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# BUSINESS CYCLES

### OVERVIEW

1. Business cycles are the fluctuations in the level of economic activity. A cycle has four phases: peak, recession, trough, and recovery. An extended, deep trough is called a depression.
2. There are many theories of the business cycle including sunspots, changes in business inventories, and technological innovations. But all fail to successfully explain cycles. The classical view was another approach to business cycles.
3. The classical economist believed that the government should not interfere in the economy. This laissez-faire attitude was based on the idea that the economy would be prevented from obtaining its natural level of full employment. Two major reasons for this view were Say's law and markets. Say's law states that supply creates its own demand. Everything that is produced will be bought, and the economy will be in equilibrium. In addition, market forces will establish equilibrium at full employment.
4. The Great Depression of the 1930s revealed flaws in the classical way of thinking. The economy went into a depression and showed no sign of recovery. This could not happen in a classical world.
5. An alternate theory to the classical view was provided by John Maynard Keynes. He concluded that there was no tendency to full employment and that equilibrium in the economy could occur at any level of output. Keynes argued that supply creates its own demand only as long as all that is earned is spent. When dollars are saved and not used for consumption, investment, or government spending, production and employment will fall. In addition, Keynes found markets to be imperfect. Prices and wages may not fall when there is a surplus of goods, labor, or money, and unemployment results.
6. Keynes revolutionized economics by providing a different way of looking at the economy. He established a macro point of view.

### MATCHING

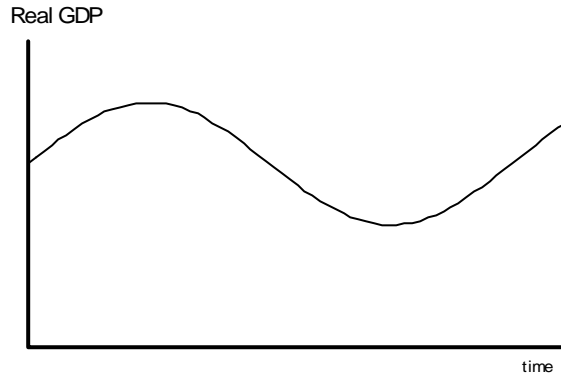
- |       |    |                      |    |   |
|-------|----|----------------------|----|---|
| _____ | 1. | business cycle       | a. | the British economist who revolutionize macroeconomics              |
| _____ | 2. | classical economics  | b. | supply creates its own demand                                       |
| _____ | 3. | <i>laissez-faire</i> | c. | more or less regular fluctuations in the level of economic activity |
| _____ | 4. | Say's Law            | d. | the economic model that dominated economics prior to the 1930's     |
| _____ | 5. | Keynes               | e. | the idea that the government should not interfere in the economy    |

### TRUE-FALSE

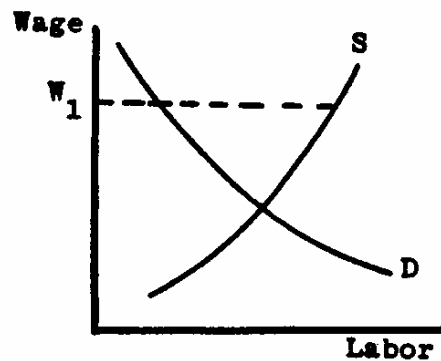
- \_\_\_\_\_ 1. Classical economics would recommend that during a recession, the government should try to eliminate the recession.
- \_\_\_\_\_ 2. Keynes argued that the economy always returned to full employment.
- \_\_\_\_\_ 3. When unemployment occurs, the labor market indicates that a fall in the real wage will eliminate the unemployment.
- \_\_\_\_\_ 4. The classical model believes that the labor market will always come to equilibrium.
- \_\_\_\_\_ 5. In the business cycle, a trough always follows a recovery.

## PROBLEMS

1. Label the phases of the business cycle on the following graph.



2. a. In the following market for labor, find the amount of unemployment at wage  $W_1$ .



- b. How can this market reach full employment? \_\_\_\_\_  
\_\_\_\_\_

## IN THE NEWS

1. The Russian economy is moving toward a market system. There is no reason to believe that the Russians will be more successful than we are at avoiding the business cycle. A business cycle would be new to a society used to a planned economy with little unemployment and unchanging prices set by the government.
- a. Would the business cycle encourage the Russians to return to central planning? Explain. \_\_\_\_\_
- b. In a communist society where everyone is to share the wealth, how could the Russians decide who would be unemployed? \_\_\_\_\_  
\_\_\_\_\_

2. It is widely observed that the hemlines on women's skirts move up and down with the business cycle.
  - a. If we know which way the hemlines are going, could we predict the direction of the economy? \_\_\_\_\_  
\_\_\_\_\_
  - b. Can you find a link between the length of hemlines and the direction of the economy?  
\_\_\_\_\_
  
3. Business cycles are not a new thing. Historians have been writing about them for centuries. In the early 1800s, English writers were discussing business cycles and their causes. The history of the United States is filled with many episodes of the ups and downs of business. If it is only recently that economists have discovered the business cycle, it must be because they were asleep.
  - a. Why did it take the Great Depression before there were any serious studies of the business cycle? \_\_\_\_\_
  - b. Can we conclude that because of the progress that economists have made in the last sixty years we now can control the business cycle? \_\_\_\_\_  
\_\_\_\_\_
  
4. Discussions of the business cycle include topics like the up and down movement of the economy, as well as inflationary pressure. The two main indicators of the business cycle are the level of income and the price level.
  - a. Why doesn't a discussion of the business cycle include a discussion of the interest rate or the level of wages? \_\_\_\_\_
  - b. What is the relation of the level of income to the level of employment? \_\_\_\_\_  
\_\_\_\_\_
  - c. The level of income, gross domestic product, always seems to rise. Yet we know that the level of employment goes up and down. How can this be? \_\_\_\_\_  
\_\_\_\_\_
  
5. Indian tribes were also subject to business cycles. Their cycles were generally caused by nature. In the years when there was plenty of game and the crops were good, the Indians fared well. In the years when the game was scarce or the crops bad, the Indians did not fare as well.
  - a. What difference is there between the business cycles we have and the cycles experienced by the Indians? \_\_\_\_\_
  - b. What could the Indians do to alter their cycle? \_\_\_\_\_  
\_\_\_\_\_
  
6. One impact of recession is that businesses go bankrupt. In fact, business failure increases substantially in a recession. Small businesses are hardest hit although big firms are not immune to failure.
  - a. Why is there so much focus on unemployment and less on business failure? \_\_\_\_\_  
\_\_\_\_\_
  - b. Do you expect new business formation to go up or down with the business cycle? Why? \_\_\_\_\_  
\_\_\_\_\_

## PRACTICE TEST

Circle the correct answer.

1. Which is not a phase of the business cycle?
  - a. Peak
  - b. Recovery
  - c. Recession
  - d. Dip
2. Classical economic thinking does not include:
  - a. Say's Law
  - b. market forces
  - c. laissez-faire
  - d. government interference
3. When the economy is at less than full employment, a classical economist would predict that prices will:
  - a. rise.
  - b. fall.
  - c. stay the same.
  - d. fail to readjust the economy.
4. According to Keynes, equilibrium occurs:
  - a. at a full employment level of income.
  - b. during a depression.
  - c. during a recession.
  - d. at any level of income and employment.
5. An important part of Keynesian thought was that:
  - a. wages are flexible. .
  - b. wages are "sticky" on the downward side
  - c. firms lower wages at the slightest whim.
  - d. firms set wages below equilibrium.

## ANSWERS

Answers – Business Cycles

Matching

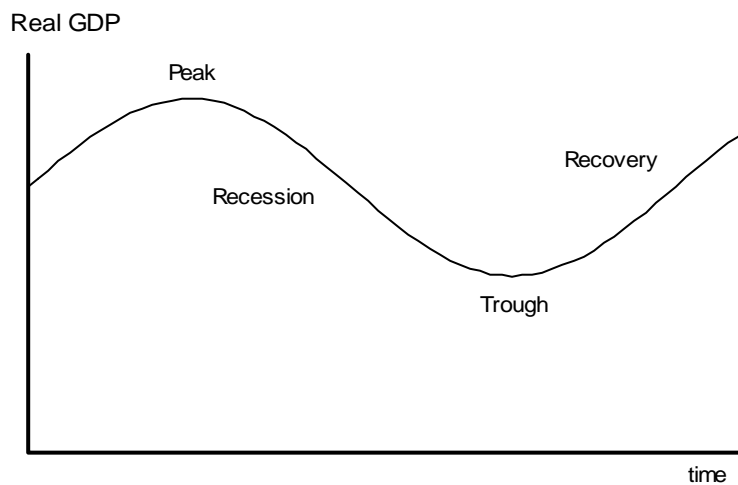
1. c
2. d
3. e
4. b
5. a

True-False

1. F
2. F
3. T
4. T
5. F

Problems

1. The phases of the business cycle are peak, recession, trough, and recovery.



2. a. The amount of unemployment is the difference between the quantity supplied of labor and the quantity demanded of labor at the wage  $W_1$ .  
b. To reach full employment, the wage must fall.

In the News

1. a. The Russians probably knew about the business cycle before they started their experiment. Either they believed that they could control the cycle or they believed that the costs the cycle would impose would be worth the gain in efficiency.  
b. The exact formula for finding who will be unemployed is not clear. But do not forget that the Russians have a part of their economy which is not a market economy. The government could find employment for those who are unable to find work on their own.
2. a. Which comes first? Do hemlines precede the economy or is it the other way around? If the economy precedes the hemline, then we can predict the hemline from the economy but not the economy from the hemline.

- b. If there is a link, it is not clear. Some people argue that in good times, people are more upbeat and the shorter skirt reflects this mood, while in the downswing of the business cycle, people are more conservative and the hemline comes down.
- 3. a. In fact, as the reading states, there was an important economic literature devoted to the ups and downs of the economy as a whole. But never was the downswing sharp enough or long enough to attract our attention as did the Great Depression. Up to that time, governments did not even keep data on the macro economy. No one had GDP statistics or price indexes. So it took a dramatic event to cause people to start thinking in earnest about the cycle.
- b. One would think that after sixty years, we would know enough to be able to control the cycle. But it is not true. We have, as you will find out, ideas about what to do to smooth out the cycle, but there are still times when our best advice does not do what we intended. So there is much room for expanded knowledge in the evolving science of economics.
- 4. a. While it is usually true that we discuss the level of income or the price level when talking about the business cycle, we also have some idea about what will happen to wages and interest rates. The usual focus is on prices and income since those are the two main signals of our economy's performance.
- b. As employment changes, we would expect the level of income to change. We should be careful to note that it is the level of real income that will change as the level of employment changes. It has been true that GDP has gone up over the last decade even when employment went down. That is because the prices went up causing GDP to rise even when the level of output, real GDP fell.
- c. When GDP rises, it may be because the prices went up, not because the amount produced went up. Only when the amount of output goes up do we expect the employment to also go up. Of course if there is a big increase in capital and workers become more productive, the level of output may rise even if the employment does not.
- 5. a. The main difference between our business cycle and that of the Indians is that the Indians' cycle was due to nature. While we cannot claim that our cycle is entirely due to society's actions, it is not entirely due to nature either.
- b. By the time the Indians knew that nature would not provide well, there was little they could do except move on or live off stored goods. The Indians could do little to alter their cycle. Will we be luckier?
- 6. a. Unemployment is important because of the human suffering that is a part of it. Many of the businesses that go out of business are operated by people that start another business fairly quickly, or go to work for someone else fairly quickly.
- b. It is most likely that new business formation will move with the business cycle. In good times, people are optimistic and expect the business to do well. In a recession, people suspect that the probability of success is less likely and that they should wait until a better time.

#### Practice Test

1.d., 2.d., 3.b., 4.d., 5.b.