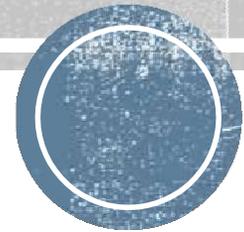


Trade Cycle



Meaning of Trade Cycle:

- If we study the economic history of the various countries of the world, we shall find that economic activities are marked by waves of Expansion and Contraction.
- There have been times when economic activities show expansion with production, employment, income, prices, etc. rising in accumulative manner, while at other times, economic activities remain depressed with production, employment, income, prices, etc. showing a continuous downward trend.
- In fact, these rhythmic fluctuations are normal features of all modern capitalist economies. These fluctuations are normally known as Trade Cycles or Business Cycles.



- **Definition:**

- *“Cyclical fluctuations are characterized by alternating waves of expansion and contraction. They do not have a fixed rhythm, but they are cycles in that the phases of contraction and expansion recur frequently and in fairly similar patterns.” – **Estey***

- *“A Trade Cycle is composed of periods of trade characterized by rising prices and low unemployment percentages altering with periods of bad trade characterized by falling prices and high unemployment percentages.” – **Keynes***

- *“A Business Cycle in general sense may be defined as an alterations of periods of prosperity and depression, of good and bad trade.” – **Haberler***

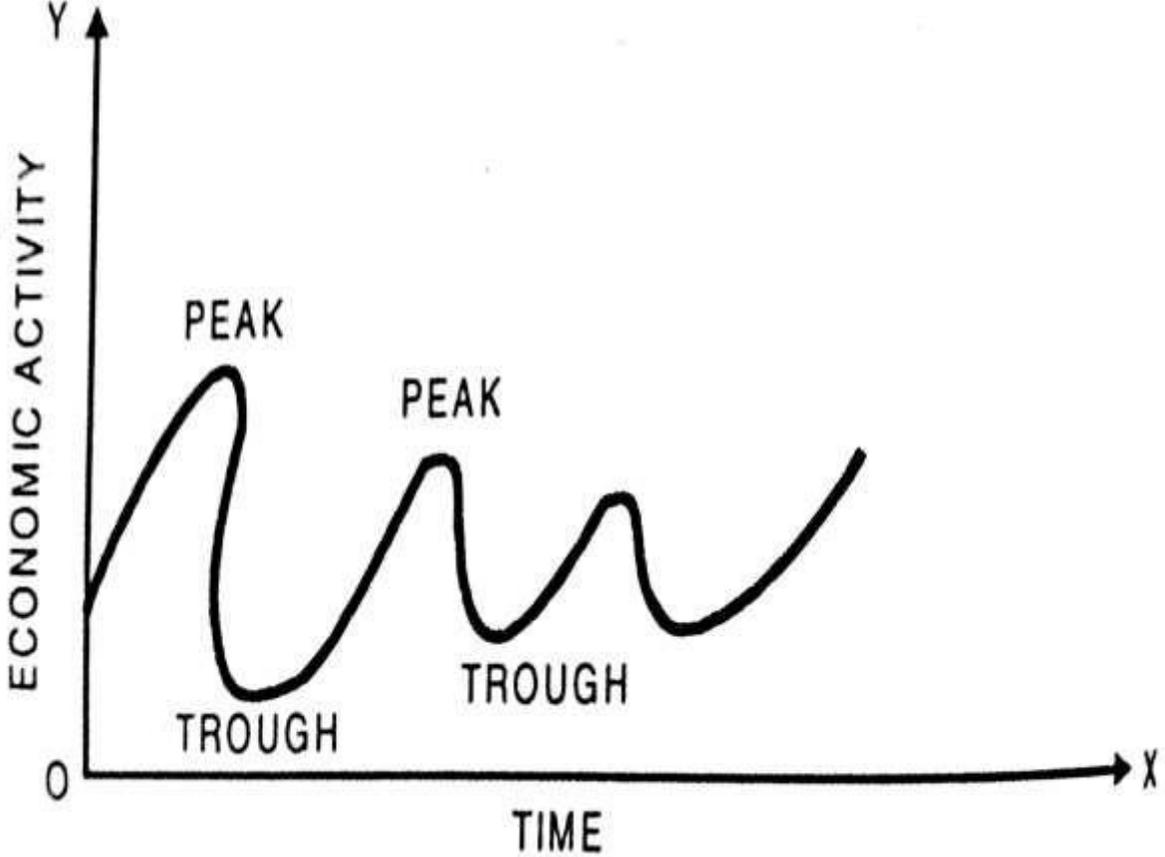
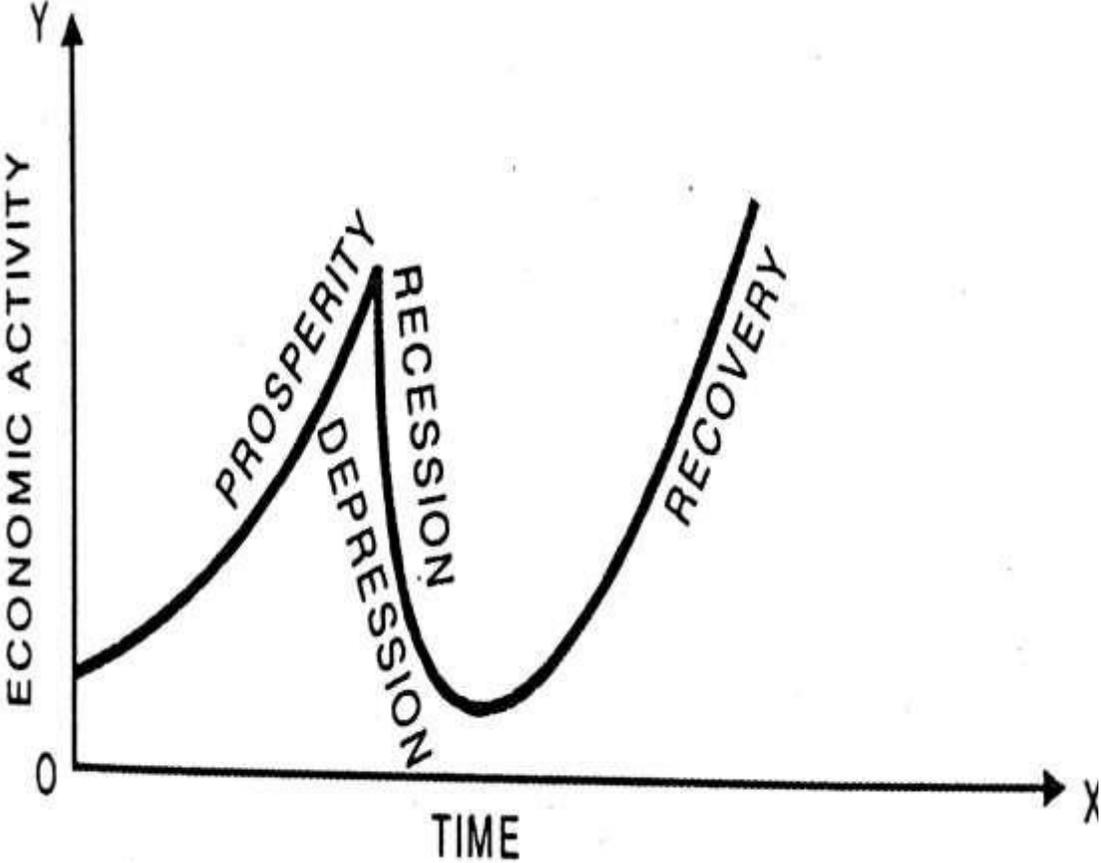


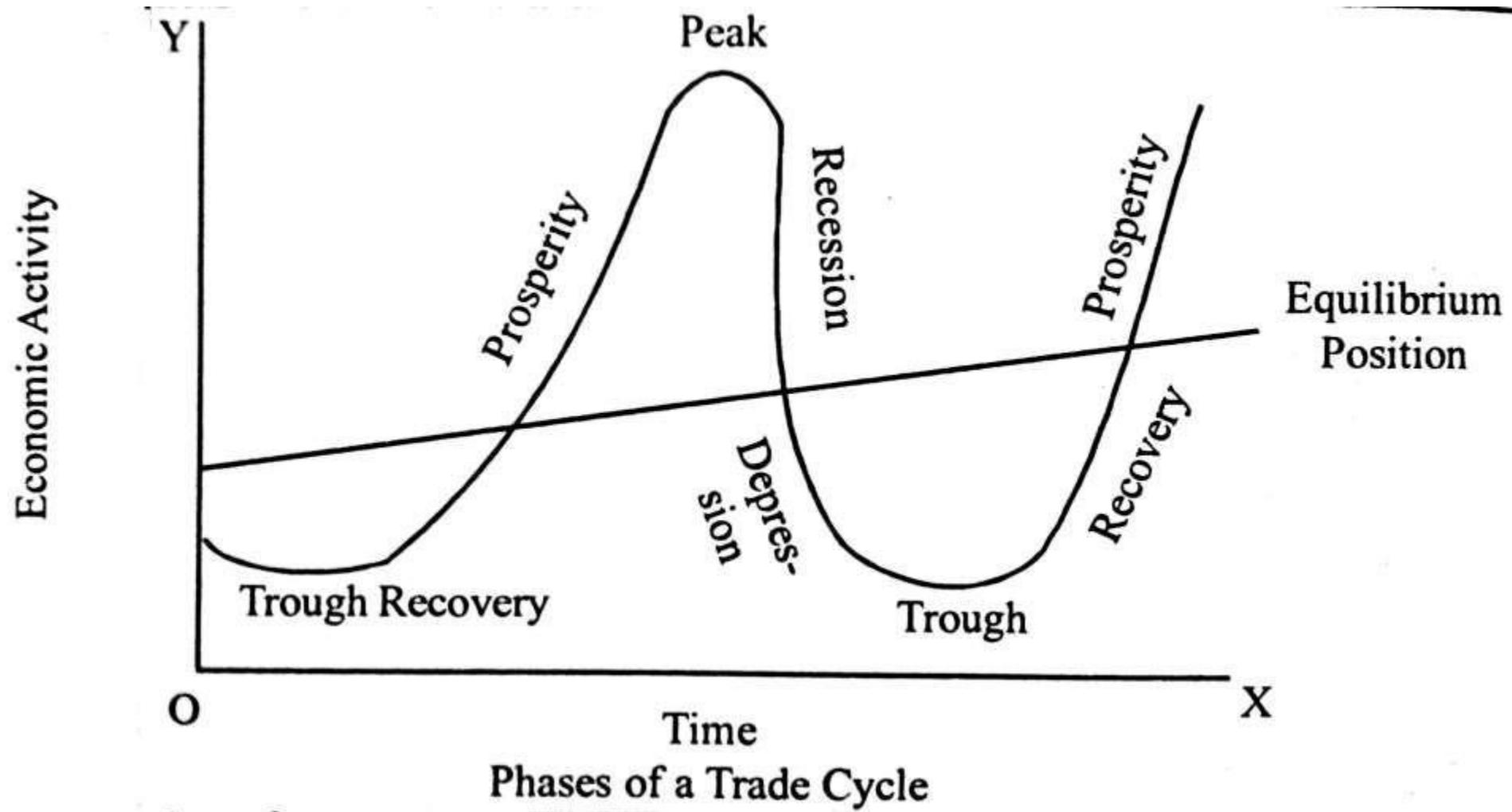
Characteristics of Trade Cycle

1. It is a wave like movement (expansion and contraction of trade activities)
2. All trade cycles are more or less similar in nature but not exactly same
3. Trade cycles are repetitive in nature
4. Repetitive but not periodical and regular
5. Trade cycle is self reinforcing in nature
6. They are self generating in nature as it terminates one phase and starts another phase on its own
7. They practically affects every sector of the economy
8. It is international in character but all countries are not equally affected
9. The movement to prosperity to depression is more sudden, sharp and steep then movement from contraction to expansion
10. Fluctuations are more marked in capital goods rather than consumer goods
11. The main effect of trade cycles is on profits than any other factor income
12. Prices, production and employment move in the same direction.



Phases of a Trade Cycle





1. **Expansion/Prosperity:**

- In this phase there will be increased production, high capital investment in basic industries, expansion of bank credits, rising prices, rising profits and rising employment. It is the stage of rapid expansion in the overall economic activities.
- The highest period of prosperity is called Boom.
- The commercial banks encourage further addition to fixed capital by liberal lending policies.
- The continuous investment even after the stage of full employment results in sharp inflationary rise in prices.
- The producers are still optimistic and continues to make new investments as prices are increasing continuously, and it finally attains a new peak.
- This will not continue indefinitely, the developing boom carries with itself the seeds of self destruction.
- Contraction soon begins to appear in the various sectors of the economy and number of limiting forces will start affecting within the economy which weakens the expansion phase and finally converts it self into recession.
- Some of the reasons for conversion of expansion to recession are:



- i. **Rising costs:** Increasing prices of factors of production will be more rapid than the general price level and eventually increases the cost of production and makes further expansion less attractive.
- ii. **Inability of banks to advance further loans:** after continues lending in the phase of expansion, the pressure accumulates on the reserves of the banks and now they are unable and unwilling to grant further loans. To complement the expansion phase, it is necessary to have continues money supply which is now not available.
- iii. **Declining Marginal Propensity to consume:** in the expansion period, the income of the factors of production increases and the level of consumption also increases but not in proportion to the increase in level of income. **An increasing proportion of income is more likely to be saved rather than spent.** Decline in MPC will reduce the aggregate demand. As demand decreases, there can be the situation of over production (supply > demand) which ultimately reduces the prices of goods and services. The reduction in price is the symbol of transformation of expansion phase into recession phase.



2. **Recession:**

- The recession phase marks the end of the phase of expansion and beginning of a prolonged phase of economic stagnation and contraction.
- The optimistic environment is now replaced by the over- pessimism characterized by feeling of hesitation, doubt and fear.
- Enterprises do not undertake any new projects and even the projects in hand are abandoned sometimes.
- There can be liquidation in stock exchange, money market and commodity market. The bank will also start contracting the size of credit and even the existing loans are forced to be recover as early as possible.
- Because of the contraction of bank credit the businessmen are not getting advances for the purpose of expansion of business.
- Orders are cancelled and workers are laid-off. Sale of the existing stock of goods at the cheaper rate to get out of the market.
- New investment stops and unemployment increases in construction and other capital goods industries, too.



- Initial unemployment will rapidly fall over the other sectors of the economy as well, a cumulative contractionary process leads to fall in production, employment and consequently income, expenditure and prices.
- The prolonged period of recession will increase the idle capacity of the productive units and new investments will decline rapidly.
- It is having a cumulative effect, as once it starts, it goes on gathering momentum, and turns into depression. Here the phase of recession turns into contraction.

3. Depression/Contraction:

- Depression is characterized by sharp reduction in production, massive unemployment, falling prices, falling projects, low wage rates, contraction of bank credit, a high rate of business failure and an atmosphere of all around pessimism.
- A decline in investment will reduce the level of production and high level of unemployment arrives, which reduces the income and demand in the economy.
- Price fall reduces the profit level of the enterprises and may turn into negative also. Investment fall due to lack of profitability.
- No business is ready to take a risk and do not apply for loans to the banks. The surplus with the banks increases and the rate of interests comes down.



- Due to reduction in the demand for capital goods and some of the consumer goods many firms close down on account of accumulated losses.
- Reduction in prices are followed by reduction in money supply and reduction in velocity of circulation of money.
- The effect of contraction is universal but not uniform as the prices of agricultural products and raw materials fall sharply as compared to finished goods.
- The lowest point of depression is called trough.
- The economic activities are at its lowest level.
- But this cannot be a permanent situation in the economy, in fact the same forces that makes depression so severe will work for the revival also.
- The same forces within will work out to be positive and the phase of depression will be converted into the phase of Recovery.



4. **Recovery/ Revival phase:**

- It is the situation when the economic activities take turn from the depression phase to prosperity.
- The propensity to consume cannot become zero even at the lowest point of depression. The stock with the producers is exhausted now and the demand for the consumer goods arises.
- The demand for consumer durable also gets turned as it was postponed in the time of depression.
- The demand for the capital goods cannot be postponed for a long period of time and therefore, it is required to be replaced or repaired.
- After a certain period of time there will be a moderate revival in the demand for durables and capital goods from the side of consumers and producers.
- This naturally call for increase in investment, leading to increase in employment, income and effective demand.
- Normally the phase of revival starts with the replacement demand for capital goods..



- In order to meet these demand, investment and employment in capital goods industries increases. This leads to general increase in effective demand which in turn leads to rise in prices and profits resulting in further investment, employment and income.
- During this phase as the marginal efficiency of capital increases which improves business optimism.
- Rise in security's prices also marks the start of revival process.
- Remember, these phases are seldom show a regular and periodic change, they are having different span every time and differs from country to country.



Thank You

