How Does the Business Cycle Relate to the Economy? (HA)

Economies are always changing. Or, as economics writer Charles Wheelan puts it, they “proceed in fits and starts.” Wheelan is referring to the recurring periods of growth and decline in economic activity that all economies experience. Economists call this recurring pattern the **business cycle**. The business cycle is a recurring pattern of growth and decline in economic activity over time.

### The Four Phases of the Business Cycle

<table>
<thead>
<tr>
<th>Phase of the Business Cycle</th>
<th>Real GDP</th>
<th>Unemployment Rate</th>
<th>Inflation Rate</th>
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</thead>
<tbody>
<tr>
<td><strong>Expansion</strong>: Period of economic growth</td>
<td>increasing</td>
<td>generally decreasing</td>
<td>generally increasing</td>
</tr>
<tr>
<td><strong>Peak</strong>: Highest level of economic activity</td>
<td>stops increasing</td>
<td>stops decreasing</td>
<td>stops increasing and may start decreasing</td>
</tr>
<tr>
<td><strong>Contraction</strong>: Period of economic decline</td>
<td>decreasing</td>
<td>generally increasing</td>
<td>generally decreasing</td>
</tr>
<tr>
<td><strong>Trough</strong>: Lowest level of economic activity</td>
<td>stops decreasing</td>
<td>stops increasing</td>
<td>stops decreasing and may start increasing</td>
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The business cycle consists of four phases. These phases include a period of growth and a period of decline, as well as the turning points that mark the shift from one period to the next.
A period of economic growth is known as an expansion [expansion: a period of economic growth]. During this phase of the business cycle, economic activity generally increases from month to month. The longest expansion of the U.S. economy lasted a decade, but expansions typically run out of steam in three to five years.

The point at which an expansion ends marks the peak [peak: the highest point of an expansion, or period of economic growth; a peak is followed by economic decline] of the business cycle. At that peak, economic activity has reached its highest level. The peak also marks the start of a decline in economic activity. Economists do not know when a peak is occurring until they look back at the economic data. At that time they designate one month as the peak phase.

Following the peak comes the contraction phase of the business cycle. A contraction [contraction: a period of general economic decline marked by falling GDP and rising unemployment] is a period of general economic decline marked by a falling GDP and rising unemployment. One of the longest contractions on record—43 months—occurred at the start of the Great Depression. Since 1945, however, contractions have averaged about 10 months.

The lowest point of a contraction is called the trough [trough: the lowest point of a contraction, or period of economic decline; a trough is followed by economic growth]. Like the peak, the trough marks a turning point. Once the economy hits bottom, a new expansion begins.

**Economic Indicators and the Business Cycle**

The term *business cycle* implies that expansions and contractions occur at regular, predictable intervals. But in fact, the opposite is true. Business cycles are irregular in both length and severity. This makes peaks and troughs difficult to predict. Nonetheless, economists attempt to do just that, using a variety of economic indicators. The illustration on the opposite page shows how three of these indicators—GDP, inflation rate, and unemployment rate—relate to each phase of the business cycle.

Economists categorize the indicators they use to track the business cycle based on whether they signal a future change, an ongoing change, or a change that has already begun.

*Leading indicators.* Measures that consistently rise or fall several months before an expansion or a contraction begins are called leading economic indicators [leading economic indicators: measures that consistently rise or fall several months before an expansion or a contraction begins]. They are used to forecast the peak and trough of a business cycle, although not very precisely.

The Census Bureau’s monthly estimate of housing starts is one such leading indicator. It shows the number of new home-construction projects started in the previous month. A rise in housing starts signals that there is enough money and confidence in the economy to begin preparing for the next expansion. As the economy improves, there will be plenty of people eager to buy new homes. A decline in housing starts indicates trouble ahead as consumers grow more cautious about buying new homes.

*Coincident indicators.* Coincident economic indicators are measures that consistently rise or fall along with expansions or contractions. They coincide with the phases of the business cycle. Coincident indicators are most helpful in tracking expansions and contractions as they happen.

One of the most reliable coincident indicators is real GDP. As a rule, if total output is increasing in real terms month after month, an economy is expanding. If total output begins to shrink, the economy is contracting. Because inflation also tends to rise and fall with economic activity, economists use the inflation rate as an important coincident indicator as well.

*LAGging indicators.* Measures that consistently rise or fall several months after an expansion or a contraction are known as lagging economic indicators [lagging economic indicators: measures that consistently rise or fall several months after an expansion or contraction begins]. Economists use lagging indicators to confirm that one phase of the business cycle has ended and another has begun.

One of the most important lagging indicators is the unemployment rate. The reason is that firms are often reluctant to make decisions to lay off or hire workers until they are sure about the direction of the economy. For example, when an expansion begins, firms may delay hiring new workers until they know that the economy is really growing. As a result, unemployment rates do not drop until weeks or months after an economy hits its low point and begins to recover.

**From Boom to Bust to Boom Again**
Business cycles are popularly known as periods of boom and bust. A boom is the expansion phase of the cycle. It may also be known as a recovery, upturn, upswing, or period of prosperity. All these terms mean the same thing—the economy is healthy and growing.

One of the key characteristics of a growing economy is an increase in business investment. When firms invest in capital goods, such as factories, machinery, and equipment, their productivity increases. This increased productivity contributes to a rise in real GDP. At the same time, firms hire more people to work in their stores, offices, and factories, thus increasing employment throughout the economy.

Other factors can also contribute to growth. The discovery of new resources, such as by drilling or mining, can boost the quantity of raw materials available for production. Innovations in science or technology can improve efficiency and increase productivity. Such positive “shocks” to the economy can stimulate an expansion.

America’s entry into World War II pulled the nation out of the Great Depression, the worst economic downturn in U.S. history. The war caused an immediate upsurge in demand for fighter planes, ships, arms, and supplies for the troops. This demand spurred an increase in production. Factories started hiring, unemployment fell, and an economic recovery began.

Consumer confidence is typically high during an expansion. Jobs are plentiful, and both business profits and wages are rising. The future looks bright, leading consumers to borrow and spend money, especially on “big ticket” items such as cars, appliances, and furniture.

An economic expansion can go on for years, leading people to think that it might go on forever. But inevitably, boom turns to bust. The bust, or contraction phase of the business cycle, is also called a downturn, a downswing, or a recession. Most economists define a recession [recession: a period of declining national economic activity, usually measured as a decrease in GDP for at least two consecutive quarters (six months)] as a decline in economic activity lasting at least six months. During a recession, real GDP falls, as do real wages, employment, profits, and production.

Why does an expanding economy stop growing and start shrinking? There is no single answer to that question. A number of different obstacles to growth can push an economy into recession. They include:

- a negative shock to the economy, such as rapidly rising oil prices, a terrorist attack, or a stock market crash.
- a rise in interest rates, which makes it harder for consumers and firms to borrow money.
- shortages of raw materials, which can cause price increases.
Consumers typically react to higher prices and higher interest rates by cutting back on spending. As sales slow, businesses begin to see profits fall and inventories rise. **Inventory** is merchandise that companies or stores have on hand. Faced with rising inventory, firms cut back production and lay off workers. If profits continue to fall despite these adjustments, firms must cut back further. In this way, an economy enters a contraction phase.

Some recessions are short and relatively mild in their effects. Others are severe. **On rare occasions, a recession will last a long time and cause serious damage to the economy.** Economists refer to this kind of severe contraction as a depression. A depression is a prolonged economic downturn characterized by plunging real GDP and extremely high unemployment. Americans have suffered through several depressions, with the Great Depression of the 1930s being the worst.

For many people, a recession is a time of anxiety about the economy and their own financial futures. How do consumers regain confidence? What brings bust back to boom? The answer may depend on the severity of the contraction. It took a war to end the Great Depression. The demand for armaments and other goods to fight World War II spurred production and finally turned the slumping economy around.

Recoveries are usually triggered by a combination of events. As business inventories shrink over time, firms begin to increase production. Hiring begins to pick up. Optimism returns and consumers start spending again. A new expansion begins.

The ups and downs of the business cycle may hold little interest for you at this point in your life. This is likely to change once you enter the job market. Should you start looking for work during an expansion, you may find many employers eager to hire you. But should you start your job search during a recession, good jobs may be hard to find. The next chapter explores what the government can—and cannot—do to smooth out the bumps in the business cycle.