which can be proved. Moreover, each and every cyclic fluctuation in different parts of the world cannot be explained in term of it. A good and bad crop can only be one of the many factors that can cause a trade cycle to emerge.

**2. Psychological Theory:**

Prof. Pigou has attributed occurrence of a trade cycle to psychological factors, more specifically the feeling of optimism and pessimism among entrepreneurs. When the entrepreneurs are optimist and confident about the future, they will expand investment and produce more.

In contrast, if they are not sure about the future, they will be pessimist and will follow a cautious and conservative approach towards investment and production. The former will give rise to a situation of boom while the latter to a slump. Hence, a trade cycle will emerge.

These two feelings will have cyclic occurrence. Under the feeling of optimism, they may end up producing more due to over estimation of market growth. As a result, they will be left with large inventories. This will pave the way for pessimism. Now, they may be too much conservative and will produce much less than what the market can absorb. This will be reflected in market scarcity which will pave the way for optimism. With both the feelings, the entrepreneurs are usually over optimist and over pessimist.

**3. Theory of Under-Consumption or Over-Saving:**

An important explanation on the occurrence of trade cycle is given by Hobson, Foster and Douglas. They argued that a capitalist economy is characterized by high and growing income inequalities. The rich class of the society has large income which is much more than their consumption needs. Hence, they save and invest considerably in the production of consumption goods. As a result, availability of consumables increases and gives rise to a situation of boom in the economy.

But, sufficient demand may not reach the market because of large low-income population who has shortage of buying power. Hence, there will be growing inventories with the producer which cannot be sold at a profit.

This will depress the market forcing producers to lower the production and postpone their investment plans. This will pave the way for recession.

As such, boom and slump will emerge alternatively. That is, it is the over saving which will produce a boom and the under consumption which will produce a slump in the economy. Hence, a business cycle will be surfaced.

**4. Monetary Explanation of Trade Cycle:**

Monetarist economists, such as Hawtrery, Friedman, and Hayek consid­ered the trade cycle just as a monetary phenomenon.

The Hawtrery attributed occurrence of trade cycle to a change in money supply, more specifically the bank credit. When the bank credit expands, the upward movement in economic activities will take place. Similarly, when it contracts it will cause a downward movement.

The expansion of bank credit will take place when interest rate is low encouraging entrepre­neurs to borrow and invest. This will lead to expansion of business activities and, hence, an upward swing in the economy. It will result into an increase in production, income and employment, as also the market prices paving the way for a boom.

Higher borrowings at a low interest will result into a decline in bank reserve, following which banks may hike the interest rate and adopt a conservative policy towards providing further loans.

As such, a contraction in the bank credit will take place along with an increase in interest rate. This will de-motivate entrepreneurs to borrow and, hence, the business activi­ties will settle at a lower level. This will produce a downward movement in the trade cycle or a slump.

**5. Innovation Theory:**

In the opinion of Schumpeter, basic reason for a trade cycle to emerge lies in the innovation. Introduction of an innovation will cause a positive technological shock to the economy and through it the economy will witness the upward swing in the economic activities.

An innovation will provide some gains to the inventor over its competitors as it will either lower the cost or will increase the sales. It, thus, facilitates profit margins to grow. This will motivate the entrepreneur to invest in that area so as to increase the production. Even bank will support such initiatives of the entrepreneurs by way of providing loans. When such activities become successful, the entrepreneur will repay the bank money along with interest.

If other entrepreneurs in the same industry want to keep up, they have to either imitate the same or come up with something better through heavy investment. Overtime, thus, the success story of the original innovator will be imitated by other entrepreneurs in as warm like cluster.

All these will stimulate output and employment generation, as also income in economy. Hence, it will give rise to a boom or an upward swing to the economy. Initially, the upward swing may start with only a few firms leading the sector and, subsequently, other firms may also contribute in it.

This phenomenon of rising economic activities among all the firms will lead factor demand to rise. Since there is already a full employment of resources, it will push up the factor price and cost of production. As a result, households’ income will rise, as they are the factor owners, and they will demand more consumer goods for consumption. It, in turn, will increase the producers’ income as well as their profits.

After some time, the advantage of innovation will be shared by all the players of the industry and production will stabilize. The boom will gradually taper off into contraction when some new innovation is intro­duced. Assuming that no new innovation is introduced, the cyclic move­ment will drag the economy towards recession.

In reality, however, waves of new innovation will continue. A primary wave of innovation will be followed by a secondary wave and so on. It will continue to cause positive effects on output and employment. It may even induce new firms to enter in the industry in the backdrop of rising profit prospects.

At the other end, older products will witness a fall in demand and their respective prices. This will force their producers to wind up operation and move to some newer area. It involves a process of readjustment in the economy which may be at times painful. It will cause a downward swing in the economy.

In short, boom and slump will emerge alternately in the economy and a trade cycle will be witnessed.

The theory is criticized on several grounds. For example, it is not appropri­ate to argue that that the innovations are the only cause of trade cycle. There are other causes of a trade cycle as well. Thus, it provides a partial explanation to the phenomenon. Secondly, it is difficult to accept the assumption of full employment in real world.

**6. Saving and Investment Theory:**

Trade cycles are explained in terms of saving and investment by the Keynes. According to him, macro-economic equilibrium in an economy is achieved through saving-investment equality.

**In case there is disequilib­rium in the economy then there are two possibilities:**

i. Investment may exceed saving, or

ii. Investment may be short of saving

In case of situation (i), aggregate expenditure in the economy will be more than the output level. This means more demand of goods in the economy than what the producers are supplying. It will cause a scarcity of product in the market. This will induce producers to produce more and hence will facilitate a boom.

In the second case, the economy is producing more than what is demanded by the market, the aggregate expenditure being less than the output level. This will be reflected in excess unsold supply in the market. This will forced producers to lower production and hence will result into a slump.

**7. Theory of Over Production or Competition:**

This theory attempts to explain the occurrence of trade cycle in terms of over production in a free market economy. It argues that in a free market economy, every individual producer tends to produce more to take advan­tage of rising prices under the conditions of boom.

As such, market is over flooded and gives rise to an intense competition (a cut-throat competition) among producers. In the process, what they ignore is the total size of market demand. This put pressure on factor services and, in turn, raises cost of production.

In a situation of over-supply, market prices tend to fall. However firms may shy away from reducing production expecting the market to improve in future at some point of time. However, such an improvement may not take place due to dynamics of market mechanism.

Hence, the demand-supply imbalance will continue forcing some of the firms to ultimately collapse and others to pay a price of miscalculation of market mood in the form of large inventories. All these will pave the way for recessionary forces to strengthen.

As a result, market supply will fall and a scarcity may emerge. This will again lead all the producers to step up production resulting in another boom. This will mark beginning of a new trade cycle.

**8. Controlling Business Cycle:**

Given that the trade cycle causes considerable economic instability and far reaching adverse consequences on firms, there is a need to take measures which can minimize the ill-effects of recession. Towards this, firms may take both the preventive as well as relief measures.

**Preventive Measures:**

Some of the preventive measures that a firm can take at the time of boom so as to reduce its pain when the recessionary forces will become activated in the economy are as follows:

1. Build Reserve for a Period of Crisis:

2. Prudently Managing the Product Inventories:

3. Stock of Raw Materials:

4. Not to go too far in Employing Manpower:

5. Careful Capacity Expansion:

6. Avoid Excessive Borrowing:

7. Conservative Approach to Sale Promotion through Credit Offering:

**Relief Measures:**

Similarly, firms also have options to introduce some measures for reducing adverse effects of recession.

1. Reduce Production and Over-Head Costs (overseas trips, free food and transport facilities, participation in less important trade fairs,):

2. Reduce the use of Manpower and Redeployment:

3. Improve Product Quality:

4. Lower Price to Hold Demand:

5. Clearing Inventories from Time to Time:

6. Put on Hold its Investment Plans:

7. Avoid less Productive Sale Promotion:

**9. Trade Cycle – Stabilizing Policies:**

While firms may take measures to protect themselves from the vagaries of a trade cycle, it is the duty of the government to maintain economic stability. For this purposes, it introduces various measures within the broader framework of stabilization policies.

In other words, policies of economic stabilization will reduce the scope for cyclic fluctuation in the economy and will contribute in providing environment for a stable long run growth. Most measures which the government takes towards eco­nomic stabilization may fall under three broader policy areas.

**They are:**

1. Monetary policy

2. Fiscal Policy, and

3. Direct control

**1. Monetary Policy:**

Monetary policy is a policy framework under which a government or the country’s Central Bank regulates the flow of money supply in the economy so as to influence the interest rate structure for promoting economic growth and stability. It also aimed at a price stability and expansion of employment opportunities in the country.

There are several instruments with the help of which a monetary policy functions. They include bank interest rate, reserve requirements (Cash Reserve Ratio & Statutory Liquidity Ratio), open market operations, selective credit controls etc. A central bank uses them in different permu­tation and combination to achieve a goal.

For example, when an economy peak out following boom conditions, inflationary forces are quite strong and, hence, a cooling is required. Towards this, the Central Bank may attempt to slow down the growth in money supply in the economy.

For this to achieve, it may increase bank rate, sells securities in the market and/or increases both the reserve requirements (CRR and SLR) for banking institutions. The reverse may be applied when the Central Bank intends to enhance the money supply. The measures of selective credit controls are applied only when the intentions are to affect the availability of money supply to selected sectors only and not for the entire economy.

There are two kinds of monetary policies. These include:

i. Expansionary monetary policy and,

ii. Contractionary monetary policy.

An expansionary monetary policy leads to increase in the supply of money resulting into a low interest rate and easy availability of credit. It makes borrowing convenient for the businesses. As such, investment will rise and economic growth will be stimulated. It will also lead to an increase in the general price level in the economy. Such a policy is suitable when the economy is under the grip of recession. It is also known as a cheap monetary policy.

Likewise, a Contractionary monetary policy will result into a fall (or a slower growth) in money supply which causes interest rate to rise, invest­ment to fall and prices to decline. The low availability of credit in the economy will force a slowing down of the growth process.

Such a policy is introduced when economy is over-heated due to a high level of aggregate expenditure and marked by higher than the targeted level of prices. The policy will have a cooling effect on the economy. It is also known as a dear (or tight) monetary policy.

This shows that the instruments of monetary policy can play an important role in limiting the cyclic movements in the economy and will help in achieving economic stability.

However, its effectiveness depends upon several other variables. A busi­nessman, for example, will not take a call on investment just because credit is easily available at a low rate of interest. What matters more to him is the profitability associated with the investment.

If the marginal efficiency of capital is high, investment will be profitable even at a high interest rate and vice versa. That is why it is often observed that investment continue to grow, despite high and rising interest rate, during a period of boom while it continue to fall despite low interest rate during the period of slump.

Still the use of monetary policy for economic stability is very common across the countries. Since under the cyclic fluctuations, a boom follows a slump and a slump follows a boom, the use of two kinds of policies is witnessed alternatively on almost a regular basis in most countries.

**2. Fiscal Policy:**

Fiscal policy is another important instrument at the disposal of a govern­ment to bring economic stability. It has two components namely, the tax and expenditure policies. It was the Keynes who highlighted its importance as an instrument of economic stability.

According to him, the two compo­nents of fiscal policy can be used to significantly change the effective demand in the economy and, thus, the level of output and employment. The effective market demand depends upon the aggregate expenditure which consists of consumption as well as investment expenditures.

In the period of boom, the fiscal policy is used in a manner so as to curtail the effective market demand. This will help in containing inflation in economy. Towards this, government may hike the tax burden on economy leaving a relatively smaller amount of spending power in the hands of people and firms.

At the same time, government may also reduce its expenditure. Both of these will lower the market demand. Such a policy will be reflected in a smaller budgetary deficit of the government. In nutshell, when economy will be approaching at peak of the trade cycle, the fiscal policy may act to reduce effective market demand.

In the period of recession, the government may lower the burden of taxation on the economy and increase its expenditure on its various activities. As a result, its budgetary deficit will widen but more demand will be created in the economy. As such, private investment will pick up, more employment opportunities will be created and production of goods and services will increase. This will help the economy to come out from the grip of recession.

In short, Keynes has recommended a Contra-cyclic fiscal policy to achieve economic stability. In a situation of recession, according to such a policy, government will opt for a larger budgetary deficit (i.e., lower taxes and more expenditure) which will boost economic activity and, in turn, will generate more employment. Such a fiscal policy is also termed as an expansionary fiscal policy.

In contrast, under a situation of boom reaching to its peak, government may adopt a smaller budgetary deficit or a surplus budget (i.e., higher taxes with smaller expenditure) which will be having a negative effect on economic activities and, in turn, lower the level of unemployment.

**3. Direct Controls:**

Direct controls are the measures usually applied when monetary and fiscal policy measures are unable to produce a desired result. For example, during a period of war, excessive deficit financing may lead to economic instability and prices to shoot up. This will push the low income population into an unbearable hardship.

In this situation, government may impose direct price and distribution controls so that all the citizens may get a certain minimum quantity of basic necessaries at a fair price. Towards this, government may restrict the distribution of essential items through public distribution network only at a fair price.

Alternatively, it may even introduce a dual pricing policy under which a minimum quantity of a product is made available to everyone at a fair price from public distribution network and remaining quantity of it is offered at a market driven price. Such measures will help in a proper allocation of the essential items which are in short supply.

Likewise, these instruments can also be used for allocating critical growth inputs.

In the field of investment, production and foreign trade, government can resort to licensing and quotas as measures of direct controls.

**Advantages and Disadvantages of Direct Controls:**

An important advantage of such measures of direct control is that they can be introduced quickly and easily and their impact is instant. They are more of a discriminatory, rather than monetary, nature. However, such mea­sures are useful in short run only.

In the long run, they will be counter­productive since they suppress individual initiative. They tend to inhibit innovations, such as new techniques of production or introduction of new products. They may generate a black market for such products and lead to large scale hoardings.