Q) What do you mean by Business/Trade cycle. Briefly discuss the features of Trade cycle.

Meaning :—

Ans:— The Term "Trade cycle" refers to the wave-like fluctuations in the economic activities particularly in employment, output, income, profit, prices etc. Trade cycles are ups + downs in economic activity. One complete period of such movements is called cycle. cycles have a free rhythm and are irregular. Trade cycle is a part of the capitalist system. Trade cycles are the changes/alteration of the economic activities which repeat themselves after a period of time.

The Term Business cycle has been defined in various ways by different economists :—

① According to prof Mitchell, "Business cycle are a type of fluctuations found in the aggregate economic activity of nation that organise their work mainly in business enterprises."

② According to Haberler, "The business cycle in the general sense may be defined as an alternation of periods of prosperity and depression, of good and bad trade."

③ Acc. to prof Estey, " Business cycles are the alternating waves of expansion and contraction. They do not have a fixed rhythm."

④ According to Keynes, " A Trade cycle is composed of periods of good trade characterised by rising prices + low unemployment, altering with the period of bad trade characterised by falling prices and high unemployment."

Features | characteristics of Trade cycle

1. A Trade cycle is a wave-like movement.

2. Trade cycles are recurrent in nature i.e they are repetitive.

3. All Trade cycles are more or less similar in nature, but they are not exactly the same.

4. In Trade cycles, profit fluctuates more than other activities like income, price, employment etc

5. Business cycles are International in character. But all countries are not equally affected by Trade cycles.

6. Fluctuations under Trade cycles are more in capital good industries than the consumer good industries.

7. A business cycle is self-generating in nature. The self-generating forces terminate one phase and start another phase.

8. Trade cycles are rhythmic fluctuations of the economy i.e period of prosperity followed by the periods of depression etc.

9. Under Trade cycles, prices and production generally rise or fall together.

10. Industries are so interrelated that fluctuations in one will be passed on to others. Thus, cyclical fluctuations affect all the industries. Moreover, Trade cycles of one country gets affected by the trade cycle of other country through Foreign Trade.

Q) Describe various phases of Trade cycles.

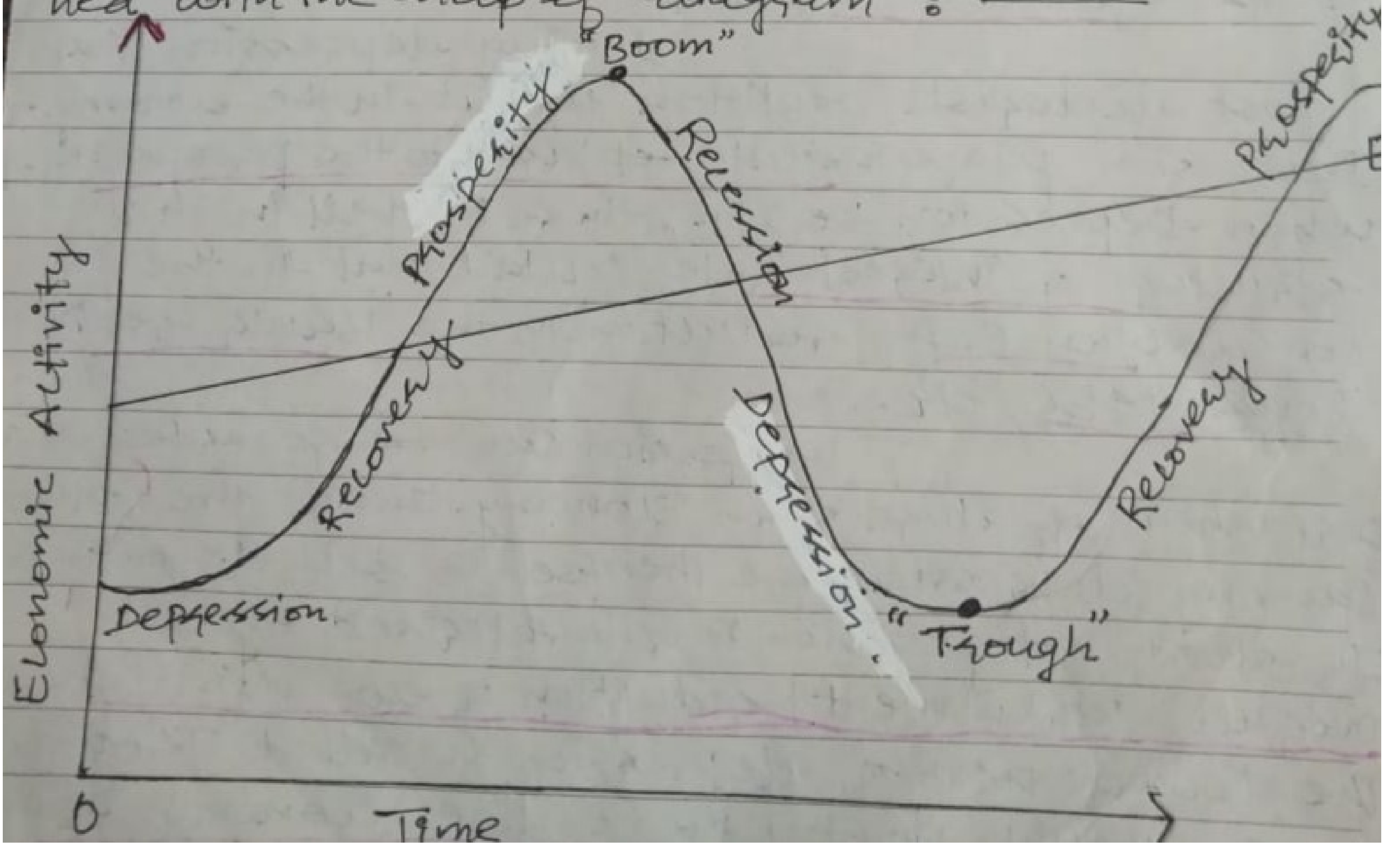
INTRODUCTION :–

Ans:– Generally Trade cycle is divided into four phases i.e

(1) prosperity phase
(2) Recession phase
(3) Depression phase
(4) Recovery phase

These phases are recurrent in nature and follows a free rhythm and a regular sequence. This means when prosperity ends, recession starts, depression follows recession, recovery follows depression, prosperity comes after recovery and in turn gives way to recession. However, there is no hard and fast time limit for a cycle and its phases. i.e No phase has any definate periodicity or Time interval. "Boom & Trough" are the two main mark-off points of Trade cycle. Boom is the peak point of prosperity And Trough is the lowest point of depression.

The Different phases of Trade cycle can be explained with the help of diagram :——



① Prosperity :—

When prosperity sets in, profits tend to rise, production goes up, output increases. The period of prosperity is marked by all round improvement in the economy with respect to employment, income and output. The Distributive shares also go up. A period of mild inflation sets in. There is generally a feeling of optimisium among the business people. There is increase in the volume of Trade & commerce. There is no idle resources or unemployed workers. Moreover, there is high MEC, arising structure of Interest Rate, and a large expansion of bank credit. Boom is the highest point of prosperity stage. At this Boom point there is over production, over income, over full employment.

② Depression :— Depression is the first stage of a trade cycle. During this stage, eco. activity is at a low ebb. Income, output, prices, employment all go down. Investment falls, business people do not take the risk in making new investments, market becomes dull. Business people go out of business.

During depression, the most deplorable conditions prevail in the economy. Depression phase is quite opposite to the prosperity. When Depression sets in, there is fall in the structure of Interest Rate, curtailment in the consumption Exp, reduction in the Bank credit, lower MEC, etc.

Depression can't be regarded as a permanent feature of an economy. Infact the forces causing depression are themselves self-defeating. In short, depression is characterised by an overall curtailment / reduction of eco. activities. The lowest point of depression is called Trough. At this Trough point, the entire economy is at worse condition.

(3) Recovery :—

The revival or recovery phase refers to the lower turning point at which an economy undergoes change from depression to prosperity. Recovery sets in when the demand for consumer goods rises, this increases the demand for capital goods and thus new investment starts to take place. Such a new investment will cause a rise in employment and income. This increased income will in turn increases the consumption which in turn leads to rise in prices, profits etc.

During the revival/Recovery period, employment, output, income slowly and steadily improve, expectations of the entrepreneurs improve. In this phase, the economy starts looking up. The general climate of optimism takes the place of pessimism which is marked by previous period. During this phase, new purchases start, new manufacturing is started, industries begin to revive, MEC increases + business people starts expecting good for trade. In brief, During this phase, all the economic activities slowly + steadily improve and gets momentum towards prosperity.

(4) Recession :—

When Boom or prosperity ends, the recession begins. Recession is known as upper turning point. It lasts relatively for a shorter period of time. During recession all the economic activities like income, output, prices, employment etc starts falling. It is quite opposite to the recovery phase. In this phase, business men lose confidence, everyone feels pessimistic about future profits. Hence investment will be drastically curtailed and production starts falling.

Moreover, credit sharply contract, Business expansion stops, orders are cancelled, leading to increase in unemployment this.

lead to fall in income throughout the economy. This reduced income causes a decline in total expenditure and thus general demand falls, which in turn decreases the price level and profits and business declines.

Fearing of that profits has come to close, businessmen stop ordering further investment/equipment & materials. The bankers insist on repayment rather than credit giving.

— × ——— × ——— × ——— × ———

NOTE :— ① Prosperity phase is also known as expansion phase or upswing phase.

② Depression phase is also known as contraction phase or downswing phase.

③ Recovery phase is also known as Revival phase or lower turning point (coz it turn from Depression to prosperity)

④ Recession phase is also known as upper turning point (coz it turn from prosperity to depression).

TYPES OF INFLATION

Inflation is that state in which the prices of goods and services rise on the one hand and value of money falls on the other. When money circulation exceeds the production of goods and services, the state of inflation takes place in the economy.

① **Creeping inflation :-** When the rise in prices is very slow, it is called creeping inflation. Such an increase in prices is of regarded safe and essential for economic growth. It is less than 3 percent

i.e $> 3\%$

② **Walking or trotting inflation :-** When price rise moderately, is called walking inflation. Such an increase is a warning signal for government. It ranges from 3% to 7% or less than 10%

i.e 3% —— 7% or $> 10\%$

③ **Running inflation :-** When price rise rapidly like the running of a horse, is called running inflation. Such an inflation affects the poor and middle classes adversely. It range from 10 to 20%

i.e 10% —— 20%

④ **Hyperinflation :-** When prices rise very fast at double or triple rate, is called Hyper inflation. It is usually called runaway or galloping inflation. Such an inflation brings a total collapse of the monetary system. It ranges from 20 to 100 percent.

i.e 20% —— 100%

(5) Demand-pull Inflation :- or excess demand inflation is the traditional and most common type of inflation. It takes place when aggregate demand is rising while the available supply of goods is becoming less.

(6) Cost-push Inflation :- It is also known as New inflation. The increase in prices induces the trade unions to demand higher wages. In this way, the wage-cost continues, thereby leading to cost-push or wage-push inflation.

(7) Open Inflation :- When Govt uses no instrument (like Monetary policy, Fiscal policy,) to control inflation, is called open inflation. Where there is no control, no restrictions, no boundaries by the Govt.

(8) Suppressed Inflation :- When Govt uses different instruments or policies to control inflation, is called suppressed inflation.
In other words, Govt uses monetary policy, fiscal policy, Administrative policy etc to control inflation.

(9) Sectoral or Sporadic Inflation :- When inflation takes place in some ~~sectors~~ sectors, some goods, is called sectoral inflation.

(10) Comprehensive Inflation :- When inflation takes place in all the sectors, all the goods, is called comprehensive inflation.

(11) Mark-up inflation :- This concept was given by prof Ackley. when the producer charge additional price, to earn profit & that additional prices lead to inflation — is called Mark-up inflation.

(12) Core inflation :- Core inflation is of two types - permanent & Non permanent inflation.

(a) permanent inflation :- such an inflation takes place due to increase in factor cost i.e increase in wages, transport, raw material, electricity, fuel, money flow, Budget, deficit, etc.

(b) Non-permanent inflation :- Due to natural calamities like war, earthquake, Tsunami etc the supply of goods becomes short and thereby lead to rise in price and hence inflation.

(13) Stagflation :- This concept was given by MR VOM in the year 1970. Stagflation is a combination of two words — 'stag' means stagnation and 'Flation' means inflation. It is a situation where the economy experiences — stagnation, unemployment, low economic growth, along with high rate of inflation. It is also known as 'inflationary recession'.

(14) Imported inflation :— when due to increased demand for imported good, the local/domestic prices shoots up and thereby leading to inflation — is called imported inflation.

(15) Hidden inflation :— when the artificial shortage of supply is created by the producers to earn more profit — ~~that~~ ~~is known~~ thereby leading to rise in price — is known as Hidden inflation.
Black Marketing also leads to such inflation.

(16) Branded inflation :— when due to increased demand for Branded goods, the local prices goes up and leads to inflation — is called branded inflation.

...discussed below : ... in the balance of payments. ... measures. There are ... Important among them are

(1) **Deflation.** Deflation is the classical medicine for correcting the deficit in the balance of payments. Deflation refers to the policy of reducing the quantity of money in order to reduce the prices and the money income of the people. The central bank, by raising the bank rate, by selling the securities in the open market and by other methods can reduce the volume of credit in the economy which will lead to a fall in prices and money income of the people. Fall in prices will stimulate exports and reduction in income checks imports. Thus, deflationary policy restores equilibrium to the balance (*i*) by encouraging exports through reduction in their prices and (*ii*) by discouraging imports through the reduction in incomes at home. Moreover, a higher interest rate in the domestic market will attract foreign funds which can be used for correcting disequilibrium.

(2) **Depreciation.** Another method of correcting disequilibrium in the balance of payments is depreciation. Depreciation means a fall in the rate of exchange of one currency (home currency) in terms of another (foreign currency). A currency will depreciate when its supply in the foreign exchange market is large in relation to its demand. In other words, a currency is said to depreciate if its value falls in terms of foreign currencies, *i.e.*, if more domestic currency is required to buy a unit of foreign currency. The effect of depreciation of a currency is to make imports dearer and exports cheaper. Thus, depreciation helps a country to achieve a favourable balance of payments by checking imports and stimulating exports.

(3) **Devaluation.** Devaluation refers to the official reduction of the external values of a currency. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the Government, depreciation means an automatic fall in the external value of the currency by the market forces ; the former is arbitrary and the latter is the result of market mechanism. Thus, devaluation serves only as an alternative method to depreciation. Both the methods imply the same thing, *i.e.* decrease in the value of currency in terms of foreign currencies. Both the methods can be used to produce the same effects ; they discourage imports, encourage exports and thus lead to a reduction in the balance of payments deficit.

(4) **Exchange Control.** ...

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Q.12. Explain the concepts of Reflation and Deflation.

Ans. Meaning of Deflation : Deflation is the opposite of inflation. In the words of **Prof. Crowther**, *"Deflation is that state of economy where the value of money is rising or the prices are falling."* This definition is not free from defects. From this definition, it appears that every fall in the price level is deflation but actually this may not be so. Sometimes, the price level starts failing down without any contraction in the supply of money. Now such a fall in the price level cannot be called deflation.

There is still another definition of deflation. According to this definition, deflation may refer to that state of the economy where the supply of money at a particular time is *less* than its demand. In other words, the supply of money in the economy is not sufficient to meet business requirements of the economy. Deflation is bound to result in such a state of the economy. The prices of goods and services will fall and the value of the money will start rising. This definition has one important defect insofar as it does not tell us how to make an accurate estimate of the money requirements of the economy.

According to **Prof. Pigou**, "Deflation is that state of falling prices which occurs at that time when the output of goods and services increases more rapidly than the volume of money income in the economy." Thus, according to Pigou, every fall in the price level is not deflation. Deflation occurs at that time when the output of goods and services increases at a faster rate than the money income. A fall of prices in the following situations may be termed deflationary according to Pigou : (a) If the money income diminishes but the output remains constant. (b) If the money income and the output both diminish, but the money income - diminishes much more rapidly than the output. (c) If the volume of output increases but the money income remains constant. (d) If the volume of output and money income both increase, but the output increases faster than the money income. (e) If the volume of output increases but the volume of money income diminishes. In each of these cases, the fall in prices will be deflationary.

From the above definitions, we may say that a contraction in the supply of money causes a fall in the price level, or the fall in the money supply leads to a fall in the price level. This may, however, be not wholly true. The fall in the price level is not only the result of the fall in money supply, it can also be the cause of the contraction in the supply of money. If the prices continuously go on falling, the economy may not need as much money supply as before. Thus, the falling price level is both the result as well as the cause of the fall in the supply of money. From this point of view, Prof. Paul Einzig's definition appears to be the best definition of deflation. Deflation, according to Einzig, "is a state of disequilibrium in which a contraction of purchasing power tends to cause, or is the effect of, a decline of the price level.

Reflation: Reflation is a situation marked by rising prices and expansion of money supply. Reflation is deliberately undertaken by the government to relieve a depression. As a result of this policy, income, output and employment continue to increase till the economy reaches the point of full employment.

Inflation is different from reflation in exactly the same manner as deflation is different from disinflation. According to G.D.H. Cole, "Reflation may be defined as inflation deliberately undertaken to relieve a depression."

Inflation and Reflation resemble each other in two respects:

1. In both, money supply increases.
2. Both lead to a rise in the price level.

But still there are some basic differences between inflation and reflation. Such as :

1. Inflation causes a serious problem of rising prices without any increase in output and employment, reflation does not create such problem. It rather saves the already shattered economy from the problem of deflation.

2. Inflation may be due to natural factors or may be the result of deliberate policy of the government. But, reflation is always adopted by the government as a deliberate policy.
3. Inflation occurs after the level of full employment, whereas, reflation occurs before the level of full employment.
4. Prices rise very rapidly under inflation, while they rise very slowly under reflation.

These terms inflation, deflation and reflation are explained better through the following diagram.

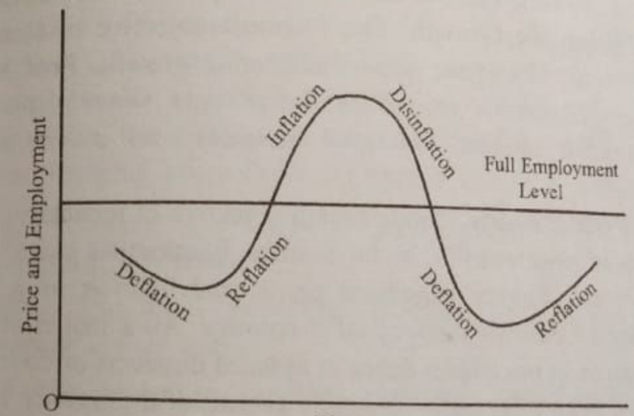

Fig. 5.3.

SHORT QUESTION ANSWERS

Q.1. Give the meaning of Monetary Policy?

Ans. Meaning of monetary policy : Monetary policy implies measures designed to ensure an efficient operation of the economic system or set of specific objectives through its influence on the supply, cost and availability' money. For this purpose, monetary policy involves the deliberate and conscious use of monetary instruments like bank rate, open market operations, change in reserve ratio and qualitative credit control measures.

inflation is supp...

Q. 17. Give the meaning of Deflation.

Ans. Meaning of Deflation : Deflation is the opposite of inflation. In the words of **Prof. Crowther**, "Deflation is that state of economy where the value of money is rising or the prices are falling."

Q.18. What is Reflation?

Ans. Meaning of Reflation: By reflation we mean, a situation marked by rising prices and expansion of money supply. Reflation is deliberately undertaken by the government to relieve a depression. As a result of this policy, income, output and employment continue to increase till the economy reaches the point of full employment.

Q. 19. What is the difference between inflating and reflation?

Ans. Inflation may be due to natural factors or may be deliberate policy of the government, but reflation is always adopted by the government as a deliberate policy.

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wage and price inflation are based on some reasonable ... of individuals, ... these policies ... inflation. Persons who accept wage increases below the target rates are rewarded with tax credits. Those who insist on wage increases above the target rates are levied a penalty tax. Similar is the case with business firms. Firms which keep wages down to the target rates are rewarded with a reduction in their business income tax. On the other hand, those who permit wage increases above the target rates are charged a penalty tax in addition to business income tax.

Third, there is need to introduce income policies. One of the import planks of the income policies is to link the increase of money wages to productivity increase. Thus the rate of increase of money wages should be limited to the overall rate of productivity increase. Further, prices should be reduced in those industries having above-average productivity growth. On the other hand, prices should be raised in industries where productivity is increasing less than the national average rate. Prices should be kept stable in industries where productivity is increasing at the national average rate. But such policies are difficult to implement in the case of an open country. If import prices of food and other consumers products rise, they tend to raise the domestic price level. This makes it difficult for unions to stick to wage agreements.

Fourth, the best policy measure is to reduce personal and business taxes because they tend to reduce labour costs and raise demand for labour. Similarly, sales tax and excise duties should be reduced in order to prevent the price level from rising. To encourage state and local government to reduce state and local sales and excise taxes, the central government should sanction additional grants-in-aid to them.

Thus to combat stagflation, a vast spectrum of policy measures is needed.

Meaning

CAUSES OF INFLATION

Inflation is caused when the aggregate demand exceeds the aggregate supply of goods and services. We analyse the factors which lead to increase in demand and the shortage of supply.

Factors Affecting Demand

Both Keynesians and monetarists believe that inflation is caused by increase in the aggregate demand. They point towards the following factors which raise it.

1. *Increase in Money Supply*. Inflation is caused by an increase in the supply of money which leads to increase in aggregate demand. The higher the growth rate of the nominal money supply, the higher is the rate of inflation. Modern quantity theorists do not believe that true inflation starts after the full employ-

ment level. This view is realistic because all advanced countries are faced with high levels of unemployment and high rates of inflation.

2. *Increase in Disposable Income*. When the disposable income of the people increases, it raises their demand for goods and services. Disposable income may increase with the rise in national income or reduction in taxes or reduction in the saving of the people.

3. *Increase in Public Expenditure*. Government activities have been expanding much with the result that government expenditure has also been increasing at a phenomenal rate, thereby raising aggregate demand for goods and services. Governments of both developed and developing countries are providing more facilities under public utilities and social services, and also nationalising industries and starting public enterprises with the result that they help in increasing aggregate demand.

4. *Increase in Consumer Spending*. The demand for goods and services increases when consumer expenditure increases. Consumers may spend more due to conspicuous consumption or demonstration effect. They may also spend more when they are given credit facilities to buy goods on hire-purchase and instalment basis.

5. *Cheap Monetary Policy*. Cheap monetary policy or the policy of credit expansion also leads to increase in the money supply which raises the demand for goods and services in the economy. When credit expands, it raises the money income of the borrowers which, in turn, raises aggregate demand relative to supply, thereby leading to inflation. This is also known as credit-induced inflation.

6. *Deficit Financing*. In order to meet its mounting expenses, the government resorts to deficit financing by borrowing from the public and even by printing more notes. This raises aggregate demand in relation to aggregate supply, thereby leading to inflationary rise in prices. This is also known as *deficit-induced* inflation.

7. *Expansion of the Private Sector*. The expansion of the private sector also tends to raise the aggregate demand. For huge investments increase employment and income, thereby creating more demand for goods and services. But it takes time for the output to enter the market.

8. *Black Money*. The existence of black money in all countries due to corruption, tax evasion etc. increases the aggregate demand. People spend such unearned money extravagantly, thereby creating unnecessary demand for commodities. This tends to raise the price level further.

9. *Repayment of Public Debt*. Whenever the government repays its past internal debt to the public, it leads to increase in the money supply with the public. This tends to raise the aggregate demand for goods and services.

10. *Increase in Exports*. When the demand for domestically produced goods increases in foreign countries, this raises the earnings of industries producing

export commodities. These, in turn, create more demand for goods and services within the economy.

Factors Affecting Supply

There are also certain factors which operate on the opposite side and tend to reduce the aggregate supply. Some of the factors are as follows:

1. *Shortage of Factors of Production*. One of the important causes affecting the supplies of goods is the shortage of such factors as labour, raw materials, power supply, capital etc. They lead to excess capacity and reduction in industrial production.

2. *Industrial Disputes*. In countries where trade unions are powerful, they also help in curtailing production. Trade unions resort to strikes and if they happen to be unreasonable from the employers' viewpoint and are prolonged, they force the employers to declare lock-outs. In both cases, industrial production falls, thereby reducing supplies of goods. If the unions succeed in raising money wages of their members to a very high level than the productivity of labour, this also tends to reduce production and supplies of goods.

3. *Natural Calamities*. Drought or floods is a factor which adversely affects the supplies of agricultural products. The latter, in turn, create shortages of food products and raw materials, thereby helping inflationary pressures.

4. *Artificial Scarcities*. Artificial scarcities are created by hoarders and speculators who indulge in black marketing. Thus they are instrumental in reducing supplies of goods and raising their prices.

5. *Increase in Exports*. When the country produces more goods for export than for domestic consumption, this creates shortages of goods in the domestic market. This leads to inflation in the economy.

6. *Lop-sided Production*. If the stress is on the production of comfort, luxuries, or basic products to the neglect of essential consumer goods in the country, this creates shortages of consumer goods. This again causes inflation.

7. *Law of Diminishing Returns*. If industries in the country are using old machines and outmoded methods of production, the law of diminishing returns operates. This raises cost per unit of production, thereby raising the prices of products.

8. *International Factors*. In modern times, inflation is a worldwide phenomenon. When prices rise in major industrial countries, their effects spread to almost all countries with which they have trade relations. Often the rise in the price of a basic raw material like petrol in the international market leads to rise in the price of all related commodities in a country.