INVESTOR'S GUIDE

A guide to the financial markets, investments and the economy

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NICO Asset Managers

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Topic 244: Business Cycles

Last week we concluded the topic on risk management. We discussed failures that arise in risk management. This week we will begin a new topic on business cycles. A business cycle is defined as the fluctuation of economic activity over a period of time. It is basically a pattern of expansion and contraction in the economy. These fluctuations involve shifts between periods of rapid economic growth and periods of relative stagnation or decline. Factors such as gross domestic product (GDP), interest rates, level of employment and consumer spending help determine the current stage of the business cycle of an economy. Business cycles have five distinct stages: expansion, peak, recession, trough and recovery. This week we will look at these stages of a business cycle:

1. Expansion

An expansion is characterized by increases in various economic factors such as production, employment, wages, profits, prices, demand and supply of products. During this stage, there is an increase in investment opportunities, individuals save more and debtors are able to repay their debts, creating an increase in money supply. Since debtors are able to repay their debts, this influences creditors to lend out more money.

2. Peak

This is a stage whereby the increase in an economy's growth rate reaches its maximum limit. An economy's growth rate eventually slow down and reaches its peak. During this stage, economic factors such as production, profit, sales and employment remain high and do not increase any further.

There is also a slowdown in the increase in the demand of various products due to the rapid increases in prices of factors of production during the expansion phase. In addition, the incomes of individuals remain constant while prices of goods are typically high, this influences consumers to begin to restructure their spending.

3. Recession

As discussed above, during the peak stage there is a gradual decrease in the demand of various products. This decline becomes rapid, leading to the recession stage. During this stage, economic factors such as production, wages, prices, saving and investment start to decrease. The decrease in demand for products eventually leads to a reduction in supply, which results to decline in the prices of factors of production.

4. Trough

During this stage, economic activities decline below the normal level and the growth rate of an economy becomes negative. At this point, an economy reaches it's the lowest level of contraction. There is a rapid decline in national income and expenditure. It becomes difficult for debtors to pay off their debts, unemployment becomes high, and many weak companies become bankrupt or dissolve.

5. Recovery

As discussed above, in a trough stage an economy reaches its lowest level of contraction. Once the economy reaches this level, the reversal of the business cycle begins. Organizations stop laying off individuals and start hiring in limited numbers. Consumers begin to increase their rate of consumption and this results in an increase in demand and prices for goods. Investments also begin to rise.

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