

TRADE CYCLES

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Trade cycles are wavelike movements of economic activity as a whole, marked by successive periods of rise and fall. It is not movements or variations that create problems but movements of an undesirable nature, like the contraction of production and employment which occur during the recession phase. Movement in economic activity is in fact essential for progress. During these wavelike movements employment, prices, consumer's expenditure, production and investment successively rise and fall. According to Hawtrey the fluctuations of employment and the fluctuations of prices are the two conspicuous symptoms of the cycle. His definition of trade cycle runs: "The trade cycle is composed of periods of good trade characterized by rising prices and low unemployment percentages, alternating with periods of bad trade characterized by low prices and high unemployment percentage."

The movements of prices and employment are not haphazard but are marked by considerable regularity. There is the upward movement extending over some years followed by the downswing which also continues for some years before it again gives way to the upswing. There is also found a considerable amount of uniformity in the length of the cycle which is usually eight or nine years — seldom, unless of course there are exogenous factors operating such as a war, less than six years or more than eleven. Mitchell, however, feels that this regularity should not be exaggerated too much. He says "successive cycles differ not only in length, but also in violence, and in the relative prominence of their various manifestation." This is because business situation is the resultant of "complex forces among which the rhythm of business activity is only one. Harvest conditions, domestic politics, changes in monetary and banking systems, international relations, the making of war or peace, the discovery of new industrial methods or resources and a thousand other matters all affect the prospects of profits favourably or adversely and therefore tend to quicken or slacken the pace of business." This fact, that is, that cycles differ in severity, amplitude and duration is borne out by other students of business cycle also. The variations are so marked in certain cases that some people deny that they are truly cyclical.

The movements in prices and employment are moreover, synchronic not only in different industries but also in different countries. This is but natural because the demand for the products of the various countries is interlinked.

Prosperity in one industry creates a demand for the products of others, and they in turn become prosperous creating further demand for one another's products. The psychological factor also plays an important part. Optimism and pessimism in one industry like a contagious disease spread to other industries. It should not from this be inferred that all industries are affected by a depression or a boom to the same degree. No two industries are affected by a business cycle in the same way; some are hit early and hit hard, while others may feel only slightly any fluctuation in business activity. Industries making goods which do not form the necessary consumption of the public, *i.e.* durable goods suffer the greatest during a depression and do best in a boom. Consumption goods industries show no very wide fluctuations. The international character of the trade cycle can be explained by the same two facts: the demands of the countries for each other's goods and the psychology of the business class. Pessimism once started quickly becomes universal. The greater the international trade the more easily will depressions and booms in a particular country be transmitted all over the world.

Types of Cycles

We have so far referred in particular to only one type of cycle, the 'trade' cycle — one which is perhaps the most important and with which we shall be primarily concerned. But it should be pointed out that there is not just one wave-like movement pervading economic life. Some students of business cycles believe that three types of cycles can be discerned, the three-cycle scheme suggested by J. A. Shumpeter is that there are the major cycles, the minor cycles and the long waves.

The Major Cycles

They are the fluctuations which are implied when most persons use the term trade cycle. They are the type of cycles which most influence the activities of the businessmen. Major cycles average between 8 and 9 years from boom to boom but vary between 6 and 11 years.

The major cycles have been traced by many eminent students, because of their very great importance from practical point of view. the curse of unemployment and the wastage of potential wealth can be rightly attributed to these cycles.

Minor Cycles

They approximately have a duration of forty months. The existence of these shorter cycles has been pointed out repeatedly these hundred years or more, and still oftener has it been felt and recognized implicitly. Their establishment is chiefly due to the two studies by Mr. Kitchin and Professor

Crum. These cycles have little effect on the day to day operations of most business. Only those industries, particularly heavy industries and certain kinds of consumer durables, which are very sensitive to cyclical movement may be effected. Firms which sell basic foods and low-price clothing etc. may be hardly aware of them.

These short-term cycles are superimposed on the major cycles — when the booms and depressions of the two cycles fall on one another they shall be intensified.

Long Waves

This cycle which is sometimes called “Kondratieff Cycle” after the name of the economist who has worked it out in the greatest detail, has a period between forty-five and sixty years. It has been occasionally recognized and even measured before Kondratieff by Spiethoff.

Superimposed on the “Kondratieff Cycle” is the Major cycle just as the minor cycle is superimposed on the major cycle. Good times are more prevalent during the rising phase of the “Kondratieff Cycle” and had times during the falling phase. Hansen has found that in each of the long periods of good times there developed four major recoveries and three major depressions. In the downswing of the “Kondratieff Cycle” there developed two major recoveries and three depressions.

Special Cycles

There are numerous types of special cycles which can be found in particular kinds of economic series. One of the most important is perhaps the building cycle which seems to have a duration of about seventeen years. Cycles in crops, weather, migration etc. are other examples.

The trade cycle, we can say, in general has four phases. (There could be a further sub-division for a more detailed study. The National Bureau of Economic Research, for instance, divides each reference cycle into nine stages). They are:

1. The Upswing — during this phase there is general prosperity and expansion. Prices rise, unemployment percentages are low, there is an ever increasing demand both for consumption and durable goods resulting in greater activity and further fall of unemployment. This process continues cumulatively for some years.

2. The Downswing — prices fall and unemployment increases during this phase. Profits decrease which result in lesser activity and rapidly falling

demand especially for the durable goods. This is in short a period of depression and contraction all round.

3. The upper turning point, *i.e.* the turn from prosperity to depression. This is always sharp and can be easily discerned.

4. The low-turning point, *i.e.* the change from depression to prosperity. This change is always slow and gradual and not noticeable at the time.

In the last half century, economists, business leaders and government officials have been giving more and more thought to this complex problem of the trade cycles. This can be explained by the fact that there has been noted a tendency for the inherent instability of the economic system to increase. As the reports of the Delegation on Economic Depression has clearly pointed out “As industrialization progresses and a greater proportion of the total productive forces of any country is devoted to the manufacture of capital goods, the instability of the economic system increases, depressions are liable to become more intense and the risk of employment becomes more serious.”

In spite of these serious studies it must be admitted that we have not yet reached a full understanding of the causes of this complex phenomena. Various explanations have been given by leading economists but there is no explanation that is accepted by all as accounting for the trade cycle. In his General Theory, Keynes has offered an explanation of what determines the level of employment and income at a particular time. Since as has already been said a trade cycle is nothing but a rhythmic fluctuation in the overall level of employment, income and output, Keynes’ explanation also provides a theory of the trade cycle. Since this theory is at the present day quoted as the best and the nearest approach to a true explanation of the trade cycle, we shall discuss it briefly and see how it is an improvement upon the various other theories, some of which have no doubt contributed considerable towards it. It is even contended by some that Keynes hardly said anything new and somewhere in economic literature every element of Keynesian system was at some time discussed. This may be true, Keynes’ ideas may be found expressed earlier, but “no single theorist worked out a complete and determinate model based on (1) the propensity to consume, (2) the marginal efficiency of capital and (3) the liquidity preference. All the predecessors of Keynes failed to make use of one or more of the Keynesian ideas” (KLEIN — THE KEYNESIAN REVOLUTION).

The Saving and Investment Theory

Any theory of the trade cycle must explain three facts. Firstly it must explain the cumulative nature of expansions and contractions which gradually exhaust themselves. Secondly it must explain the certain degree of regularity

and timing in the duration of these expansions and contractions. An lastly why is it that the transformation from boom to slump is a violent one while the turning point from contraction to expansion is usually more gradual and imperceptible.

According to Keynes employment and income at any time depend upon effective demand. Effective demand is determined by the propensity to consume and volume of investment. Changes in propensity to consume and volume of investment manifest themselves in changes in employment and income. Keynes assumes that propensity to consume is relatively stable in the short period. Depending, at any time, upon the established customs of the community, the distribution of income, tax system etc., it does not change to an important degree in the short period.

The volume of investment (investment does not mean buying bonds and shares, or expenditure on old capital goods, investment is the monetary outlay on new capital goods) is dependent upon two factors; the current rate of interest and the expected rate of profit, *i.e.* marginal efficiency of capital. The current rate of interest refers to the rate which has to be paid to overcome people's liquidity preference and the expected rate of profit is the percentage return on capital outlay over the original cost which the entrepreneurs expect to receive on their investments.

Liquidity preference and the quantity of money which determine the rate of interest do not change significantly and therefore the rate of interest is relatively stable (in short period).

Thus, of the three independent variable factors (the marginal efficiency of capital, the rate of interest and the propensity to consume) it is the marginal efficiency of capital that plays the all important role in trade cycles. Keynes finds, therefore, the essence of trade cycle in variations in the rate of investment caused by cyclical fluctuations in the marginal efficiency of capital.

Let us see how far this approach explains the three tests which we laid down for any theory of trade cycle.

Course and Phases of the Trade Cycle

We shall begin our sketch of the trade cycle with the point where depression has given way to recovery and the period of expansion has begun. People are optimistic, the confidence in future is high and the expected rate of profits is bright, *i.e.*, there is a high marginal efficiency of capital. The result is a high volume of investment, which means rising employment. Through the multiplier effect each increment of new investment stimulates

consumption to cause a multiple increase in incomes. The marginal efficiency of capital continues to increase with increasing profits and the prevailing opinion is that the business activity will continue to improve. This makes the process cumulative. Why does this process of expansion, which at one time looks never ending, does ultimately give way to depression? Why cannot it continue for ever? It could if marginal efficiency of capital continued to increase for ever but that is not the case. With continued expansion, forces are brought into play which lower the marginal efficiency of capital. There are firstly after the full employment level, no idle resources and this shortage of material and labour increases the cost of production of new capital assets. Secondly the propensity to consume is less than unity which means that consumers are not willing to spend as much on final output as the increment of income warrants. This coupled with the fact that increase in income always means a greater part going to the business class (whose propensity to consume is low) than to the wage-earners brings about a decline in effective demand relative to increased income and output. These two factors destroy the psychological optimism and confidence in future is shaken and the marginal efficiency of capital collapses.

The depression following collapse of the marginal efficiency of capital proceeds more rapidly than the recovery both because of the multiplier effects and the rise in the rate of interest. (The rate of interest initially rises because the liquidity preference goes up as a result of the desire to liquidate inventories and securities whose prices are falling, the postponement of purchases in view of falling prices, and the need for money to meet contractual obligations). With the marginal efficiency of capital standing at a low level, there is a fall in investment and employment is pushed lower. Decreased investment through multiplier effects results in a much greater decrease in incomes which reflects back upon investment through lower demand. This process continues till recovery sets in again. The time that will elapse before the expansion begins depends upon (1) the time necessary for the wearing out and obsolescence of durable goods and (2) the time that elapses before heavy stocks, which have been piled up during the prosperous period, can be liquidated. During the period in which this depletion of the stocks is going on, it is an important cause of "dis-investment" which has effects contrary to positive investment. When the absorption of the stocks is over there will be an improvement in employment even if there is no increase in consumption or investment. Moreover as the capital goods grow scarce due to depreciation and obsolescence the marginal efficiency of capital will rise. The rise in marginal efficiency of capital coupled with the low interest rates which prevail due to excess of funds available, even after a high liquidity preference is satisfied, will increase the

inducement to invest and the expansion period will begin once again. Thus we find that Keynes satisfactorily explains the cumulative nature of both expansion and contraction which ultimately give birth to each other.

Why does the trade cycle take approximately the same time to work itself out on different occasions? This is our second question.

We mentioned just now that the surplus stocks which collect at the top of the boom are absorbed in the course of the depression. This together with time taken for the wearing out of capital assets determines the approximate length of time of the depression.

The length of the boom is determined roughly, by the time which must elapse before a sufficient increase in capital assets may take place and cause a break in the marginal efficiency of capital.

These two periods are determined by the particular stage of economic development and are liable to variations but normally the period does not vary much and the time of a complete cycle is more or less fixed.

The tendency for a sharp reversal at the top and a very gradual one at the bottom can be explained by the following factors.

(1) The determining influence in the trade cycle, as we have seen, is that of investment which depends upon expectation of profits. It is very easy to make one feel that prospects are dark, but the change from depression to boom requires the restoration of confidence which is not an easy factor. Collapse in the marginal efficiency of capital is sharp and sudden. As Keynes has said "It is of the nature of organized investment market — that, when disillusion falls upon an over-optimistic and over-bought market, it should fall with a sudden and even catastrophic force."

(2) The presence of a large amount of stocks at the top of the boom also play a part. The holders of the stocks in view of the uncertain future wish to get rid of these stocks as quickly as possible.

(3) If the boom is brought to an end through a shortage of money that too is sharp.

Saving and Investment Theory Vs. Other Theories

As we have said already, Keynes' ideas were expressed earlier in other theories but it shall probably never be possible to know how much stimulation Keynes received from many of his anticipators. The theories which have been propounded in the explanation of the trade cycle are numerous — we shall take only the two or three important ones and see briefly how Keynes explanation is superior to them.

1. Hawtry in his pure Monetary Theory attributes the trade cycle solely to the changes in the 'Flow of Money'. According to him easy money conditions could stimulate any revival and the expansion phase could continue indefinitely if credit could be expanded indefinitely. Keynes has said that investment does not solely depend upon the rate of interest (introducing the other factor — the marginal efficiency of capital) nor is investment indefinitely expansible and this is proved by experience.

2. The monetary over-investment theories (Wicksell, Mises, Hayek, Robbins etc.) also believed that the manipulation of interest rates could ensure full employment. They said that if the 'market rate' of interest was below the 'natural rate' there would be expansion. They did not realize that the natural rate may be so low that no practical low market rate would be low enough to stimulate investment. Again their explanation of the upturn is quite the opposite of Keynesian theory. They said that the expansion came to an end due to a mistaken banking policy or a lack of saving — investment opportunities were inexhaustible. Keynes' explanation attributes the upper turning point to an excess of saving.

Their concept of natural rate is somewhat related to Keynes' concept of the marginal efficiency of capital. They defined natural rate as the expected net return on new investment and their cost of production, pointing out thus the importance of entrepreneurial expectations in shaping the decisions to invest.

3. The non-monetary over-investment theorists (Spiethoff, Cassel etc.) believe that the moving force behind cyclical fluctuations is the level of investment, and come therefore much closer to Keynes. 'For Keynes the mischief maker has always been the ever changing rate of investment' (Klien — *Keynesian Revolution*).

They do not, however, explain the upper turning point satisfactorily attributing it to the lack of capital which could be avoided if people refrained from consuming too much. They did not consider the lack of investment opportunities. Keynes has emphasized both consumption and investment as factors contributing towards increased income and employment.

4. The underconsumptionists traced the cause of the trade cycle to the 'oversaving' (resulting from maldistribution of incomes), which leads to 'an accumulation of capital' releasing a flood of goods so great that consumers' demand is incapable of absorbing them. The crucial flaw in their theory lies in the tacit assumption that all savings pass automatically into investment. This is a wrong assumption for it is not the savings which are invested which

cause the trouble but the savings which fall to be invested. The fault is of under-investment than of over-investment.

But in spite of the fact that the underconsumptionists had faulty theoretical structure their policy measures are quite in accordance with those of Keynes.

- (i) They would like Keynes, advocate greater expenditure on consumption.
- (ii) They explicitly state that capital formation owes itself not so much to saving as the actual or expected demand for consumption.
- (iii) They too like Keynes recommend the redistribution of incomes in a more equitable manner in order to increase the demand for consumption goods and services.

Keynes advocates also an increase in investment — ‘advancing on both fronts at one’ — but this the underconsumptionists feel is the root of the depression.

We have, thus, found the saving and investment theory a fairly satisfactory explanation of the trade cycle. It is a definite improvement upon all theories so far advocated by different economists and is coming to find greater and greater favour in all countries.

There are, however, some criticisms leveled against it by certain economists, especially against the concept of saving and its negligence of the consumption function as a variable factor, etc. They would not give this theory a universal acceptance. In fact it is hardly possible for such a complex phenomena to be explained by any one factor.

We cannot as Habler says “speak of *the cause* of the business cycle.” But we have still to contend by saying, that, so far at least, Keynes’ explanation is perhaps the best single approach to the trade cycle.

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TRADE CYCLE

The human race faces three gigantic problems, the solution of any one of which will vastly increase the happiness of mankind, while any one if it is not solved may lead to ruin. These three are the problems of abolishing armed conflict between states, the problems of ensuring that enough human beings are born to keep the race alive and the problem of removing the trade cycle. The last is not the least.