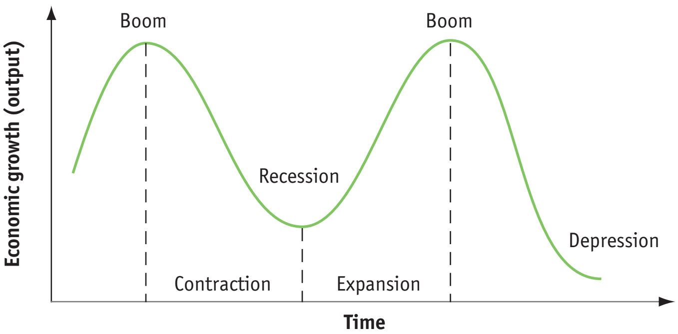
13.2

The business cycle (1)

Imagine your local shopping centre to be a small-scale representation of the Australian economy. Now, imagine what would happen to the businesses within the shopping centre if all their customers decided to shop at another centre for a day. Economic disaster! If this situation continued for a month then the centre's businesses would close, employees would be laid off, and landlords and suppliers would not be paid. Eventually, as the 'economy' plunged into a **recession**, business owners would lose confidence in the economy's future. However, at the rival shopping centre, new businesses would open, many new jobs would be created, landlords and suppliers would gain new customers and the confidence of the local business owners would soar. The 'economy' of this shopping centre would boom.

While such an extreme situation would not happen in reality, the Australian economy does experience a cycle of 'booms' and 'busts'. These periods of high and low economic activity are referred to as the **business cycle**. After a period of prosperity, business activity gradually slows until a recession or **depression** is reached. Eventually, business picks up again until prosperity is restored. This completes the cycle. These cycles are a basic feature of our economic system.



Contraction

Key features
- Falling levels of production (output)
- Decreasing consumer spending
- Rate of inflation may fall
- Wage rates generally fall
- Interest rates eventually fall
- Level of unemployment rises

Expansion

Key features
- Rising levels of production (output)
- Increasing consumer spending
- Rate of inflation may rise
- Wage rates generally rise
- Interest rates eventually rise
- Level of unemployment falls

Phases of the business cycle

No economic system works perfectly all the time under all conditions, and the Australian economy is no exception. The level of economic activity does not remain at a constant level. Instead, it fluctuates (moves up and down) over time. In other words, total production, incomes, spending and employment rise and fall. The main cause of the fluctuations in the level of economic activity is the change in the level of total spending — consumer spending (consumption), business spending (investment) and government spending — within the economy.

The Great Depression

In the United States of America especially, 1929 appeared to be a golden year. Economic growth and affluence seemed to be entrenched. The US had never been richer. There was a great rush to buy shares in companies in order to profit from the expanding business wealth.

But on 24 October 1929, the euphoria rapidly evaporated. On 'Black Thursday', the New York Stock Exchange saw share values begin to fall sharply. American factories now found it difficult to sell their goods. Employers were forced to reduce wages and dismiss many workers. This meant more people had less money to spend, and so the whole process accelerated. US household spending fell from $79 billion in 1929 to $46 billion in 1933.

As a result, US businesses cut back production and investment. Business and consumer confidence were shattered. Thousands of businesses were declared bankrupt. Mass unemployment was now common. Lifetime savings were wiped out when thousands of banks suspended operations. Farmers were bankrupt. Families were evicted from their homes for not being able to meet their mortgage repayments. And all the while, the unemployment queues grew longer. People who had worked hard all their lives, who had planned and saved for the future found themselves financially ruined.

As the US economy toppled, it dragged down other national economies. Like the ripples in a pond, the effects of the Great Crash of Wall Street soon appeared to touch every country in the world. What began as a financial crisis of confidence in the USA ended up as the Great Depression of the 1930s.

2009 Global economic crisis

In September 2008, the US financial system suffered a massive loss of confidence as homeowners with **subprime loans** (or low doc loans as they are referred to in Australia) defaulted on their mortgage payments. Previously, vast amounts of mortgage cash had been lent to 'Ninja' (no income, no job applicants) borrowers who could not afford them. The housing bubble finally burst! Quickly, the US financial crisis spread to the rest of the world. Large financial institutions became bankrupt or were bought out, and governments were forced to implement rescue packages to bail out their financial systems.

The global financial crisis inevitably led to a severe global economic recession, the worst since the 1930s Great Depression. World stock markets collapsed and world economic growth and trade severely declined with a consequent increase in unemployment. The economic deterioration was so severe in some countries that the International Monetary Fund was forced to bail them out by offering massive loans.

Expansionary fiscal and monetary policies were needed to act as a buffer against the deteriorating global conditions. Consequently, in early 2009, governments of the rich nations launched economic stimulus packages in order to pour millions of dollars into their economies. In Australia, for example, the Rudd Government injected about $53 billion into the Australian economy through two budgetary measures. These packages contained a mixture of immediate stimulus to encourage consumer spending and longer-term infrastructure projects. In the US, President Obama introduced a $1.21 trillion stimulus measure designed to create or protect 3.5 million jobs. Additionally, world central banks cut interest rates with the aim of stimulating consumer spending and business investment.

Unemployed men queuing for soup and bread during the Great Depression

Activities

Understand

1. What do you understand by the 'business cycle'?
2. List the main phases of the business cycle. Use a diagram to illustrate your answer.
3. Why does the level of economic activity fluctuate over time?
4. Total spending consists of spending by which three groups (sectors)?
5. What is a subprime loan?

Think

6. If our economy grows (i) rapidly or (ii) slowly, why should we be concerned?
7. Read the case study about the Great Depression.
   (a) List the main economic effects of the Great Depression.
   (b) In small groups, brainstorm the policies you would put into action to fix a depressed economy. Share your answer with the rest of the class.
   (c) Investigate what the economic role of the government should be in a depressed economy, according to the famous English economist John Maynard Keynes. (Hint: you may need to refer to some economic references.) Compare and comment on your solutions, with those developed by Keynes.
   (d) What was the main cause of the 2009 global economic crisis?
   (e) Why did governments in rich nations introduce economic stimulus packages in early 2009?

Investigate

8. Prepare a one-page report on living conditions in Australia or America during the Great Depression. In your report refer to the following points:
   - the number of people unemployed
   - effects of unemployment on the individual.

eBook*plus* **Worksheet 13.2** Complete and analyse a graph on the 'ups' and 'downs' of economic growth.

Glossary

business cycle the cyclical fluctuations in the level of economic activity that an economy goes through over time

depression a severe contraction in the level of economic activity resulting in many business failures, high and sustained levels of unemployment and sometimes falling prices

recession a relatively mild contraction in the level of economic activity resulting in reduced spending, rising unemployment and a slow rate of economic growth

subprime loans loans to borrowers who have a poor credit rating. They are offered at a higher rate of interest than for prime loans.