The Business or Trade Cycle

Specification—The impact of the Business Cycle on business activity.

The Business Cycle, also called the Economic or Trade Cycle, has been studied by economists for over 100 years.. We all know of its effects. Sometimes the economy is booming are other times when economy is in recession. During times of boom unemployment is relatively low, wages are rising and inflation is also likely to be rising. During times of recession unemployment is relatively high, wages may be stagnant and inflation is likely to be low.

Within A Level Business Studies we need to examine the parts of the business cycle, what causes the fluctuations in the cycle and the implications of the business cycle for businesses.

The parts or phases of the Business Cycle.

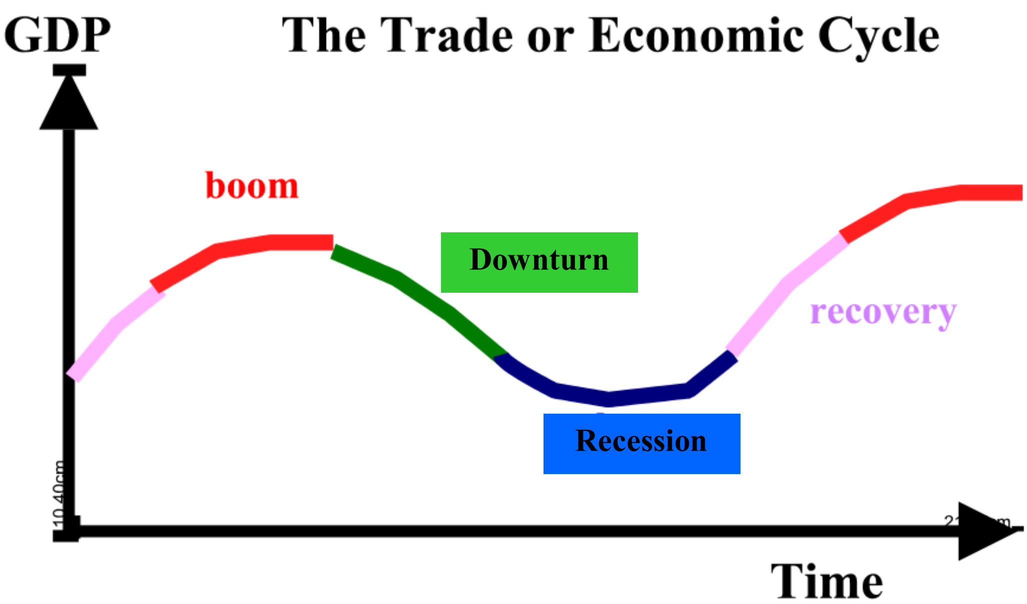
Within the UK economy the business cycle typically moves from boom to bust over a 4 to 7 year period. But we did have a much longer than average period of uninterrupted growth between 1993 and 2008. Within this cycle there are four distinct phases.

Note. The business cycle measures fluctuations in GDP over time. GDP (Gross Domestic Product), is a measure of the value of all outputs in the economy over time. The current value of UK GDP (2009) is around £1400 Billion, and over the last 40 years GDP has increased on average by around 2.25% per year in real terms (i.e. allowing for inflation)

The Four Phases of the Business Cycle

Boom

This phase is marked by low unemployment or even full employment in certain sectors of the economy, increasing interest rates, increasing inflation, high consumer demand, a balance of payments deficit and often a budget surplus for the government caused by high tax revenues and lower expenditure on Social Security.



Downturn

Following boom comes the downturn. During this phase we see increasing unemployment, falling demand from consumers, falling investment by firms and a decline in the levels of inflation and interest rates. A downturn happens when growth in gross domestic product falls from perhaps 3% a year to 1% a year.

Recession
The next phase is recession, the bottom of the business cycle. In this stage unemployment is relatively high, inflation is low, demand from consumers is low especially in regard to consumer durables (cars, fridges, washing machines etc.) and luxuries such as foreign holidays , there is very little investment by firms. The economy is shrinking in size, two consecutive quarters of negative growth is the strict definition of a recession. Sometime it takes a long time to recover from a recession, and rates of growth stay low (below 1% a year), this is the situation in the UK 2008-12.

Recovery
The final phase is recovery, during this phase investment by firms increases, unemployment falls and consumers start to spend again. Doing the first part of recovery there is little inflation or pressure for increased wages as there is spare capacity for firms, and no shortage of workers. But as we progress through recovery there will be inflation when there are shortages of labour, housing, capital etc,

Causes of Fluctuations in the Business Cycle

There are four main contributors to the pattern of fluctuation. The first contributors are consumers, the second businesses, the third government, and fourth external factors such as world economic conditions.

Consumers and the Business Cycle
The activities of consumers are often quite predictable. During the bust phase consumer spending is low, people do not have the confidence to spend on large consumer items or other luxury goods. They may feel insecure about their position in work, they may be unemployed, or they may just be waiting for signs of recovery in the economy. Instead of buying consumer durables such as TVs, washing machines or cars, they will defer the purchase of these goods and continue to use their existing consumer durables.

A time will be reached where interest rates and inflation are so low, and that the rate of increase in unemployment slows, so that some confidence returns, this will encourage borrowing and spending. Demand will increase, and so output by firms will increase. As this increase in demand grows in momentum then the recovery phase of the business cycle starts. As more people will be employed, more people will have greater confidence in the future, so again demand will increase. This increase in demand will be especially evident in markets such as housing and luxury goods.

It is worth noting that the activities of consumers are not always predictable. During the period 92-94 all the conditions were ripe for an economic recovery, but consumers refused to spend, they still remembered the boom and bust of the late 80's and were lacking confidence in the future. It will be interesting to see if consumers in 2013 will be willing to spend again, and jump back into the housing market after the recent fall in housing prices and the problems in the banking system.

As the economy moves through the recovery phase, interest rates and inflation will start to rise. These increases will eventually put a limit on the growth in consumer spending . Expensive borrowing will discourage long term financial commitments. There will be a point where consumer's spending will start to decline, or the rate of increase in spending will fall. At this point we reach the top of the boom phase and perhaps start to move into recession. Although levels of demand are still high, people will now feel less secure about the future and start limiting demand especially where long-term commitments are involved, such as buying a car or purchasing houses. As the recession gathers momentum, redundancies start to mount, often reported on the news every night, people feel even less secure about the future and so again demand starts to fall. This continued fall in demand causes an increase in recession, and so self perpetuates the business cycle effect.

Business and Industry

In regard to business, in the bust phase firms have often suffer from cash flow problems and lack of working capital. Banks are unwilling to lend to what they see as risky businesses, but their unwillingness to lend increases the risk of the firms failure. There is plenty of spare capacity in industry, this leads to lack of return on previous investment and unemployment levels of all factors of production are high.

Because of the higher levels of spare capacity and lower cost of factors of production such as borrowing money, employing land and labour, a point will be reached where businesses can employ extra resources at a relatively low cost, so profits can be made by selling at relatively low prices. This will encourage investment and output. This increased investment in stock for sale is often a response to increasing consumer demand, or the increased investment may be caused by increasing levels of exports, this is especially likely the if the value of the pound is low making British goods cheap to foreign purchases. As the recovery phase gathers momentum , investment in capital goods increases, (as spare capacity is used up) along with consumer demand, this encourages further investment, which can still be achieved at relatively low cost. At this stage in the business cycle demand might outstrip supply, so firms can increase prices, maximising profits, but this in turn may lead to inflation.

As the recovery phase progress there will appear shortages of land and labour in specific areas and industries. There may be shortages of specialist skills required or shortages of land in such regions as the southeast. This will lead to inflationary pressure on wages, the cost of land and on the cost of borrowing, causing interest rates is to increase. It is worth noting that some regions of the country might be booming, whilst others still have a long way to go before recovery fully sets in.

As inflationary pressure builds this discourages investment as firms are now less likely to gain an adequate return on the cost of investment. During the recovery stage, firms often build large stocks in the expectation of later sale and to meet increasing demand. But towards the end of the recovery phase these stocks are rundown, this happens because management believe that it may soon be hard dispose of these high levels of stocks. This is running down of inventories is known as destocking.

This combination of falling investments and running down of stocks leads to the end of growth and the beginning of a recessionary period. During this period of the business cycle, firms will have to start cutting prices to dispose of their goods and also start reducing their costs. This reduction in costs often requires large numbers of redundancies, short-time working or pay cuts. Firms can also suffer from cash flow problems. Firms who have over extended themselves by borrowing heavily during the recovery or boom phase may find that they have liquidity problems and therefore have to cease trading. It is in this recessionary phase that most business failures occur.

Eventually the point is reached where investments levels are falling no more but there is very little new investment. Firms concentrate on trying to sell through lower prices and minimising their costs. This is typical of the situation in the bust phase.

It is worth noting that some businesses look forward to recessionary and bust periods, as this is when demand for their goods and services are most buoyant. These businesses include low cost clothing shops, low price basic supermarkets (aldi and Lidl), firms that offer money for valuable possessions (pawnbrokers) and even holiday companies concentrating on holidays in the UK. These firms have reverse trading cycles i.e. their sales boom during recessions, but suffer during booms!

Other companies can suffer more than others from the fluctuations in the trade cycle. These are industries that suffer from an exaggerated trade cycles. A good example are manufacturers of haulage vehicles, such as trucks, lorries and vans e.g. LDV. In a boom, new businesses are demanding these products like they are the only thing to be seen with, but once recession hits, and firms start going out of business, the market can be flooded with second hand vehicles at bargain prices, and demand for new evaporates.

Effects of Trade Cycle on Business

Throughout the trade cycle businesses will suffer from a range of benefits and pressures. These can have a major impact upon the operation of firms, and the awareness of these impacts can often dictate business planning.

Recovery.
Improved demand will benefit businesses, turnover increases and so do profits. As the recovery progresses prices can be increased and profits maximised. There is often pressure to invest, and management of expansion is one difficulty faced by management. During the later stages of recovery, firms will find that pressure on wages mounts, increasing costs. Often firms focus on profitable home markets, and do not try to win export markets.

Boom.
Firms must balance maximising profits with the risks of overextending themselves should recession come. Should prices be pushed to the limit, or should firms concentrate on providing customer value? Profits will be lost if stocks are not built and sold, but high stock levels can sow the seeds of cash flow and liquidity problems during the recession which is likely to follow.

Recession.
As the economy moves from stowing of growth into an actual recession, it becomes the time for shedding labour. Firms with lost orders and lower demand start to make workers redundant. Redundancies can be expensive, and can cause resentment and de-motivation amongst those employees who feel their jobs might be the next to go. Also further HRM problems can

be caused by lack of opportunity for overtime, short time working, and the likelihood of reduced wages. Short-time working can become the norm in some industries, (only working 3 days a week instead of 5) and firms sometimes temporarily close down entire plants (e.g. Tata Steel), mothballing the facility, so it is ready to be used when demand picks up again.

Liquidity and cash flow problems can also occur at this time. Firms that have over borrowed during a boom may have problems meeting debt repayments and cash flow can be affected by the likely increase in bad debts (as other businesses fail) and problems in disposing of existing stocks.

In a recession the government is likely be forced to increase taxes or borrow heavily in an attempt to balance its books. These Fiscal policies can have the effect of further reducing total demand in the economy. Current macro economic policy (2012-13) is focused on keeping interest rates low to stimulate demand, and limiting growth in government spending. If the government needs to raise more money to fund spending, this means increased taxes. Increased taxes can directly impact firms, increasing their costs, and indirectly by leaving consumers with less money to spend. Many firms believe that this is the time for retrenchment, concentrating on core business strengths. Others may look for the opportunity to buy and employ resources cheap, taking advantage of low costs. Other firms will look for overseas markets, where demand may still be buoyant.

For those firms whose cash reserves and resources are low, survival may be the best that they can hope for. Firms must be ready to use spare capacity when recovery comes, and be first into the new expanding markets as consumer demand recovers. But in the mean time they must cut costs.

Exaggerated Business or Trading Cycles.

As already noted some industries suffer from exaggerated business cycles. This means that as the economy moves from boom to bust and back again, there will be very large fluctuations in demand levels. Examples of these type of industries are aircraft manufacturers and commercial vehicle manufacturers. The key to success in these industries is size, gaining from economies of scale, and a presence in the multi national market, which will hopefully even out over-all sales, (sales fall in one country but rise in another).

Notes