RESERVE BANK OF AUSTRALIA

The Business Cycle

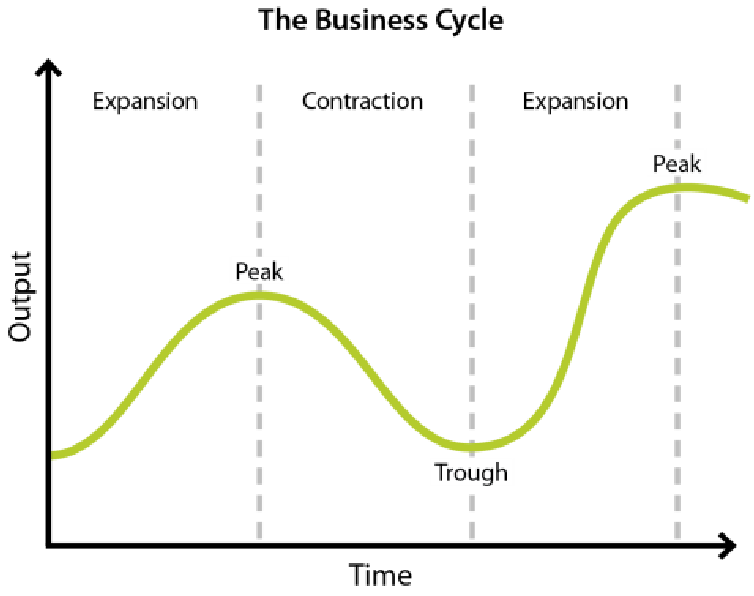
Education

What is the business cycle?

The **business cycle** depicts the rise and fall in output (production of goods and services), over time.

Each business cycle has four phases:

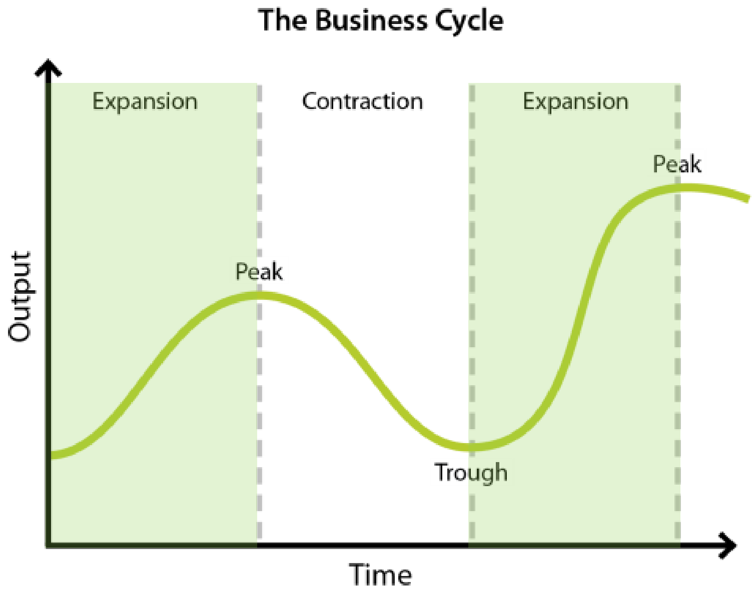
- Expansion
- Peak
- Contraction
- Trough



Economic expansion

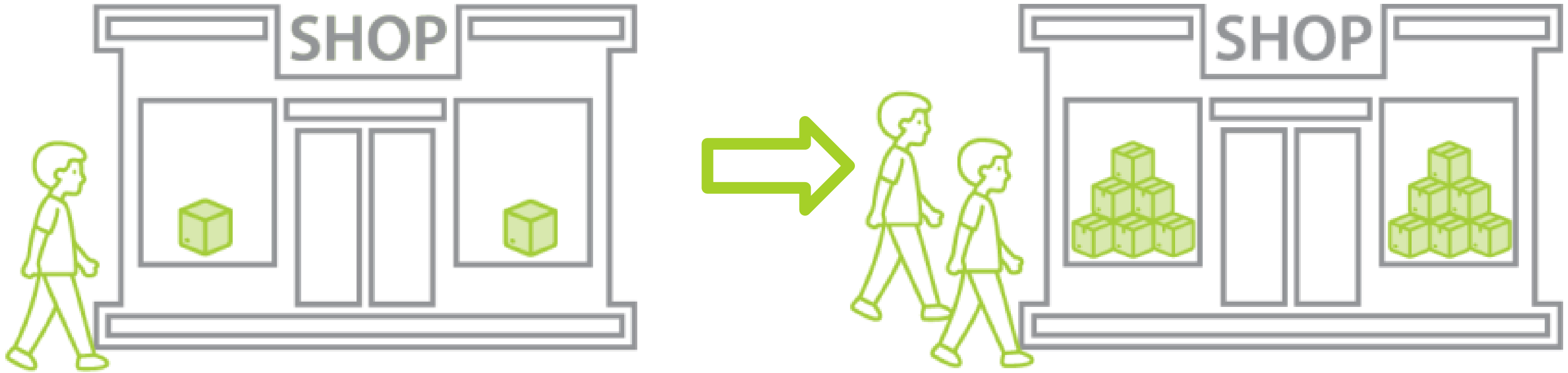
The **upswing** of the business cycle towards a peak is called an **economic expansion**. An economic expansion is associated with:

- increase in production/output
- decrease in unemployment
- increase in wages
- increase in consumer spending.



Increase in production/output

As the economy expands, businesses generally see an increase in sales or *demand* for their products. They will produce more goods and services to meet this increase in demand.

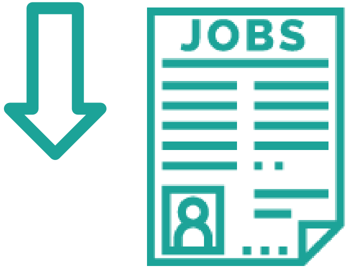


Decrease in unemployment

As businesses need to produce more goods and services to meet demand, they need to hire more workers. Consequently, the level of unemployment declines.

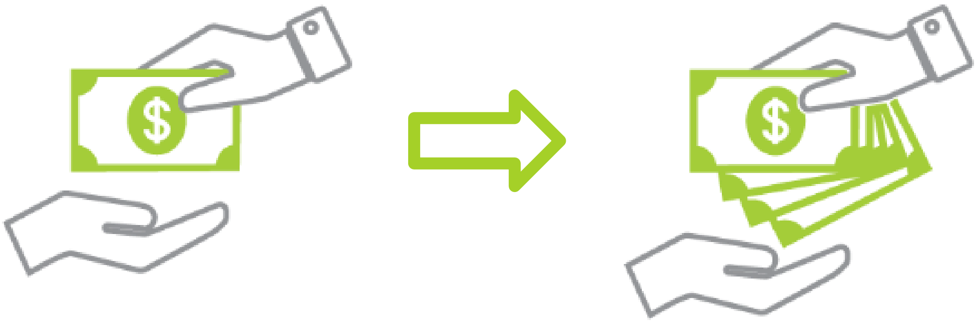
Output

Unemployment rate



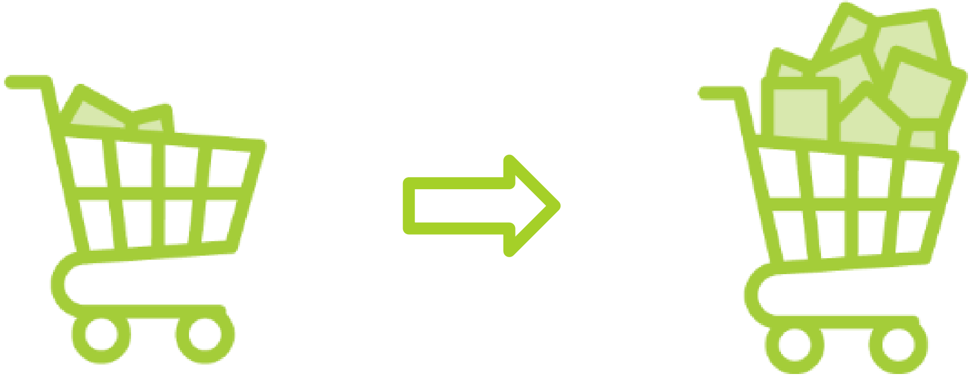
Increase in wages

Because businesses are doing well, they need to attract and keep workers by offering higher wages.



Increased consumer spending

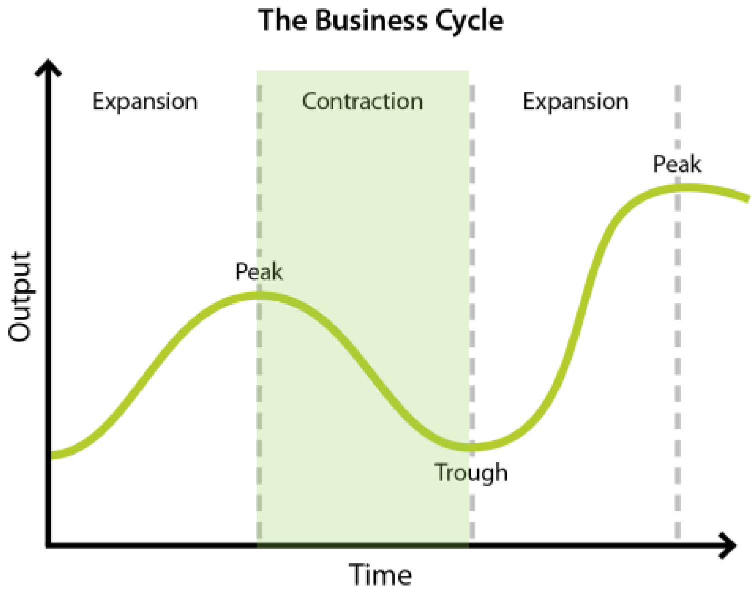
As people are earning higher wages, they spend more money in the economy – adding to demand.



Economic contraction

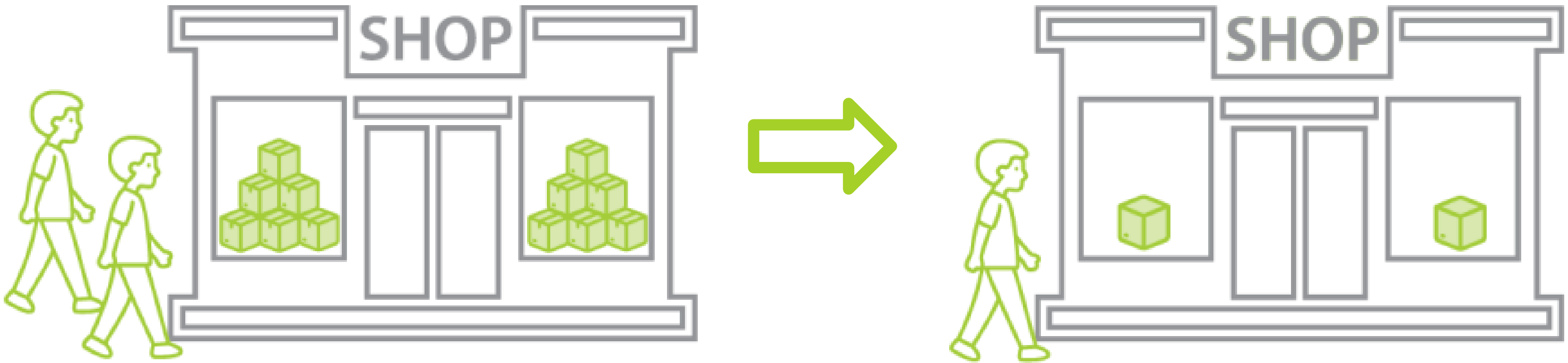
The **downswing** of the business cycle towards a trough is called an **economic contraction**.
It is associated with:

- decrease in production/output
- increase in unemployment
- decrease in wages
- decrease in consumer spending.



Decrease in production/output

As the economy contracts, businesses generally see a decrease in sales or demand for their products. Businesses will respond to this reduction in demand by producing fewer goods and services.



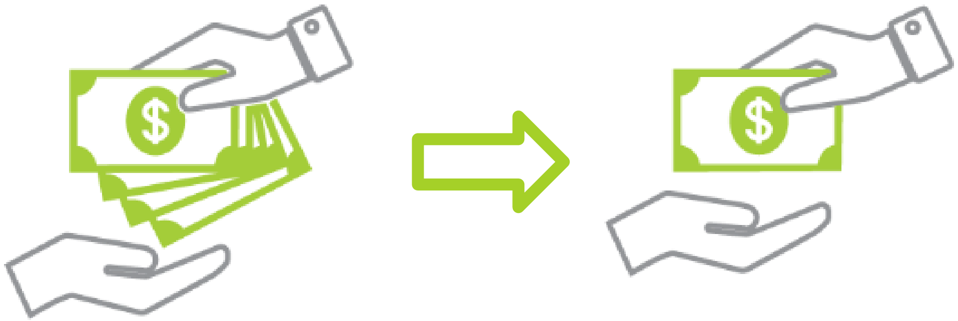
Increase in unemployment

As businesses don't need to produce as much to meet demand, some businesses will reduce the size of their workforce by letting go of some of their employees. This increases the number of unemployed workers.

Decrease in wages

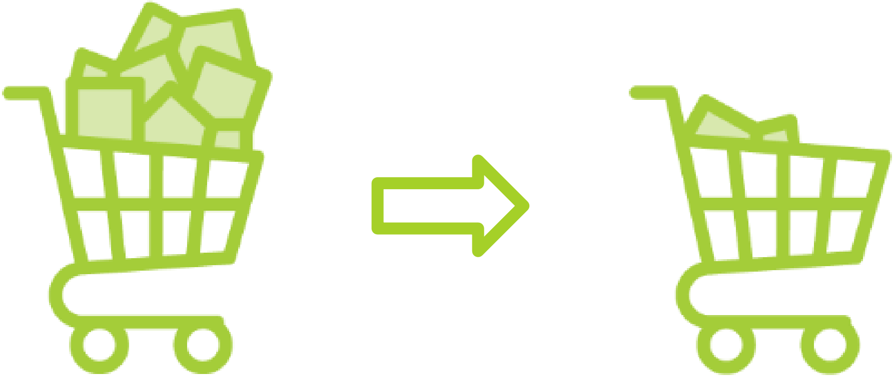
Because businesses are doing less well, they don't need as many workers. They can attract enough workers at lower wages.

Workers are willing to accept lower wages, as the increase in unemployment has meant there is more competition for jobs.



Decreased consumer spending

Because people are earning lower wages, they spend less on goods and services. They may be more concerned about losing their job, so they may be more likely to save, rather than spend, their money.



Boom, recession and depression

The business cycle can also go through more extreme phases.

A **boom** is a period of strong economic expansion where many businesses are operating at full capacity or above capacity, and the unemployment rate is very low. Income and production are at very high levels. This can lead to rapid growth in prices.

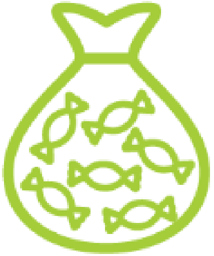
A **recession** is when output has fallen for a period of time and the unemployment rate increases.

A **depression** is a very severe recession. There is a large contraction in the economy, and the unemployment rate is likely to be at a very high level.

What is inflation?

Inflation is an increase in the prices of the goods and services that households buy. It is measured as the rate of change of those prices. Typically, prices rise over time, but prices can also fall (called deflation).

Your grandparents might have told you that they could buy a bag of lollies for 20 cents when they were your age. You would be more likely to pay 2 dollars for the same lollies today.



Then

$0.20

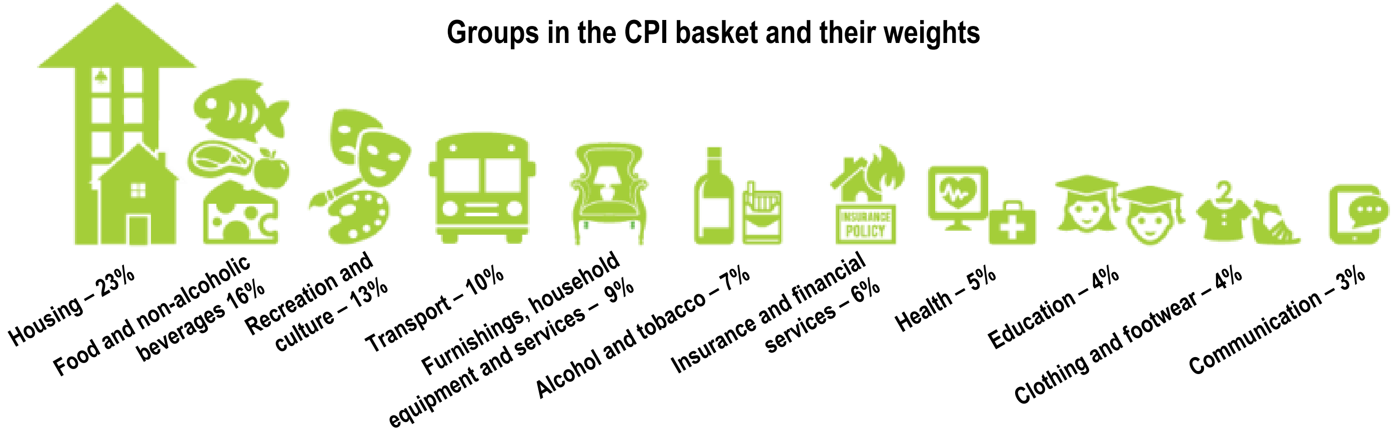
Now

$2.00

How is inflation measured?

The most well-known indicator of inflation is from the Consumer Price Index (CPI), which measures the changes in the price of a typical basket of goods and services consumed by households. The inflation rate is the percentage change in the price of this basket over time. If the inflation rate is 3%, a ‘basket’ of goods and services that cost you $100 last year will cost you $103 this year.

Groups in the CPI basket and their weights



Inflation and the business cycle

During an expansion

As consumers demand more output (goods and services), businesses produce more output to meet this increased demand, but they will eventually reach their productive capacity (their maximum level of supply). There will be more demand for their output than output available. This pulls prices up.

During a contraction

As consumers demand less, businesses produce less output. Some businesses may lower their prices or offer discounts to increase sales. This leads to lower inflation or deflation.

Why is inflation important?

It is important for the rate of inflation in an economy to be managed. A low, steady rate of inflation is good for the economy. But if inflation is too high, the currency loses its value. If inflation increases at a very rapid rate, it is called **hyperinflation**. Examples:

- In the early 1920s, inflation in Germany reached rates of more than 30,000 per cent per month. Prices doubled every few days.
- In 2019, inflation in Venezuela reached 1 million per cent.

The Reserve Bank of Australia

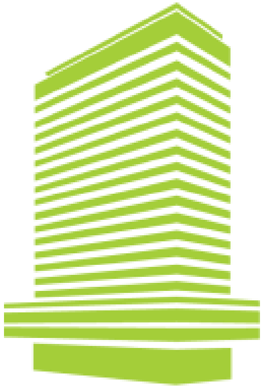
In Australia, '**inflation targeting**' was introduced in the early 1990s to control the rate of inflation.

The **Reserve Bank of Australia** is the country's central bank. One of its many roles is to keep inflation between 2 and 3 per cent, on average, over time.

Economists at the Bank analyse data to understand what is happening in the economy.

Central bank versus commercial banks

As a central bank, the Reserve Bank doesn't hold deposits for, or lend money to, people and businesses.

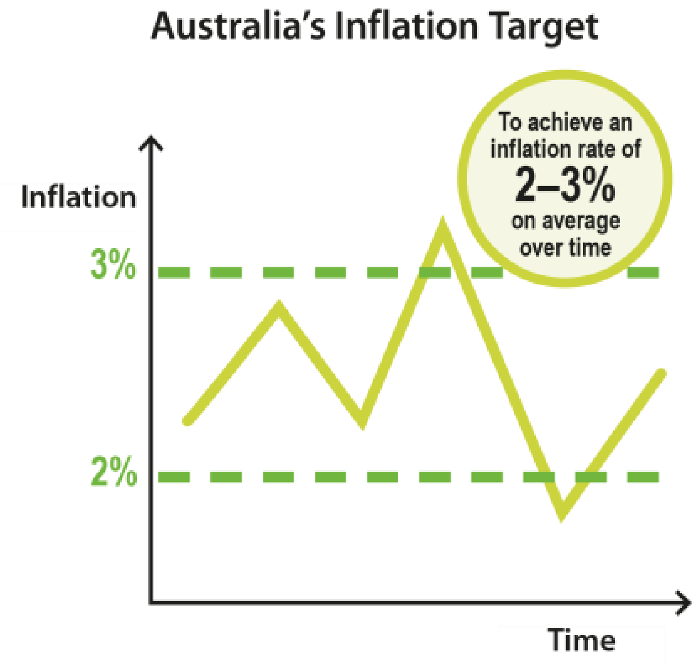


Commercial banks, however, lend money (in the form of loans) to people and businesses, and accept deposits of savings.

Influencing interest rates (and inflation)

The Reserve Bank of Australia influences the economy by carrying out ‘**monetary policy**’.
It sets the ‘**cash rate**’, which influences the interest rates offered by commercial banks to their customers.

Raising or lowering interest rates can stimulate or dampen economic activity if needed, helping to achieve a low and steady inflation rate.



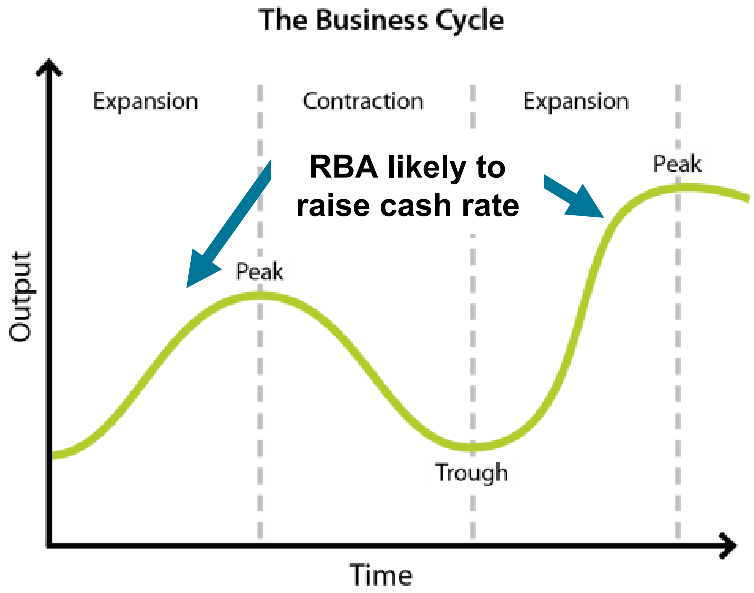
Smoothing the business cycle

If the economy is expanding too quickly

The Reserve Bank is likely to raise the cash rate.

Commercial banks will raise interest rates, making it more expensive to borrow money, and more attractive to save money.

People will tend to save more and borrow/spend less.



Interest rates

When people/businesses borrow money from a bank, the bank charges them **interest**. The **interest rate** is the percentage they are charged.

Example: Tia wanted to borrow $10,000 from her bank to buy a car. If the interest rate was 5% per year and she took one year to repay the loan, she would have to pay back the $10,000 borrowed plus $500 in interest.

Banks also pay interest to people/businesses who save money with them (although the rates tend to be lower than for borrowers).

Example: Eddy deposited $100 he received for this birthday in a savings account at his bank, which paid an interest rate of 2% per year. After one year, Eddy had $102 in his account – the $100 saved plus $2 in interest.

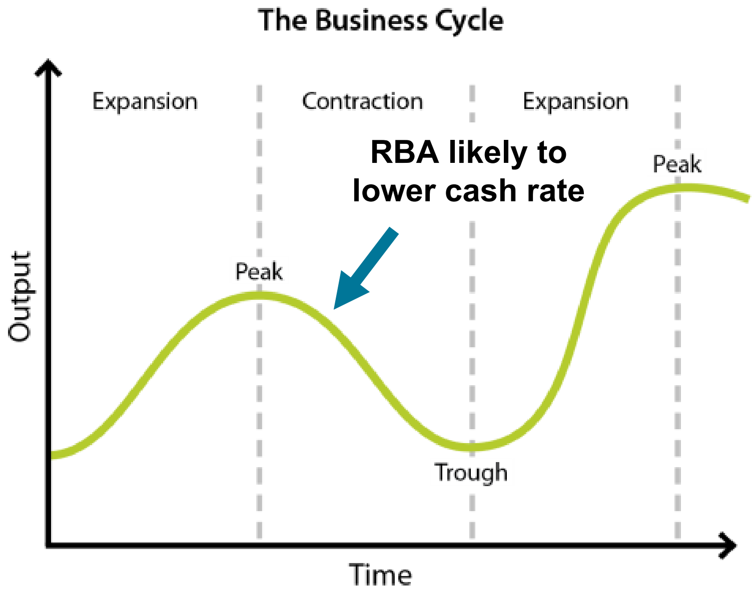
Smoothing the business cycle

If the economy is growing too slowly

The Reserve Bank is likely to lower the cash rate.

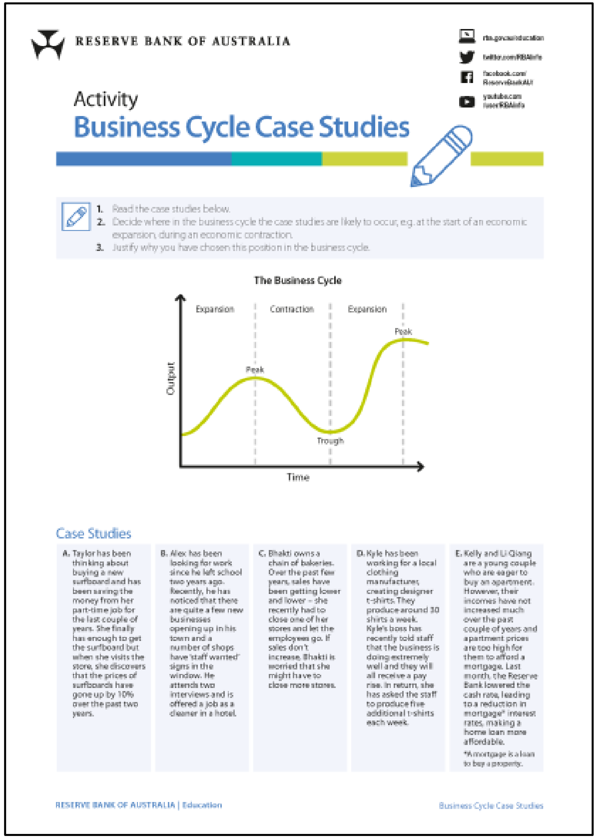
Commercial banks will lower interest rates, making it cheaper to borrow money.

People will tend to save less and borrow/spend more.



Activity: Business Cycle Case Studies

1. Read the case studies in **Activity: Business Cycle Case Studies**.
2. Decide where in the business cycle the case studies are likely to occur, e.g. at the start of an expansion, during a peak, during an economic contraction.
3. Justify why you have chosen this position in the business cycle.



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Activity

Business Cycle Case Studies

1. Read the case studies below.
2. Decide where in the business cycle the case studies are likely to occur, e.g. at the start of an economic expansion, during an economic contraction.
3. Justify why you have chosen this position in the business cycle.

The Business Cycle

Expansion
Contraction
Expansion
Peak
Peak
Trough
Output
Time

Case Studies

A. Taylor has been thinking about buying a new surfboard and has been saving the money from her part-time job for the last couple of years. She finally has enough to get the surfboard but when she visits the store, she discovers that the prices of surfboards have gone up by 10% over the past two years.

B. Alex has been looking for work since he left school two years ago. Recently, he has noticed that there are quite a few new businesses opening up in his town and a number of shops have 'staff wanted' signs in the window. He attends two interviews and is offered a job as a cleaner in a hotel.

C. Bhakti owns a chain of bakeries. Over the past few years, sales have been getting lower and lower – she recently had to close one of her stores and let the employees go. If sales don't increase, Bhakti is worried that she might have to close more stores.

D. Kyle has been working for a local clothing manufacturer, creating designer t-shirts. They produce around 30 shirts a week. Kyle's boss has recently told staff that the business is doing extremely well and they will all receive a pay rise. In return, she has asked the staff to produce five additional t-shirts each week.

E. Kelly and Li Qiang are a young couple who are eager to buy an apartment. However, their incomes have not increased much over the past couple of years and apartment prices are too high for them to afford a mortgage. Last month, the Reserve Bank lowered the cash rate, leading to a reduction in mortgage* interest rates, making a home loan more affordable.

*A mortgage is a loan to buy a property.

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Business Cycle Case Studies