48 The business cycle

A Expansion and contraction

All market economies have periods when **consumption** – spending on goods and services – rises. Consumers buy more, companies invest more, and production, income, profits and employment increase. These periods are always followed by periods when spending and investment fall, and unemployment rises. This is the **business cycle**.

A period during which economic activity increases and the economy is expanding is an **upturn** or **upswing**. If it lasts a long time it is called a **boom**. The highest point of the business cycle is a **peak**, which is followed by a **downturn**, during which the amount of economic activity decreases. If the economy keeps contracting for more than six months, the downswing is called a **recession**. A serious, long-lasting recession is called a **depression** or a **slump**. The lowest point of the business cycle is a **trough**, which is followed by a **recovery**, when economic activity increases again, and a new cycle begins.

Note: A **downturn** is also called a **downswing** or a **period of contraction**; a **recovery** is also called an **upturn**, an **upswing** or a **period of expansion**.

B Fiscal policy

Governments and central banks use **fiscal policy**, which involves changing the levels of **government expenditure** and **taxation** to try to limit the extent of the business cycle.

If an economy is moving into a recession, the government might have a **reflationary** fiscal policy. This means trying to **stimulate the economy** by increasing government spending, or by cutting levels of direct or indirect tax so that individuals and companies have more money to spend.

If an economy is **overheating** – expanding too quickly – it means that industry is working at **full capacity** and producing as much as it possibly can. Because demand is greater than supply, leading to rising prices and inflation, the government might have a **deflationary** fiscal policy. This means trying to **cool down the economy**: reducing the amount of economic activity by raising tax rates or cutting government expenditure. This reduces the level of demand in the economy and helps to reduce inflation.

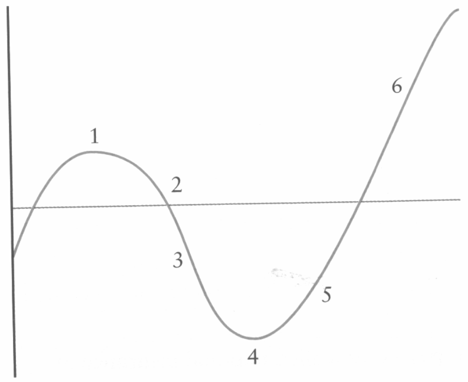
C Monetary policy

Governments or central banks can also use **monetary policy** – changing interest rates and the level of the money supply – to influence the level of economic activity. (See Unit 27) They can **boost** or increase economic activity if the economy is in a downturn by reducing interest rates and allowing the rate of growth of the money supply to increase. Alternatively, if the economy is growing too fast and causing inflation, they can slow it down by increasing interest rates and reducing the rate of growth of the money supply.

The main reason for having an independent central bank (see Unit 23) is to prevent governments from creating a **political business cycle** – a cycle that will be at a high point at the time of the next election. Governments can do this by beginning their periods of office with a couple of years of policies designed to stop the economy from growing, followed by tax cuts and monetary expansion in the two years before the next election. This policy, sometimes called **boom and bust**, helps the government get re-elected but is not good for economic stability. An independent central bank makes this less likely to happen.

48.1 Label the graph with words from the box. Look at A opposite to help you.

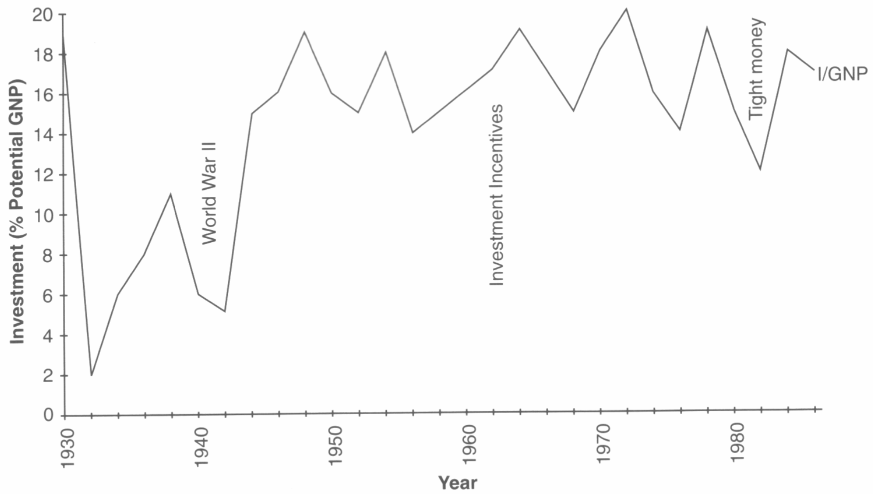
boom	downswing	peak	recession	recovery	trough



1 ....
2 ....
3 ....
4 ....
5 ....
6 ....

The Business Cycle

Look at the graph below which illustrates fluctuations in domestic investment in the USA as a percentage of potential Gross National Product, from 1929-1988. The level of investment is clearly linked to the business cycle. Insert the words in the boxes in the texts below.



EXERCISE 1

boom	**contracted**	**depression**
downturns	**expanded**	**peak**
recession	**recovery**	**upturns**

A period of stock market speculation ended dramatically in October 1929 with the infamous Wall Street Crash. There followed a dramatic (1) . . . . The economy (2) . . . . again after World War II. There was a series of (3) . . . . and (4) . . . . in the 1950s. There was a long (5) . . . . in the 1960s. Investment reached a (6) . . . . in 1972, just before the first oil crisis. There was a (7) . . . . in 1975 and the economy (8) . . . . again in 1982, but each time there was a rapid (9) . . . .