***Week 15 – The Business Cycle***

Economic growth is not a steady phenomenon, rather, it tends to show a pattern of ups and downs (known as peaks and troughs) as the economy expands or contracts.



Boom

Trough

Generally, the pattern tends to be as follows:

* + An expansion of above-average growth
	+ A peak
	+ A contraction of below-average growth
	+ A trough

The troughs are then followed by periods of expansion and so they cycle continues. The aim for economists is to try and restrain the size of these peaks and troughs over the course of the business cycle.

**A Peak (or boom)**

A boom is a period of high economic activity. This is when the economy is operating close to full capacity. There are many positives involved in having a boom period, however there are also disadvantages. When a boom has lasted for a long time, for example, there will be a shortage of resources. This leads to difficulties in meeting the demand and hence prices rise.

Common characteristics of a boom

* + High economic activity
	+ High level of consumer confidence
	+ High levels of investment and production
	+ Demand for goods and services is increasing, putting pressure on scarce resources
	+ Prices rise, mainly from Demand Pull inflation
	+ Unemployment will decrease
	+ Economic growth is high

**Downturn (or contraction)**

When a boom starts to slow the economy will enter into a period of contraction or downturn where economic growth slows. This is usually characterised by a sharp decline in investment spending and higher prices leading slower spending.

Common characteristics of a downturn

* + Declining levels of economic activity
	+ Declining consumer confidence
	+ Firms start to realise that they’re storing excess stock
	+ Prices start to fall because of excess stock levels and hence reduce the amount of production
	+ Firms are no longer investing in capital – and may not need to for quite some time
	+ Fewer resources are demanded
	+ Unemployment starts to increase
	+ Economic growth slows

**Trough (or recession)**

In a trough the level of economic activity is at its lowest point in the cycle. Confidence is low causing decreased levels of investment and spending. There are also high rates of unemployment with some businesses even closing down.

Sometimes a trough will be continual. When it is prolonged, it may lead to a recession. A recession is defined as two or more quarters of negative growth. During the GFC most of the world entered into recession however Australia was one of the only economies in the world that did not. This was largely because of our interaction with China and their continued strong demand for our minerals, as well as the government’s financial stimulus plan (School gyms project and the two $900 bonuses given to all tax payers).

**Upturn (recovery or expansion)**

A recovery is stimulated by an autonomous increase in spending. This can be kick started by the government spending lots of money (as it did in the GFC), but can also be caused by a decrease in interest rates or tax cuts. The idea is that in order to get people spending more money, and hence driving the economy, we need to give them more money. Government policies are aimed at doing this in order to kick start the economy in times of economic difficulty.

Common characteristics of an upturn

* + Confidence starts to rise (both business and consumer)
	+ Businesses start to invest in capital – possibly to replace old worn or old equipment
	+ Stock levels start falling and so firms start buying more
	+ Production increases
	+ Households income increases with more employment
	+ Consumer spending increases
	+ Firms use excess capacity at first, then move into more investment
	+ Prices start to rise and the labour force participation rate increases
	+ Unemployment begins to fall

**Activity 1**

*Question 1.*

Explain the main characteristics of the business cycle

Downturn

Trough

Recovery

Peak (Boom)

*Question 2.*

Use the following graph to determine when Australia has gone through a boom, downturn, trough and recovery



X axis = time

Y axis = percentage growth per quarter

Boom

Downturn

Trough

Upturn

*Question 3.*

At what stage of the business cycle is Australia at the moment. You will need to do some internet research to determine this.

*Question 4.*

What are some factors that may lead to a downturn in the economy?

**AUSTRALIA ABLE TO AVOID RECESSION**

http://news.bbc.co.uk/2/hi/8080446.stm

**The Australian economy has unexpectedly avoided falling into recession after its economy grew by 0.4% in the first three months of 2009.**

Increased exports and consumer spending helped the economy to rebound from the 0.5% contraction recorded between October and December last year.

Australian Prime Minister Kevin Rudd said the country was now the only advanced economy not in recession.

An economy is said to be in recession after two straight quarters of decline.

**Stimulus moves**

To help avoid the country falling in recession, the Australian central bank cut interest rates to a 45-year low of 3.25% in February.

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| http://newsimg.bbc.co.uk/shared/img/o.gif | http://newsimg.bbc.co.uk/nol/shared/img/v3/start_quote_rb.gif**We have technically avoided recession, but if you look at the details in the data it is not a pretty picture** http://newsimg.bbc.co.uk/nol/shared/img/v3/end_quote_rb.gifJP Morgan economist Helen Kevans |

The government also introduced a number of multi-billion dollar stimulus packages, including increased infrastructure spending and cash handouts to most Australians since the end of last year to lift consumer spending.

Despite the economic growth in the first quarter of the year, Mr Rudd said Australia remained at risk of recession.

"We're not out of the woods yet, we've got a long way to go," he said.

Analysts agreed that the risk of recession remained as 2009 continues.

"We have technically avoided recession, but if you look at the details in the data it is not a pretty picture," said Australian-based JP Morgan economist Helen Kevans.

"We have imports falling off a cliff, which is a symptom of firms smashing investment and which is bad for our employment outlook

1. What caused Australia to be able to overcome the GFC?
2. Why did Australia not enter into a ‘technical recession’?

**Interpreting Statistics**

Statistics are often used to determine economic activity. When interpreting these graphs you need to be careful to look for patterns. Four of the main patterns include:

**Trend**

The average direction of an indicator over time. Short fluctuations are not really considered. These trends are usually upwards or downwards.

**Cyclical Patterns**

Some indicators will go through regular cycles which closely match the business cycle.

**Seasonal Factors**

Some indicators will go through regular patterns of highs and lows. E.g. Tourists visiting Australia will increase in the summer months, retail spending will usually increase in the winter months, Ski equipment sales will increase in the lead up to the ski season.

**Erratic Factors**

Sometimes there is no real pattern due to erratic, one off events. E.g. a drought affecting farmers. Its not something that you can predict.

**Indicators of economic performance**

There are different types of indicators that we use in economics. They can be broadly categorised into Key and Composite indicators.

**Key Indicators**

A single indicator that measures the performance of the economy. Key indicators include:

* + Unemployment rate
	+ Rate of growth of GDP
	+ Amount of change in the CPI
	+ Exchange rate
	+ Balance of Payments
	+ Interest rates
	+ Housing loan approvals
	+ Job vacancies
	+ Retail sales

**Composite indicators**

Composite indicators are made up of a combination of several single indicators. The ABS and several major banks create and publish composite indicators to show macroeconomic trends.

In addition to these key and composite indicators, these indicators can tell the past and predict the future. There are three categories of Key and Composite indicators

**Leading Indicators**

Leading indicators allow economists to predict the future course of the business cycle. While not completely reliable, they are used as a tool to forecast a change in economic activity before it actually happens. An example of a leading indicator would be housing approvals, factory overtime, change in economic activity among our major trading partners (E.g. China, India and South Korea).

The Westpac-Melbourne Institute also produces a leading index of economic activity which combines 9 indicators that typically lead economic activity by six to nine months.

**Activity 2**

Look up the following video on youtube and write a summary paragraph on leading indicators

<http://www.youtube.com/watch?v=nkQKUEgIePo>

How would temporary employment show you what may happen in the economy in the future?

**Co-incident indicators**

Co-incident indicators undergo fluctuations at the same time as the business cycle. They show actual changes in current economic activity and confirm the current position on the business cycle. GDP is the main example of a co-incident indicator, however others include current spending levels, car registrations, interest rates, exchange rates and share prices.

**Lagging indicators**

Lagging indicators undergo fluctuations after the business cycle. They confirm the path that the economy has taken. The inflation rate is a lagging indicator because a peak in the inflation graph will follow a peak in the business cycle. This is because inflation depends partly on the effect of changes in economic growth. E.g. strong economic growth may lead to higher inflation. Other examples include employment rates and average weekly earnings.

**Activity 3**

Why are indicators important to government and to the economists who advise them?

What does the exchange rate indicate about money inflows and outflows?

Distinguish between a recession and a downturn in economic activity.

Explain these terms

* Seasonal adjustment
* Cyclical pattern
* Composite indicator

Using an example, what is a lagging indicator and how might they be used?

The use of key and composite indicators of economic performance assist in identifying and understanding the four phases of the business life cycle. Discuss this statement with reference to examples.

***Week 16 – The circular flow model***

The circular flow model is a model of the entire economy. It shows how a market economy works and how its different sections are interrelated. The circular flow model can be broken into five sectors.

Resources



Income (Y)

Firms

Households

Consumption spending (C)

Goods and Services

Investment (I)

Savings (S)

Financial Sector

Taxes (T)

Government Spending (G)

Government sector

Exports (X)

Imports (M)

Overseas sector

**LEAKAGES**

**INJECTIONS**

**Legend**

= Real Flows

 = Money Flows

This model is originally seen as only having households and firms and is known as the 2 sector circular flow model. It assumes that households own all the resources which they seel to firms in return for income. The firms then make goods and services from these resources and consumers purchase them with the income they receive. It assumes that the economy is always in equilibrium. In other words, people spend all their income on buying goods and services.

The reality is very different to this. We don’t spend all our income on goods and services. Some of it goes in taxes, we save some, and some of it we even spend overseas and Australian businesses don’t get to see that money. This is the reason that we use the five sector model.

The sectors of the model are as follows:

***Household sector.*** This assumes that

* Households own all the resources
* Sell resources to firms in return for incomes in the form of wages, rent, interest and profit
* Spend all their income on goods and services

***Business sector (Firms)***

* Buy all resources from households
* Produce goods and services
* Sell their production to households

***Financial sector***

* Encompasses all types of financial institutions
* Financial institutions borrow household savings (S) and lens those savings to firms who wish to invest (I)

***Government sector***

* Collects revenue in the form of taxation (T) and
* uses this money for government spending (G) on public goods and services (E.g. Health and Education)

***Overseas sector***

* Consists of Australians buying items from overseas, known as imports (M)
* Selling our products overseas as exports (X)

The model shows that economic activity is affected by the spending decisions of all five sectors. The total value of spending on Australian goods, or aggregate demand consists of

* Consumption spending by households (C)
* Investment spending by firms (I) on capital goods
* Government spending (G) on public goods and services
* Export earnings from selling goods overseas minus the things we import (X-M)

This means that the formula for Aggregate Demand of GDP is:

AD = C+I+G+(X-M)

The total model is affected by the amount of leakages and injections. If there are more leakages than injections then more money is going out of the economy, so, the economy will shrink. If there are more injections than leakages, then the economy will grow.

**Activity 1**

Watch the following video on youtube and write a short summary on its contents.

<http://www.youtube.com/watch?v=QSEuEPgQPC4>

Why is a two sector model of the economy unrealistic?

What effect will increasing leakages have on the economy?

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**The expenditure multiplier**

The multiplier process shows how a change in the level of consumption (C), Investment (I), Government spending (G) or net exports (X-M) causes a multiplied change in the total level of spending and therefore economic activity over time. The initial change in spending causes a much greater change in the level of income and GDP. E.g. an increase in investment spending of $50 million may lead to a multiplied increase in total spending and add $300 million to the circular flow. The multiplier in this case would be 6. The reason for the multiplier is that the initial increase in spending leads to extra income which causes more spending which leads to extra income and so on.

You would therefore expect that this injection of money would just keep going around the economy. Sadly this is not the case because this money will leak out of the economy in the form of taxes, savings and even in imports.

***Consider the following example.***

Imagine that the government increased its spending by $100 million in order to buy a new fleet of cars for a government department. In this case, the government initiates the multiplier process by purchasing the new cars from Holden’s Adelaide factory. Holden will now need to hire more labour and pay more for capital resources to make the cars. Payment for these resources increases income payments to households. Households will now spend this money on other goods and services.

However, some will be saved, some will go in tax and some may even buy goods from overseas. It is for this reason that eventually the multiplier effect will stop.

***A positive and negative multiplier***

The multiplier process can be positive or negative. E.g. an injection of money into the economy is going to result in more economic growth and this money will continue to be spent and make more money. Likewise, if money is taken out in the form of leakages, then the economy will contract more that the initial leakage.

**Activity**

Watch the following video for an example of how the multiplier will work in reverse.

<http://www.youtube.com/watch?v=i4m8m5CnNNw>

1. With reference to the above video, how can the multiplier effect work in reverse?
2. What will be the effect on the Australian economy if there is a massive loss of jobs?
3. Use the circular flow model to describe the multiplier effect of a decrease in investment spending of $100 million.
4. What factors might limit the size of the multiplier?

**The Financial Sector**

The Financial sector consists of all types of financial institutions including banks, credit unions, building societies, finance companies and life assurance firms. Financial institutions and an efficient market have an essential function in encouraging the flow of spending in a growing economy by performing the following roles

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