CHAPTER 5

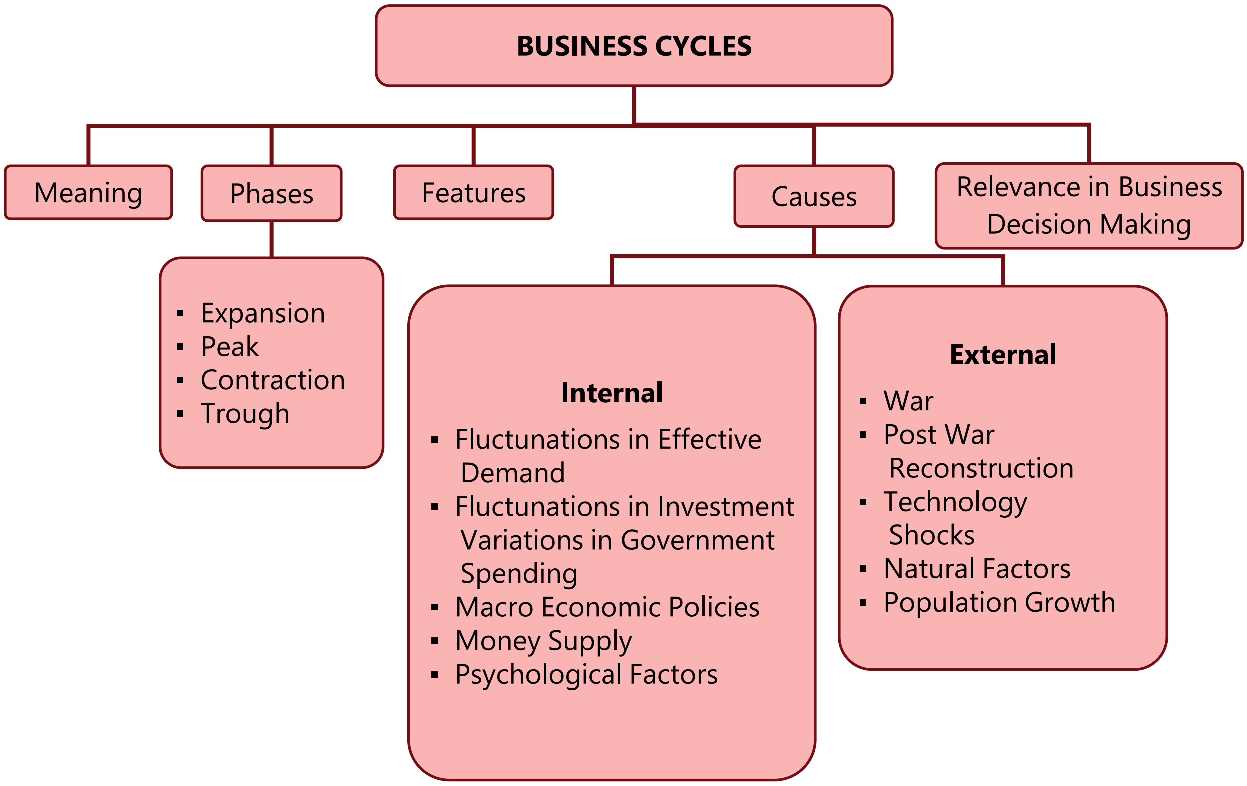
BUSINESS CYCLES

LEARNING OUTCOMES

After studying this unit, you would be able to:

- Explain the Meaning of Business Cycles.
- Describe the Different Phases of Business Cycles.
- Explain the Features of Business Cycles.
- Explain the General Causes behind these Cycles.
- Elucidate the relevance of Business Cycles in Business Decision Making.

CHAPTER OVERVIEW



5.0 INTRODUCTION

Consider the following:

1. During 1920s, UK saw rapid growth in Gross Domestic Product (GDP), production levels and living standards. The growth was fuelled by new technologies and production processes such as the assembly line. The economic growth also caused an unprecedented rise in stock market values.
2. China's recent economic slowdown and financial mayhem are fostering a cycle of decline and panic across much of the world, as countries of nearly every continent see escalating risks of prolonged slumps, political disruption and financial losses.

What are these? These are examples of business cycles. The first example shows that the UK economy was going through boom during 1920s while the second example of the recent slowdown in China indicates the beginning of a recessionary phase.

We have seen in chapter 1 that Economics is concerned with fluctuations in economic activities. The economic history of nearly all countries point towards the fact that they have gone through fluctuations in economic activities i.e. there have been periods of prosperity alternating with periods of economic downturns. These rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles. A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentage, altering with periods of bad trade characterised by falling prices and high unemployment percentages. In other words, business cycle refers to alternate expansion and contraction of overall business activity as manifested in fluctuations in measures of aggregate economic activity, such as, gross national product, employment and income.

A noteworthy characteristic of these economic fluctuations is that they are recurrent and occur periodically. That is, they occur again and again but not always at regular intervals, nor are they of the same length. It has been observed that some business cycles have been long, lasting for several years while others have been short ending in two to three years.

5.1 PHASES OF BUSINESS CYCLE

We have seen above that business cycles or the periodic booms and slumps in economic activities reflect the upward and downward movements in economic variables. A typical business cycle has four distinct phases. These are:

1. Expansion (also called Boom or Upswing)
2. Peak or boom or Prosperity
3. Contraction (also called Downswing or Recession)
4. Trough or Depression

The four phases of business cycle are shown in Figure 1. The broken line (marked 'trend') represents the steady growth line or the growth of the economy when there are no business cycles. The figure starts with 'trough' when the overall economic activities i.e. production and employment, are at the lowest level. As production and employment expand, the economy revives, and it moves into the expansion path. However, since expansion cannot go on indefinitely, after reaching the 'peak', the economy starts contracting. The contraction or downturn continues till it reaches the lowest turning point i.e. 'trough'. However, after remaining at this point for some time, the economy revives again and a new cycle starts.

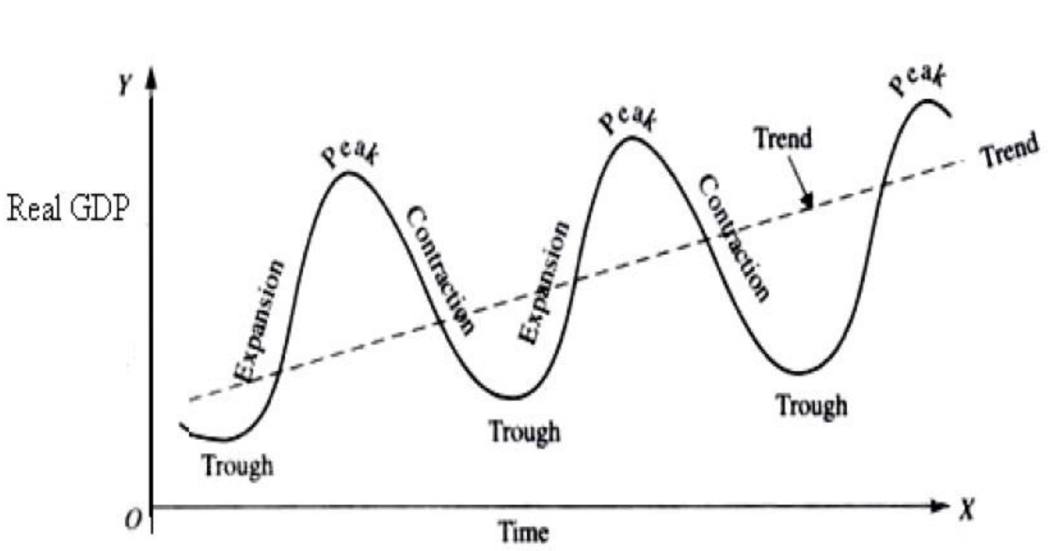


Figure 1 Phases of Business Cycle

- **Expansion:** The expansion phase is characterised by increase in national output, employment, aggregate demand, capital and consumer expenditure, sales, profits, rising stock prices and bank credit. This state continues till there is full employment of resources and production is at its maximum possible level using the available productive resources. Involuntary unemployment is almost zero and whatever unemployment is there is either frictional (i.e. due to change of jobs, or suspended work due to strikes or due to imperfect mobility of labour) or structural (i.e. unemployment caused due to structural changes in the economy). Prices and costs also tend to rise faster. Good amounts of net investment occur, and demand for all types of goods and services rises. There is altogether increasing prosperity and people enjoy high standard of living due to high levels of consumer spending, business confidence, production, factor incomes, profits and investment. The growth rate eventually slows down and reaches its peak.

- **Peak:** The term peak refers to the top or the highest point of the business cycle. In the later stages of expansion, inputs are difficult to find as they are short of their demand and therefore input prices increase. Output prices also rise rapidly leading to increased cost of living and greater strain on fixed income earners. Consumers begin to review their consumption expenditure on housing, durable goods etc. Actual demand stagnates. This is the end of expansion and it occurs when economic growth has reached a point where it will stabilize for a short time and then move in the reverse direction.

- **Contraction:** The economy cannot continue to grow endlessly. As mentioned above, once peak is reached, increase in demand is halted and starts decreasing in certain sectors. During contraction, there is fall in the levels of investment and employment. Producers do not instantaneously recognise the pulse of the economy and continue anticipating higher levels of demand, and therefore, maintain their existing levels of investment and production. The consequence is a discrepancy or mismatch between demand and supply. Supply far exceeds demand. Initially, this happens only in few sectors and at a slow pace, but rapidly spreads to all sectors. Producers being aware of the fact that they have indulged in excessive investment and over production, respond by holding back future investment plans, cancellation and stoppage of orders for equipments and all types of inputs including labour. This in turn generates a chain of reactions in the input markets and producers of capital goods and raw materials in turn respond by cancelling and curtailing their orders. This is the turning point and the beginning of recession.

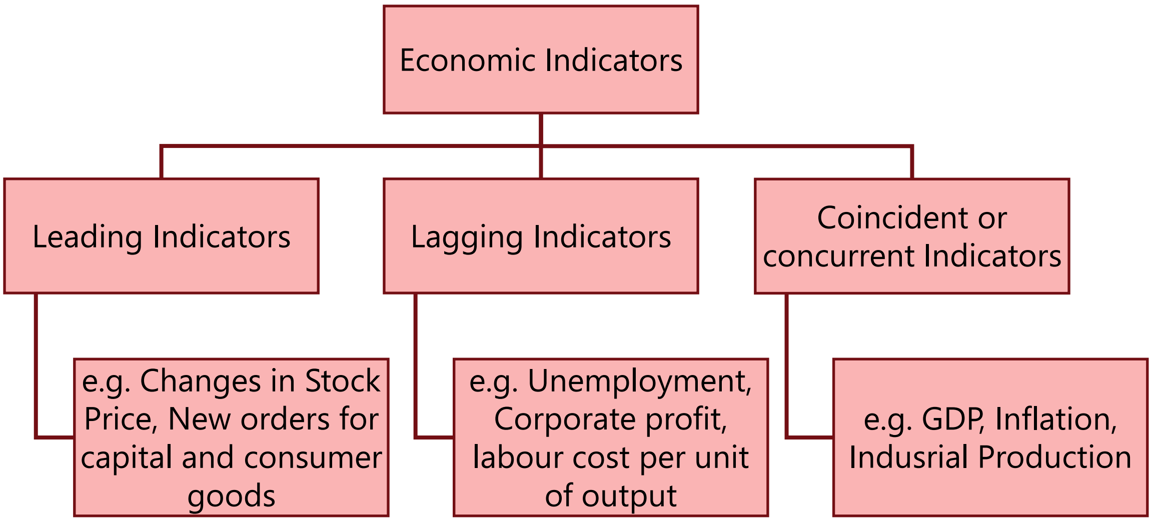
  Decrease in input demand pulls input prices down; incomes of wage and interest earners gradually decline resulting in decreased demand for goods and services. Producers lower their prices in order to dispose off their inventories and for meeting their financial obligations. Consumers, in their turn, expect further decreases in prices and postpone their purchases. With reduced consumer spending, aggregate demand falls, generally causing fall in prices. The discrepancy between demand and supply gets widened further. This process gathers speed and recession becomes severe. Investments start declining; production and employment decline resulting in further decline in incomes, demand and consumption of both capital goods and consumer goods. Business firms become pessimistic about the future state of the economy and there is a fall in profit expectations which induces them to reduce investments. Bank credit shrinks as borrowings for investment declines, investor confidence is at its lowest, stock prices fall and unemployment increases despite fall in wage rates. The process of recession is complete and the severe contraction in the economic activities pushes the economy into the phase of depression.

- **Trough and Depression:** Depression is the severe form of recession and is characterized by extremely sluggish economic activities. During this phase of the business cycle, growth rate becomes negative and the level of national income and expenditure declines rapidly. Demand for products and services decreases, prices are at their lowest and decline rapidly forcing firms to shutdown several production facilities. Since companies are unable to sustain their work force, there is mounting unemployment which leaves the consumers with very little disposable income. A typical feature of depression is the fall in the interest rate. With lower rate of interest, people's demand for holding liquid money (i.e. in cash) increases. Despite lower interest rates, the demand for credit declines because investors' confidence has fallen. Often, it also happens that the availability of credit also falls due to possible banking or financial crisis. Industries, especially capital and consumer durable goods industry, suffer from excess capacity. Large number of bankruptcies and liquidation significantly reduce the magnitude of trade and commerce. At the depth of depression, all economic activities touch the bottom and the phase of trough is reached. It is a very agonizing period causing lots of distress for all. The great depression of 1929-33 is still cited for the enormous misery and human sufferings it caused.

Recovery: The economy cannot continue to contract endlessly. It reaches the lowest level of economic activity called trough and then starts recovering. Trough generally lasts for some time and marks the end of pessimism and the beginning of optimism. This reverses the process. The process of reversal is initially felt in the labour market. Pervasive unemployment forces the workers to accept wages lower than the prevailing rates. The producers anticipate lower costs and better business environment. A time comes when business confidence takes off and gets better, consequently they start to invest again and to build stocks; the banking system starts expanding credit; technological advancements require fresh investments into new types of machines and capital goods; employment increases, aggregate demand picks up and prices gradually rise. Besides, price mechanism acts as a self-correcting process in a free enterprise economy. The spurring of investment causes recovery of the economy. This acts as a turning point from depression to expansion. As investment rises, production increases, employment improves, income improves and consumers begin to increase their expenditure. Increased spending causes increased aggregate demand and in order to fulfil the demand more goods and services are produced. Employment of labour increases, unemployment falls and expansion takes place in the economic activity.

It is to be reemphasized that no economy follows a perfectly timed cycle and that the business cycles are anything but regular. They vary in intensity and length. There is no set pattern which they follow. Some cycles may have longer periods of boom, others may have longer period of depression.

It is very difficult to predict the turning points of business cycles. Economists use changes in a variety of activities to measure the business cycle and to predict where the economy is headed towards. These are called indicators. The types of indicators are shown in the chart -



A leading indicator is a measurable economic factor that changes before the economy starts to follow a particular pattern or trend. In other words, those variables that change before the real output changes are called 'Leading indicators'. Leading indicators often change prior to large economic adjustments. For example, changes in stock prices, profit margins and profits, indices such as housing, interest rates and prices are generally seen as precursors of upturns or downturns. Similarly, value of new orders for consumer goods, new orders for plant and equipment, building permits for private houses, fraction of companies reporting slower deliveries, index of consumer confidence and money growth rate are also used for tracking and forecasting changes in business cycles. Leading indicators, though widely used to predict changes in the economy, are not always accurate. Even experts disagree on the timing of these so-called leading indicators. It may be weeks or months after a stock market crash before the economy begins to show signs of receding. Nevertheless, it may never happen.

Lagging indicators reflect the economy's historical performance and changes in these indicators are observable only after an economic trend or pattern has already occurred. In other words, variables that change after the real output changes are called 'Lagging indicators'. If leading indicators signal the onset of business cycles, lagging indicators confirm these trends. Lagging indicators consist of measures that change after an economy has entered a period of fluctuation. Some examples of lagging indicators are unemployment, corporate profits, labour cost per unit of output, interest rates, the consumer price index and commercial lending activity.

A third type of indicator is coincident indicator. Coincident economic indicators, also called concurrent indicators, coincide or occur simultaneously with the business-cycle movements. Since they coincide fairly closely with changes in the cycle of economic activity, they describe the current state of the business cycle. In other words, these indicators give information about the rate of change of the expansion or contraction of an economy more or less at the same point of time it happens. A few examples of coincident indicators are Gross Domestic Product, industrial production, inflation, personal income, retail sales and financial market trends such as stock market prices.

Examples of Business Cycles

Great Depression of 1930: The world economy suffered the longest, deepest, and the most widespread depression of the 20th century during 1930s. It started in the US and became worldwide. The global GDP fell by around 15% between 1929 and 1932. Production, employment and income fell. As far as the causes of Great Depression are concerned, there is difference of opinion amongst economists. While British economist John Maynard Keynes regarded lower aggregate expenditures in the economy to be the cause of massive decline in income and employment, monetarists opined that the Great Depression was caused by the banking crisis and low money supply. Many other economists blamed deflation, over-indebtedness, lower profits and pessimism to be the main causes of Great Depression. Whatever may be the cause of the depression, it caused wide spread distress in the world as production, employment, income and expenditure fell. The economies of the world began recovering in 1933. Increased money supply, huge international inflow of gold, increased governments' spending due to World War II etc., were some of the factors which helped economies slowly come out of recession and enter the phase of expansion and upturn.

Information Technology bubble burst of 2000: Information Technology (IT) bubble or Dot.Com bubble roughly covered the period 1997-2000. During this period, many new Internet–based companies (commonly referred as dot-com companies) were started. The low interest rates in 1998–99 encouraged the start-up internet companies to borrow from the markets. Due to rapid growth of internet and seeing vast scope in this area, venture capitalists invested huge amount in these companies. Due to over-optimism in the market, investors were less cautious. There was a great rise in their stock prices and in general, it was noticed, that companies could cause their stock prices to increase by simply adding an "e-" prefix to their name or a ".com" to the end. These companies offered their services or end products for free with the expectation that they could build enough brand awareness to charge profitable rates for their services later. As a result, these companies saw high growth and a type of bubble developed. The "growth over profits" mentality led some companies to engage in lavish internal spending, such as elaborate business facilities. These companies could not sustain long. The collapse of the bubble took place during 1999–2001. Many dot-com companies ran out of capital and were acquired or liquidated. Nearly half of the dot – com companies were either shut down or were taken over by other companies. Stock markets crashed and slowly the economies began feeling the downturn in their economic activities.

Recent Example of Business Cycle: Global Economic Crisis (2008-09): The recent global economic crisis owes its origin to US financial markets. Following Information Technology bubble burst of 2000, the US economy went into recession. In order to take the economy out of recession, the US Federal Reserve (the Central Bank of US) reduced the rate of interest. This led to large liquidity or money supply with the banks. With lower interest rates, credit became cheaper and the households, even with low creditworthiness, began to buy houses in increasing numbers. Increased demand for houses led to increased prices for them. The rising prices of housing led both households and banks to believe that prices would continue to rise. Excess liquidity with banks and availability of new financial instruments led banks to lend without checking the creditworthiness of borrowers. Loans were given even to sub-prime households and also to those persons who had no income or assets. Houses were built in excess during the boom period and due to their oversupply in the market, house prices began to decline in 2006. Housing bubble got burst in the second half of 2007. With fall in prices of houses which were held as mortgage, the sub - prime households started defaulting on a large scale in paying off their instalments. This caused huge losses to the banks. Losses in banks and other financial institutions had a chain effect and soon the whole US economy and the world economy at large felt its impact.

5.2 FEATURES OF BUSINESS CYCLES

Different business cycles differ in duration and intensity. But there are certain features which they commonly exhibit:

(a) Business cycles occur periodically although they do not exhibit the same regularity. The duration of these cycles vary. The intensity of fluctuations also varies.

(b) Business cycles have distinct phases of expansion, peak, contraction and trough. These phases seldom display smoothness and regularity. The length of each phase is also not definite.

(c) Business cycles generally originate in free market economies. They are pervasive as well. Disturbances in one or more sectors get easily transmitted to all other sectors.

(d) Although all sectors are adversely affected by business cycles, some sectors such as capital goods industries, durable consumer goods industry etc, are disproportionately affected. Moreover, compared to agricultural sector, the industrials sector is more prone to the adverse effects of trade cycles.

(e) Business cycles are exceedingly complex phenomena; they do not have uniform characteristics and causes. They are caused by varying factors. Therefore, it is difficult to make an accurate prediction of trade cycles before their occurrence.

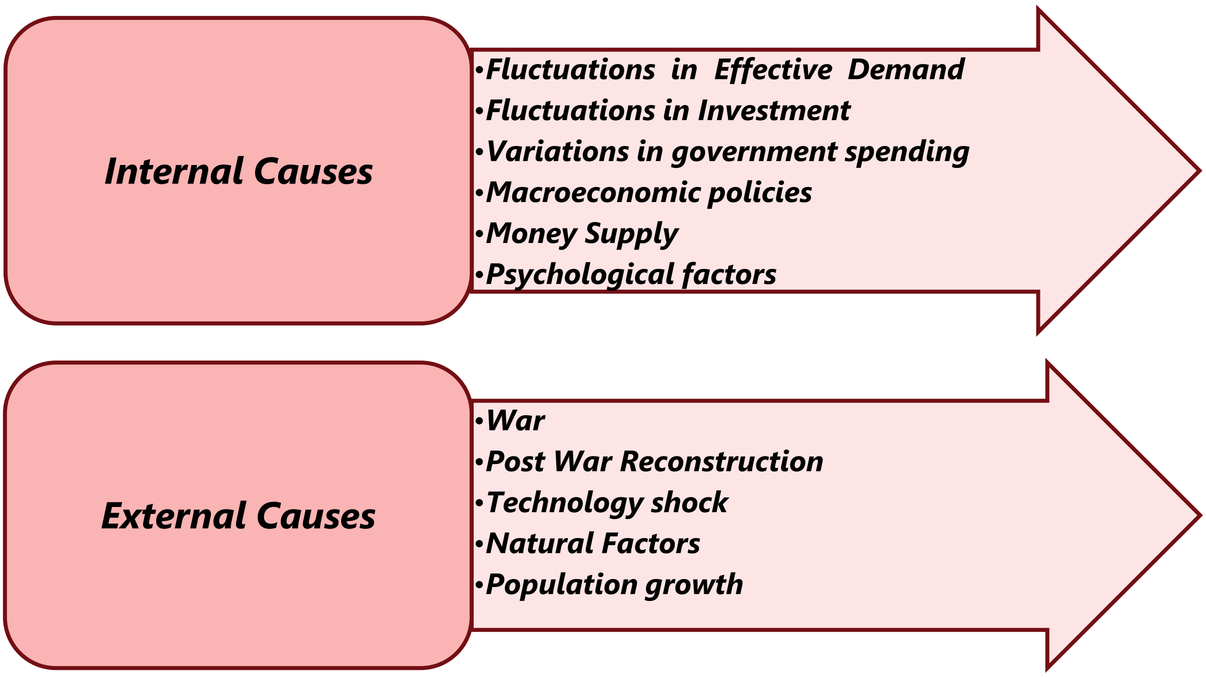
(f) Repercussions of business cycles get simultaneously felt on nearly all economic variables viz. output, employment, investment, consumption, interest, trade and price levels.

(g) Business cycles are contagious and are international in character. They begin in one country and mostly spread to other countries through trade relations. For example, the great depression of 1930s in the USA and Great Britain affected almost all the countries, especially the capitalist countries of the world.

(h) Business cycles have serious consequences on the well-being of the society.

5.3 CAUSES OF BUSINESS CYCLES

Business Cycles may occur due to external causes or internal causes or a combination of both. The 2001 recession was preceded by an absolute mania in dot-com and technology stocks, while the 2007-09 recessions followed a period of unprecedented speculation in the U.S. housing market.



***Internal Causes*:** The Internal causes or endogenous factors which may lead to boom or bust are:

Fluctuations in Effective Demand: According to Keynes, fluctuations in economic activities are due to fluctuations in aggregate effective demand (Effective demand refers to the willingness and ability of consumers to purchase goods at different prices). In a free market economy, where maximization of profits is the aim of businesses, a higher level of aggregate demand will induce businessmen to produce more. As a result, there will be more output, income and employment. However, if aggregate demand outstrips aggregate supply, it causes inflation. As against this, if the aggregate demand is low, there will be lesser output, income and employment. Investors sell stocks, and buy safe-haven investments that traditionally do not lose value, such as bonds, gold and the U.S. dollar. As companies lay off workers, consumers lose their jobs and stop buying anything but necessities. That causes a downward spiral. The bust cycle eventually stops on its own when prices are so low that those investors that still have cash start buying again. However, this can take a long time, and even lead to a depression.

The difference between exports and imports is the net foreign demand for goods and services. This is a component of the aggregate demand in the economy, and therefore variations in exports and imports can lead to business fluctuations as well. Thus, increase in aggregate effective demand causes conditions of expansion or boom and decrease in aggregate effective demand causes conditions of recession or depression. (You will study about these concepts in detail at Intermediate level in Economics for Finance).

Fluctuations in Investment: According to some economists, fluctuations in investments are the prime cause of business cycles. Investment spending is considered to be the most volatile component of the aggregate demand. Investments fluctuate quite often because of changes in the profit expectations of entrepreneurs. New inventions may cause entrepreneurs to increase investments in projects which are cost-efficient or more profit inducing. Or investment may rise when the rate of interest is low in the economy. Increases in investment shift the aggregate demand to the right, leading to an economic expansion. Decreases in investment have the opposite effect.

Variations in government spending: Fluctuations in government spending with its impact on aggregate economic activity result in business fluctuations. Government spending, especially during and after wars, has destabilizing effects on the economy.

Macroeconomic policies: Macroeconomic policies (monetary and fiscal policies) also cause business cycles. Expansionary policies, such as increased government spending and/or tax cuts, are the most common method of boosting aggregate demand. This results in booms. Similarly, softening of interest rates, often motivated by political motives, leads to inflationary effects and decline in unemployment rates. Anti-inflationary measures, such as reduction in government spending, increase in taxes and interest rates cause a downward pressure on the aggregate demand and the economy slows down. At times, such slowdowns may be drastic, showing negative growth rates and may ultimately end up in recession.

Money Supply: According to Hawtrey, trade cycle is a purely monetary phenomenon. Unplanned changes in supply of money may cause business fluctuation in an economy. An increase in the supply of money causes expansion in aggregate demand and in economic activities. However, excessive increase of credit and money also set off inflation in the economy. Capital is easily available, and therefore consumers and businesses alike can borrow at low rates. This stimulates more demand, creating a virtuous circle of prosperity. On the other hand, decrease in the supply of money may reverse the process and initiate recession in the economy.

Psychological factors: According to Pigou, modern business activities are based on the anticipations of business community and are affected by waves of optimism or pessimism. Business fluctuations are the outcome of these psychological states of mind of businessmen. If entrepreneurs are optimistic about future market conditions, they make investments, and as a result, the expansionary phase may begin. The opposite happens when entrepreneurs are pessimistic about future market conditions. Investors tend to restrict their investments. With reduced investments, employment, income and consumption also take a downturn and the economy faces contraction in economic activities.

According to Schumpeter's innovation theory, trade cycles occur as a result of innovations which take place in the system from time to time. The cobweb theory propounded by Nicholas Kaldor holds that business cycles result from the fact that present prices substantially influence the production at some future date. The present fluctuations in prices may become responsible for fluctuations in output and employment at some subsequent period.

External Causes: The External causes or exogenous factors which may lead to boom or bust are:

Wars: During war times, production of war goods, like weapons and arms etc., increases and most of the resources of the country are diverted for their production. This affects the production of other goods - capital and consumer goods. Fall in production causes fall in income, profits and employment. This creates contraction in economic activity and may trigger downturn in business cycle.

Post War Reconstruction: After war, the country begins to reconstruct itself. Houses, roads, bridges etc. are built and economic activity begins to pick up. All these activities push up effective demand due to which output, employment and income go up.

Technology Shocks: Growing technology enables production of new and better products and services. These products generally require huge investments for new technology adoption. This leads to expansion of employment, income and profits etc. and give a boost to the economy. For example, due to the advent of mobile phones, the telecom industry underwent a boom and there was expansion of production, employment, income and profits.

Natural Factors: Weather cycles cause fluctuations in agricultural output which in turn cause instability in the economies, especially those economies which are mainly agrarian. In the years when there are draughts or excessive floods, agricultural output is badly affected. With reduced agricultural output, incomes of farmers fall and therefore they reduce their demand for industrial goods. Reduced production of food products also pushes up their prices and thus reduces the income available for buying industrial goods. Reduced demand for industrial products may cause industrial recession.

Population growth: If the growth rate of population is higher than the rate of economic growth, there will be lesser savings in the economy. Fewer saving will reduce investment and as a result, income and employment will also be less. With lesser employment and income, the effective demand will be less, and overall, there will be slowdown in economic activities.

Economies of nearly all nations are interconnected through trade. Therefore, depending on the amount of bilateral trade, business fluctuations that occur in one part of the world get easily transmitted to other parts. Changes in laws related to taxes, trade regulations, government expenditure, transfer of capital and production to other countries, shifts in tastes and preferences of consumers are also potential sources of disruption in the economy.

5.4 RELEVANCE OF BUSINESS CYCLES IN BUSINESS DECISION MAKING

Business cycles affect all aspects of an economy. Understanding the business cycle is important for businesses of all types as they affect the demand for their products and in turn their profits which ultimately determines whether a business is successful or not. Knowledge regarding business cycles and their inherent characteristics is important for a businessman to frame appropriate policies. For example, the period of prosperity opens up new and superior opportunities for investment, employment and production and thereby promotes business. In contrast, a period of recession or depression reduces business opportunities and profits. A profit maximising firm has to consider the nature of the economic environment while making business decisions, especially those related to forward planning.

Business cycles have tremendous influence on business decisions. The stage of the business cycle is crucial while making managerial decisions regarding expansion or down-sizing. Businesses have to advantageously respond to the need to alter production levels relative to demand. Different phases of the cycle require fluctuating levels of input use, especially labour input. Firms should exercise the capability to expand or rationalize production operations so as to suit the stage of the business cycle. Business managers need to work effectively to arrive at sound strategic decisions in complex times across the whole business cycle, managing through boom, downturn, recession and recovery.

Economy-wide trends can have significant impact on all types businesses. However, it should be kept in mind that business cycles do not affect all sectors uniformly. Some businesses are more vulnerable to changes in the business cycle than others. Businesses whose fortunes are closely linked to the rate of economic growth are referred to as "cyclical" businesses. These include fashion retailers, electrical goods, house-builders, restaurants, advertising, overseas tour operators, construction and other infrastructure firms. During a boom, such businesses see a strong demand for their products but during a slump, they usually suffer a sharp drop in demand. It may also happen that some businesses actually benefit from an economic down turn. This happens when their products are perceived by customers as representing good value for money, or a cheaper alternative compared to more expensive products.

Overcoming the effects of economic downturns and recessions is one of the major challenges of sustaining a business in the long-term. The phase of the business cycle is important for a new business to decide on entry into the market. The stage of business cycle is also an important determinant of the success of a new product launch. Surviving the sluggish business cycles require businesses to plan and set policies with respect to product, prices and promotion.

In general, economic forecasts are not perfectly reliable. Neither, of course, are the hunches and intuitions of entrepreneurs. Understanding what phase of the business cycle an economy is in and what implications the current economic conditions have for their current and future business activity, helps businesses to better anticipate the market and to respond with greater alertness. However, taken together and applied carefully, economic forecasts can help business firms to prepare for changes in the direction of the economy either prior to or soon after these changes occur.

SUMMARY

- The rhythmic fluctuations in aggregate economic activity that an economy experiences over a period of time are called business cycles or trade cycles and are manifested in fluctuations in measures of aggregate economic activity such as gross national product, employment and income.
- A typical business cycle has four distinct phases namely,
    - Expansion (also called boom or upswing) characterized by increase in national output and all other economic variables.

   - Peak of boom or prosperity refers to the top or the highest point of the business cycle.
   - Contraction (also called downs-wing or recession) when there is fall in the levels of investment, employment.
   - Trough or depression occurs when the process of recession is complete and there is severe contraction in the economic activities.
- Economists use changes in a variety of activities to measure the business cycle and to predict where the economy is headed towards. These are called indicators.
- A leading indicator is a measurable economic factor that changes before the economy starts to follow a particular pattern or trend. i.e. they change before the real output changes.
- Variables that change after real output changes are called 'Lagging indicators'.
- Coincident economic indicators, also called concurrent indicators, coincide or occur simultaneously with the business-cycle movements.
- According to Keynes, fluctuations in economic activities are due to fluctuations in aggregate effective demand.
- According to some economists, fluctuations in investments are the prime cause of business cycles. Investment spending is considered to be the most volatile component of the aggregate demand.
- Fluctuations in government spending with its impact on aggregate economic activity result in business fluctuations.
- Macroeconomic policies, (monetary and fiscal policies) also cause business cycles.
- According to Hawtrey, trade cycle is a purely monetary phenomenon. Unplanned changes in the supply of money may cause business fluctuation in an economy.
- According to Pigou, modern business activities are based on the anticipations of business community and are affected by waves of optimism or pessimism.
- According to Schumpeter, trade cycles occur as a result of innovations which take place in the system from time to time.
- Understanding what phase of the business cycle an economy is in and what implications the current economic conditions have for their current and future business activity, helps businesses to better anticipate the market and to respond with greater alertness.

TEST YOUR KNOWLEDGE

Multiple Choice Questions

1. *The term business cycle refers to*

   (a) *the ups and downs in production of commodities*

   (b) *the fluctuating levels of economic activity over a period of time*

   (c) *decline in economic activities over prolonged period of time*

   (d) *increasing unemployment rate and diminishing rate of savings*

2. *A significant decline in general economic activity extending over a period of time is*

   (a) *business cycle*

   (b) *contraction phase*

   (c) *recession*

   (d) *recovery*

3. *The trough of a business cycle occurs when _____ hits its lowest point.*

   (a) *inflation in the economy*

   (b) *the money supply*

   (c) *aggregate economic activity*

   (d) *the unemployment rate*

4. *The lowest point in the business cycle is referred to as the*

   (a) *Expansion.*

   (b) *Boom.*

   (c) *Peak.*

   (d) *Trough.*

5. *A leading indicator is*

   (a) *a variable that tends to move along with the level of economic activity*

   (b) *a variable that tends to move in advance of aggregate economic activity*

   (c) *a variable that tends to move consequent on the level of aggregate economic activity*

   (d) *None of the above*

6. *A variable that tends to move later than aggregate economic activity is called*

   (a) *a leading variable.*

   (b) *a coincident variable.*

   (c) *a lagging variable.*

   (d) *a cyclical variable.*

7. *Industries that are extremely sensitive to the business cycle are the*

   (a) *Durable goods and service sectors.*

   (b) *Non-durable goods and service sectors.*

   (c) *Capital goods and non-durable goods sectors.*

   (d) *Capital goods and durable goods sectors.*

8. *A decrease in government spending would cause*

   (a) *the aggregate demand curve to shift to the right.*

   (b) *the aggregate demand curve to shift to the left.*

   (c) *a movement down and to the right along the aggregate demand curve.*

   (d) *a movement up and to the left along the aggregate demand curve.*

9. *Which of the following does not occur during an expansion?*

   (a) *Consumer purchases of all types of goods tend to increase.*

   (b) *Employment increases as demand for labour rises.*

   (c) *Business profits and business confidence tend to increase*

   (d) *None of the above.*

10. *Which of the following best describes a typical business cycle?*

    (a) *Economic expansions are followed by economic contractions.*

    (b) *Inflation is followed by rising income and unemployment.*

    (c) *Economic expansions are followed by economic growth and development.*

    (d) *Stagflation is followed by inflationary economic growth.*

11. *During recession, the unemployment rate __________ and output __________.*

    (a) *Rises; falls*

    (b) *Rises; rises*

(c) *Falls; rises*

(d) *Falls; falls*

12. *The four phases of the business cycle are*

    (a) *expansion, peak, contraction and trough*

    (b) *contraction, expansion, trough and boom*

    (c) *expansion contraction, peak, and trough*

    (d) *peak, depression, bust, and boom*

13. *Leading economic indicators*

    (a) *are used to forecast probable shifts in economic policies*

    (b) *are generally used to forecast economic fluctuations*

    (c) *are indicators of stock prices existing in an economy*

    (d) *are indicators of probable recession and depression*

14. *When aggregate economic activity is declining, the economy is said to be in*

    (a) *Contraction.*

    (b) *an expansion.*

    (c) *a trough.*

    (d) *a turning point.*

15. *Peaks and troughs of the business cycle are known collectively as*

    (a) *Volatility.*

    (b) *Turning points.*

    (c) *Equilibrium points.*

    (d) *Real business cycle events.*

16. *The most probable outcome of an increase in the money supply is*

    (a) *interest rates to rise, investment spending to rise, and aggregate demand to rise*

    (b) *interest rates to rise, investment spending to fall, and aggregate demand to fall*

    (c) *interest rates to fall, investment spending to rise, and aggregate demand to rise*

    (d) *interest rates to fall, investment spending to fall, and aggregate demand to fall*

17. *Which of the following is not a characteristic of business cycles?*

    (a) *Business cycles have serious consequences on the well-being of the society.*

    (b) *Business cycles occur periodically, although they do not exhibit the same regularity.*

    (c) *Business cycles have uniform characteristics and causes.*

    (d) *Business cycles are contagious and unpredictable.*

18. *Economic recession shares all of these characteristics except.*

    (a) *Fall in the levels of investment, employment*

    (b) *Incomes of wage and interest earners gradually decline resulting in decreased demand for goods and services*

    (c) *Investor confidence is adversely affected and new investments may not be forthcoming*

    (d) *Increase in the price of inputs due to increased demand for inputs*

19. *The different phases of a business cycle*

    (a) *do not have the same length and severity*

    (b) *expansion phase always last more than ten years*

    (c) *last many years and are difficult to get over in short periods*

    (d) *none of the above*

20. *Which of the following is not an example of coincident indicator?*

    (a) *Industrial production*

    (b) *inflation*

    (c) *Retail sales*

    (d) *New orders for plant and equipment*

21. *According to _______________ trade cycles occur due to onset of innovations.*

    (a) *Hawtrey*

    (b) *Adam Smith*

    (c) *J M Keynes*

    (d) *Schumpeter*

22. *Economic indicators are –*

    (a) *A one stroke solution to check the phase of economy*

    (b) *Indicators showing the movement of economy*

    (c) *Some activities which predict the direction of economy*

    (d) *Just an illusion*

23. *Which economic indicator is required to predict the turning point of business cycle?*

    (a) *Leading indicator*

    (b) *Lagging indicator*

    (c) *Coincident*

    (d) *All of the above*

24. *Business cycle generally originates in free market economies, what is a free market economy?*

    (a) *The economy where government is in possession of major assets*

    (b) *The economy where private firms control major assets*

    (c) *The economy where decisions of productions are taken by public sector undertakings*

    (d) *The economy where price is controlled by government.*

25. *Which of the following statements is correct?*

    (a) *The business cycle largely affects the agricultural sector*

    (b) *The business cycle largely affects small employees*

    (c) *The business cycle generally affects all sectors of economy but business sector in particular.*

    (d) *The business cycle affects low wages workers*

26. *According to Keynes, fluctuations in Economic activities are due to-.*

    (a) *Fluctuation in aggregate effective demand.*

    (b) *Innovations*

    (c) *Changes in money supply*

    (d) *Fluctuation in agricultural output*

27. *Which of the following is the cause of business cycles?*
    - (a) *Fluctuations in aggregate effective demand*
    - (b) *Fluctuations in investments*
    - (c) *Fluctuations in government spending*
    - (d) *All of the above*
28. *Economists use changes in a variety of activities to measure the business cycle and to predict where the economy is headed towards which are called ____________________.*
    - (a) *Signals*
    - (b) *Indicators*
    - (c) *Barometer*
    - (d) *Clues*
29. *If the growth rate of population is higher than the rate of economic growth, there will be _____ in the economy.*
    - (a) *more savings*
    - (b) *no effect on savings*
    - (c) *lesser savings*
    - (d) *none of these*
30. *The cobweb theory was propounded by _________*
    - (a) *Hawtrey*
    - (b) *Adam Smith*
    - (c) *J M Keynes*
    - (d) *Nicholas Kaldor*

ANSWERS

1.	**(b)**	2.	**(b)**	3.	**(c)**	4.	**(d)**	5.	**(b)**	6.	**(c)**
7.	**(d)**	8.	**(b)**	9.	**(d)**	10.	**(a)**	11.	**(a)**	12.	**(a)**
13.	**(b)**	14.	**(a)**	15.	**(b)**	16.	**(c)**	17.	**(c)**	18.	**(d)**
19.	**(a)**	20.	**(d)**	21.	**(d)**	22.	**(c)**	23.	**(d)**	24.	**(b)**
25.	**(c)**	26.	**(a)**	27.	**(d)**	28.	**(b)**	29.	**(c)**	30.	**(d)**