TRADE CYCLE

Nighat Malik

With the turn of the 20th century, trade cycle has become a common, but non-the-less a very important feature of the world economies. Specially has it proved to be a problem for the more advanced countries of the world, where the chances for rapid fluctuations in economic activity are higher than in the under-developed countries; they are always under the fear of moving above or below the full employment level. As against these, the under-developed countries have the problem of unemployment and under-employment persisting over centuries.

The wave-like movement of the fluctuations in general business activity, spread over a number of years, is called a trade cycle. These fluctuations result in changes in the level of National Income and employment, and create not only economic but also social and political problems. The crucial coal-miners' strike daring the Depression of the Thirties in England, and the rapid change of Governments in France during the same period, may be cited as examples.

Business-cycle is simply one further aspect of the economic problem of achieving and maintaining full employment of the economic resources, and of maximizing the total real National Income of a country. What is the criterion to know when a business-cycle is in operation? For a better analysis of this problem, it is assumed that the economic factors are working within a closed economy. This would help in avoiding complications arising from international transfers of goods, services and capital accounts, and their secondary repercussions on the volume of employment and National Income in the participating countries. There are three variables in a closed economy which may help in judging when the fluctuations in business activity occur:

(*i*) Consumption,
(*ii*) Production, and
(*iii*) Level of employment.

These three reflect back such fluctuations, individually as well as in relation to each other.

Holding consumption to be the criterion, we have to estimate the portion of income that is spent on consumption, in order to arrive at the volume of savings which ultimately go into investment. The level of the total consumption of the economy must be equal to the goods produced during a given period of time.

Production also comes into the picture at this level. Here, we take account of the famous Say's Law of Markets that supply creates its own demand, so that there can be over-production, and the economy can carry on under the optimum conditions of full employment. The whole structure of the Classical Economics is based on this law; their belief in the efficiency of the price-system, that it leads, automatically, to conditions of full employment; that divergences may appear, but they are temporary for short periods only. Later economists have, however, proved that aggregate supply may fall short of aggregate demand and thus fluctuations in business activity are possible. They study such fluctuations in terms of the levels of employment and National Income, making comparisons with a particular norm which may be called the full employment level. Full employment may fee defined as a phase when all the productive resources of a country are employed so as to yield maximum possible profits, when the labour force of the country, willing and able to work, is employed to its best advantage. Criteria for the judgement of the business-cycle fluctuations have, thus, been different with different writers as times have passed.

Business-cycle may be discussed as to the different aspects that it may assume, such as:

1. Business-cycle proper, which spreads over a duration of seven to ten years.
2. Occasional disturbances.
3. Seasonal variations, which occur from year to year, or with a lapse of two or three years.
4. Secular trend, ranging between twenty to thirty years.
5. Long waves which are also called the Kondratiaff cycles.

The most important of these, however, is the business-cycle proper, because occasional disturbances occur only sometimes and, as such, are exceptional phenomenon, while seasonal variations can always be anticipated; and the secular trend and the long waves tend to persist over a long period of time, and require certain basic structural changes. As a result, we are left with the business-cycle proper, which is the heart of these problems, and its analysis is unconditionally important because of its violent, short-term fluctuations. This sort of business-cycle has certain characteristics, that is,

(*i*) Its periodicity: it occurs at regular intervals.

(*ii*) Its regularity: each cycle takes approximately the same period of time to work itself out which normally ranges from eight to ten years.

(*iii*) It has a tendency for a sharp reversal at the top and a gradual one at the bottom.

Originally, a trade cycle has four main phases, which are popularly termed as 'expansion', 'contraction', 'recession' and 'revival'. The two main terms 'expansion' and 'contraction' may also he called alternatively as 'prosperity' and 'depression'. 'Crisis' is the turning point at the top of the business-cycle or from its bottom, and it leads to contraction and depression in the first case, to expansion and revival in the second. Here, an explanation of the working of the trade cycle, and the conditions accompanying it, would be in point. We start with the position of crisis at the top of the boom period, when there is no further possibility for expansion. 'Something' happens and the decline or depression of economic activity starts functioning. A reduction of the total National Income takes place, with a failing level of employment. Savings are either too low to finance the required amount of new investments, or they do not find appropriate channels to flow in. Prices start falling to lower levels. There is a general decline in the aggregate effective demand for goods and services that the economy is producing. These forces, once they have started operating, tend to accumulate till the lowest possible level of economic activity is reached. At this lowest pitch, then, 'something' happens, and the revival starts. Incomes begin to rise; new investment opportunities are available, and thus capital industries expand, because consumption also increases with the increase in incomes, and this means brighter prospects for the business men, who start replenishing their stocks. A higher volume of investment necessitates more money in circulation; it accelerates the pace of business activity in the consumers goods as well as the producers goods industries; production, on the whole, rises to higher levels. This cumulative process goes on till it results in a highly inflationary crisis. The bubble of optimism breaks at this point, due to some reason, and the downward trend of the cycle begins, again. One thing, however, is to be noted in this whole process, that the process of revival and expansion is much slower than that of recession and contraction. This, perhaps, is due to the inherent psychology of the human race, to fear for the worse. This belief makes them reluctant and careful in the process of recovery, so that each and every step towards expansion is taken after a lot of deliberation.

The problem of finding out that 'something' which brings about the trend towards expansion or contraction requires an explanation of the causes that give rise to a trade cycle. Different theories have been forwarded in this context from time to time, but two features stand out in almost all of these theories:

(*i*) Parallelism of production and monetary, demand. As productive, activity increases, the demand for money and credit expands to a very large extent and vice versa in the opposite position of a slump,

(*ii*) The impact of the trade cycle on the producers goods industries is much higher and much more serious than on consumers goods industries.

The cause of the trade cycle may be primarily external to the economy, or internal, and each category has certain theories to its credit. We can dispense with the external theories first, because they have been proved to be obsolete by the advances of modern economics.

There are two external theories attempting at an explanation of the trade cycle: the physical and the psychological theories. The physical-theory, called the sun-spot weather crop theory, tried to seek for a cause of the boom and slump in the changes in weather brought about by sun-spots. This theory was controversial in itself; it could not decide if good crops would lower incomes (through the adverse effect of increased supply on prices) or raise them. (It also concluded that sun-spots had their influence upon business through the optimism and pessimism of the business men, also affected by sun-spots.)

The psychological theory held the cause of the business-cycle to be the psychology of the business men. They just 'feel' a particular period of time to be more propitious for expansion, and at other times they contract their activities just without any reason, because they 'feel' such activity would be unprofitable.

Then we come to the purely internal theories, and there has been sharp competition among them to obtain a place of importance in this respect. The crudest of these is the Innovations Theory, that these fluctuations occur because of the introduction of new method of production or a new product, or the opening of a new market, and raw material resources, and a substantive change in the organization of business. But this theory, also, is no satisfactory explanation of this complex phenomenon.

Then comes the Quantity Theory of money, which has kept the field for a considerable period of time. It is the classical treatment of the problem of trade cycle; (it analyses this problem in terms of changes in the quantity of money, its inverse the value of money, and the price level). This theory assumes a level of full employment in the economy to be present, so that the problem is only of changes in the price-level. This theory explains this phenomenon in terms of a simplified equation:

$$MV = PT$$

which means that the sum of money used and its velocity of circulation (MV) are equal to the value of goods sold (PT). This was the simple equation of exchange, only a truism to explain that the value of money used in exchange equals the price paid for it. It does not tell which is the cause and which the effect of the fluctuations. It could mean either way: an increase in the quantity of money and the velocity of its circulation with constant PT may raise prices and reduce the value of money.

Alternatively, an increase in T with constant MV may result in lowering prices, and raising the value of money. This equation, however, had certain fundamental flaws, so that it could not explain why inflation or depression starts even when there is no change in the quantity of money. The Quantity Theory, at best, thus, is an imperfect guide to the causes of trade cycle; (the quantity of money is the dominant influence on the price-level only in the long periods). It tells us "how it works?" but is unable to analyze "why it works so?"

This theory was modified 1ater, and a new concept of income was introduced along with the variables of M, V, P and T and a new equation came into being,

$$My\ Vy = Py\ Ty$$

This meant that both the money spent and the transactions made depended upon incomes; but this could not satisfy the problem either. The only conclusion if reached was that the sudden lack of demand which causes a depression is due less to a lack of money than to a lack of incomes.

Apart from the Quantity Theory of money, there are certain other theories which changed the focus of their attention from money to savings, investment and consumption. (The first group of these held over-savings to be the cause of these depressions, that money once saved went out of the stream of purchasing power for ever, thus forcing under-consumption on people). Such saving meant that a disequilibrium in production and consumption would arise and so would result in depression This theory, however, proved inadequate to account for the upward swing of the trade cycle.

Another theory was forwarded by Hobson on almost the same lines. He emphasized the fact that it is over-production relative to the demand that causes these disturbances in the price-level, that savings and investments get too large, the one reducing the purchasing power with consumers, the other increasing production, resulting in a trade cycle. Also, the maldistribution of incomes between rich and poor is responsible for aggravating the situation still further. The trouble with this theory is that Hobson misjudged the consequence of over-investment, and thus the theory may hold itself under certain circumstances, but the reasons given are wrong.

Hewtrey may be mentioned after this, who held trade cycle to be a purely monetary phenomenon. He started with the demand for goods and services which in turn raises the demand for money, and this, causes imbalance in the price-level. He held that demand means a flow of money determined by consumer's outlays, *i.e.*, the expenditure of consumers from a given income. (This expenditure is on consumers current goods and durable goods and is dependent on the amount of money

available.) These two, in relation with each other, are responsible for fluctuations in business activity, other things affect indirectly or remotely. The flow of money is affected by the creation of credit by banks and the cash balances of consumers. An alternative theory was developed by Professor F. A. von Hayek which runs in terms of monetary causes and changes in interest rates. But this along with Schumpeter's theory, can be explained better, in terms of Keynes' Saving and Investment Theory, alternatively called the Theory of Employment.

Keynes theory is explained with his dynamic variables of the marginal propensity to save and to invest. He maintains that out of all levels of income, there is a tendency for consumption to be always less than income, *i.e.*, the marginal propensity to consume is always less than one. This leaves a savings gap, which must be invested in order to keep the next circle of income in pace with the first one. Thus, theoretically,

$$Y = C + S = I$$

Savings, when invested, have tendency to have a multiplied effect on income, resulting is an increase in income more; than proportionate to the initial increase in investment. This process of multiplication of income through the vicious circle of increased investment, increased incomes, more savings, and higher investment, goes on in spite of time lags, leakages and other bottlenecks involved, until it reaches the full employ merit level. From here, if the process does not meet any check, it may lead to inflation, and even hyper-inflation, when investment is very high due to the low rate of interest (result of higher savings) and the higher profits. At this point, however, the check comes in the form of falling marginal efficiency of capital, which results from too much accumulation of capital invested and many other factors; the expectations of the business men begin to fall and the downward trend begins — all because savings are left behind by investment. Then the new process of contraction starts when investment lags behind savings, and with this starts gradual unemployment, lower National Income, reduced consumption and savings and this process goes on till the bottom of depression is reached. This, then, is a point at which consumption cannot fall lower, disinvestment has been so complete that with the constant marginal propensity to consume, the business men start thinking of replenishing their capital stocks. New investment starts again, and thus the process of revival begins. This makes it clear that it is not a lack of money which brings about a depression, (or vice versa in case of a boom period) but the chase of investment and savings which results in such phenomenon. As such, Keynes maintained, fiscal measures are required to cope with such situations, and not only monetary measures.

A comparison between the Classical and the Keynesian approach would be suitable here. The main difference is that for the Classicists, full employment was

the rule rather than an end; trade cycle was only deviations from the full employment level, brought about by changes in the quantity of money and the price-level. Keynes deviated from this system, and basing his analysis of the trade cycle on the Great Depression of the Thirties he proved that trade cycle is not purely a monetary phenomenon. This led to the logical conclusion of a Secular Stagnation Theory, for which Keynes has been dubbed as a depression Economist. This theory explains the semi-permanent tendency of a mature economy to persist into at an under-employment equilibrium level because of a lack of effective demand, *i.e.*, C + I falls short of Y.

The problem of a trade cycle is thus two-fold, there may be developing an inflationary gap when the upward swing of the trade cycle is in force, or, on the other hand, a deflationary gap may be in force when the downward swing of economic activity is in action. The Measures to check these trends may broadly be classified as —

1. Monetary Measures.
2. Fiscal Measures.
3. Non-monetary, Non-fiscal Measures.

The primary object of all these three categories is to attain an equilibrium between savings and investment at the full employment level, and to maintain it so. And that is the basic problem of a trade cycle.

—— - ——