110 Economic growth and the business cycle

Economic growth

For the past 50 years, the UK economy has grown at an average rate of 2.5 per cent. This is the long-run trend rate of growth of the UK economy. ECONOMIC GROWTH is measured by changes in the size of NATIONAL INCOME. This is the value of total income in the economy. It is also equal to the value of total spending and total production or output. There is a number of different ways of calculating national income. The method most often used by economists and the media is GROSS DOMESTIC PRODUCT or GDP.

Economic growth means that more is produced. In turn, this means that households and individuals can, on average, consume more goods and services. The standard of living enjoyed by the typical family today is far higher than it was 25 or 50 years ago as Figure 1 shows.

The business cycle

GDP does not rise at a steady rate each year. There are fluctuations and in some years the level of GDP may even fall. These fluctuations tend to occur on a regular basis and follow the same broad pattern. This is known as the BUSINESS CYCLE or TRADE CYCLE or ECONOMIC CYCLE. There are four phases to the business cycle, shown in Figure 2.

Boom In a BOOM, the economy is doing well.

- Output is high and the economy is growing strongly.
- Consumer spending is high. Also consumers are willing to borrow to finance their purchases.

Figure 1: Income (GDP) per person at constant 2003 prices, UK 1956-2007.

Source: adapted from *Economic & Labour Market Review*, Office for National Statistics.

- House prices are likely to be growing, helped by high mortgage lending by banks and building societies.
- Unemployment is low and businesses may find it hard to recruit new workers.
- Wages are likely to be rising at a fast rate, as businesses compete to employ a limited pool of workers.
- Strong growth in demand for goods and services, combined with above average increases in wages, might increase inflation rates. Inflation is the rise in the general level of prices in the economy.
- With many domestic businesses working at full capacity, they could find it difficult to provide all the products that customers want to buy. So demand for imports might grow at a faster than average rate.
- There might be bottlenecks in certain sectors of the economy. This is where customers want to buy products, but they aren't available in sufficient quantities from domestic producers or importers. Delivery times might be longer. In some industries, waiting lists may develop.
- Businesses, encouraged by strong demand, will tend to increase their investment spending to increase their capacity.
- Record numbers of new businesses will be created, attracted by the possibility of earning high profits.

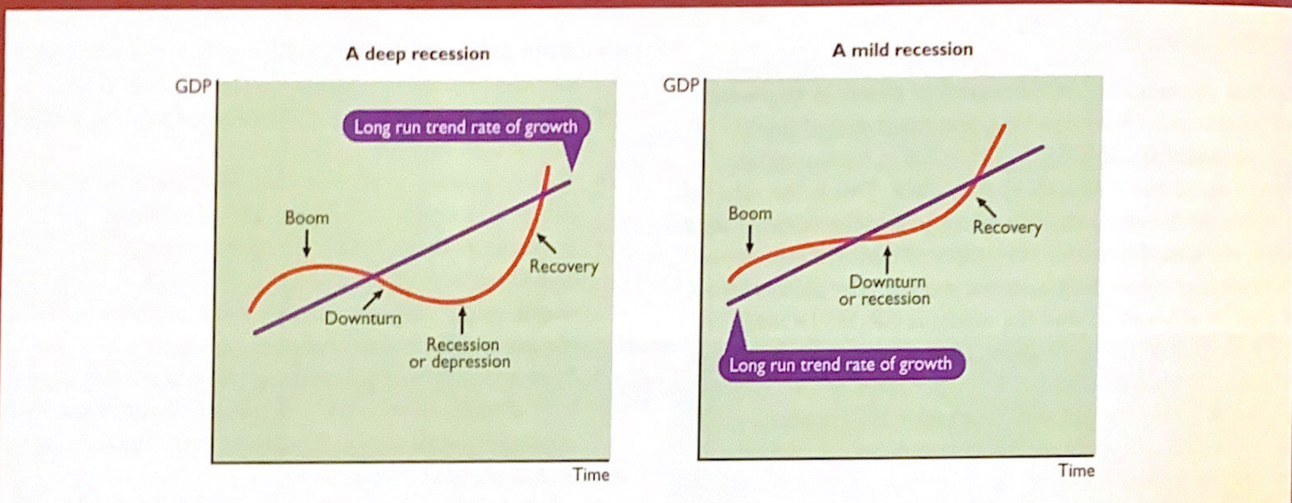
Downturn In a DOWNTURN or ECONOMIC SLOWDOWN or DOWNSWING, the rate of growth of the economy begins to fall.

- Lower growth in demand will cause unemployment to rise, which in turn will lead to even lower demand growth.
- Wage increases will start to slow and businesses will find it more difficult to push through price increases. So the rate of inflation will start to fall. Some sectors of the economy might be more affected than others.
- Many businesses will see a fall off in growth of sales and some will see an absolute fall.
- Profit growth will falter and could become negative.
- The rate of growth of imports will fall as the the rate of growth in overall spending by UK customers slows.

Recession or depression The bottom of the business cycle has a number of different names. If economic growth becomes negative, i.e. GDP falls, then it tends to be called a DEPRESSION or SLUMP. The last major prolonged depression in the UK economy occurred during the 1930s. However, there were short depressions in 1974-75, 1980-82 and 1990-92.

When GDP is still growing, but at a very low rate at the bottom of the cycle, the media use both the terms

Figure 2: The actual rate of growth measured by changes in GDP fluctuate from year to year round the long run trend rate of growth for the economy. These fluctuations are known as the business cycle. In the business cycle, recessions can either be very mild or deep.



Question 1.

The largest speculatively built office block outside London has opened to lettings in Birmingham. Owned by the private equity firm, Carlyle Group, Colmore Plaza is around 300,000 square feet.

The Birmingham economy has boomed over the last 15 years. It has, for the most part, recovered from the loss of much of its manufacturing industry in the 1970s, 1980s and 1990s. Today, the Birmingham economy is mainly service based. But up until now, Birmingham has had a shortage of modern office space. Offices built in the 1960s and 1970s are often scruffy and lacking in space for cabling. 'Historically there has been a dearth of decent office space in Birmingham', said Philippa Pickavance, a partner at property consultants Drivers Jonas. 'This year and in spring 2009 around 700,000 square feet of space will come onstream. But this is space we need.' Ms Pickavance calculates that 662,000 square feet were let last year in Birmingham, a 12 per cent increase on 2006.

However, the economy could be going into a recession. In turn, this could impact on the ability of Colmore Plaza to attract tenants. So far, one floor of the £150 million building has been rented to Davis Langdon, a project manager. This leaves another 11 floors to rent at target prices of over £30 per square foot. Carlyle Group must be hoping that any dip in growth of the Birmingham economy will be small and short lived.

Source: adapted from *The Financial Times*, 11.3.2008.

(a) Explain the links between economic growth and the building of office space.

(b) Evaluate whether Carlyle Group will have to lower its rents in 2008 and 2009 to attract tenants for its Colmore Plaza building.

downturn and RECESSION. So the word recession can be used both to describe a period of very low growth or a period when GDP is actually falling.

At the bottom of the business cycle:
- unemployment is relatively high and inflation relatively low;
- low increases in demand or, at worst, falls in demand will lead to workers being laid off;
- it will be difficult for businesses to increase their prices without losing sales;
- investment by businesses will be low and there will spare capacity in the economy.

Recovery In a RECOVERY or UPSWING, the economy begins to pick up again, and:
- the rate of growth of GDP starts to increase or moves from being negative to positive;
- unemployment begins to fall as businesses take on more workers to cope with the rise in economic activity;
- inflation might start to increase as the rate of growth of demand increases;
- businesses will begin to increase their investment spending as business confidence increases.

Causes of the business cycle

The causes of the business cycle are complex. Major slumps in the UK are arguably caused by international trade. In the 1930s, the Great Depression was triggered by a slump in the US economy, which led to a fall in UK exports. This was made worse by many countries, including the USA, putting up trade barriers such as taxes on imports (called **tariffs**) or limits on the amount that could be imported (called **quotas**). In the 1970s and 1980s, the two depressions of 1975-6 and 1980-82 were

Question 2.

JCB warned of a 'flat' year ahead because of weakening demand in the US and parts of Europe. John Patterson, the chief executive of Britain's biggest maker of construction equipment, said he was cautious about 2008. There were increasing signs that the slowdown in the economy would affect demand for JCB's productions, used widely in housing and road construction in the US and in important parts of western Europe including the UK.

In the US, the overall market for construction machines slumped 13 per cent in 2007, according to John Patterson, and JCB's US sales fell by almost that amount. There were signs of similar weaknesses in countries such as Spain and Italy. The UK had held up fairly well in 2007, but 'there is a question mark over how the UK market will perform this year' said Mr Patterson.

However, the company highlighted the opportunities outside of these markets, particularly in India, Russia, South America and the Middle East. 'The growth in these places is likely to offset what could be a downturn elsewhere', commented Mr Patterson. He singled out India as the country were JCB had made the most headway recently. In 2007, India, where JCB has three plants, accounted for sales of 17,000 JCB machines, almost a quarter of the world total. This was an increase of 60 per cent since 2006.

Source: adapted from *The Financial Times*, 12.3.2008.

(a) Explain, using a diagram and examples from the data, what is meant by a 'slowdown in the economy'.

(b) Evaluate strategies JCB could use to deal with a slowdown in its western European and US markets.

arguably caused by steep rises in the price of oil on world markets. On the other hand, the depression of 1990-92 was caused by the British government putting up interest rates to 15 per cent to reduce rising inflation. The depression was made worse by an exchange rate of the pound which was too high, hitting exports. Minor downturns since then have had a variety of external causes. For example, the downturn in 2002-2003 was caused by the fall in international spending following the terrorist attacks on the Twin Towers in New York on 9.11. 2001. The downturn in 2008-2009 was caused by a fall in international spending following difficulties in world financial markets. These difficulties were initially caused by problems with bad lending to some homeowners in the USA (so called 'sub-prime mortgage lending).

Even without these external shocks, economies might recover but then go back into recession on a regular basis. There is a number of factors which can cause these regular fluctuations.

Consumer durables During the recession phase of the business cycle, households will delay buying consumer durables. These are consumer products, such as furniture, cookers, carpets, television sets and cars which are used up (or consumed) over a number of years. This causes a fall in growth of demand for these products or even a negative growth in demand, i.e. there is a fall in sales.

As the recession progresses, there comes a point when some households are forced to replace consumer durables. A car, for example, might cost so much to repair this time that it is better to buy a new car. This is often helped by government policy. At the bottom of the cycle, government often cuts interest rates to stop the economy falling further into recession. Consumer durables are often bought on credit. Low interest rates reduce repayments and so encourage consumers to buy.

At the top of a boom, in contrast, the government often raises interest rates to slow down the economy and reduce inflation. This rise in interest rates chokes off demand for credit and so buying of consumer durables falls.

Stock levels At the top of a boom, businesses will expand production. However, small falls in the rate of economic growth will leave them with excess stocks. These might be finished goods which they can't sell. Or businesses might have bought in stocks of raw materials which, because of lower demand for their products, they haven't used up.

Businesses will then start to DESTOCK, i.e. reduce their stock levels. This can have a significant effect on demand. Assume that a business suffers a small fall in sales and ends up with two weeks' worth of extra raw material stocks. At some point it will reduce its stock orders or it might simply cancel stock deliveries for two weeks. This has a knock-on effect on suppliers. A customer that cancels two weeks' worth of orders can lead to a significant downturn in production. This effect is then magnified because reducing stock is an easy way of stemming a cash flow crisis. Businesses in financial trouble in a recession can get much needed cash to survive by running down their stocks. Destocking then fuels a downward spiral in demand in the economy.

At the bottom of the cycle, there is a point when businesses can no longer destock without going out of business. Many will be operating with too little stock for greatest efficiency. So stock buying will start to increase. Once this happens, there is an upward spiral of spending which contributes to recovery and eventually boom.

Investment At the top of a boom, businesses will be investing to expand their capacity. However, growth in production can become unsustainable with bottlenecks emerging. For example, very low unemployment means that some businesses will be unable to recruit all the labour they need. Suppliers may not be able to keep up with all the orders they receive and will delay deliveries. New production capacity, the result of that extra investment, will come onstream which is not fully utilised. At this point, some businesses will cut back on their investment to better match their production and capacity. Also at the top of a boom, the government may have put up interest rates if it feels the need to reduce inflationary pressures in the economy. Higher interest rates increase the cost of borrowing to finance new investment. So some businesses will abandon investment plans.

If investment spending begins to fall, this reduces demand in the economy. Businesses which make investment goods, such as construction companies building offices and factories or machine tool manufacturers, will suffer first. They could lay off workers, which further reduces demand in the economy. This leads to a downward spiral known as a recession.

At the bottom of the business cycle, businesses will have been putting off investment because of financial difficulties. However, there will come a point when they have to invest to replace worn out capital equipment. This decision may be helped by low interest rates set by government more worried about recession than inflation. A small increase in investment starts an upward spiral of demand in the economy. More spending by one business leads to more jobs and more spending.

The impact of the business cycle on business

Changes in the level of economic activity affect all businesses. But some are affected more than others.

Output The major impact of the business cycle is on output and sales. In a boom, output and sales will be growing. In a recession, growth will be sluggish at best. At worst, output and sales will fall. Some businesses will be more affected than others. Businesses that make or sell consumer necessities, such as food, gas or petrol will not be too affected. People will continue to buy these products. Businesses which make luxury products or products whose purchase can be delayed, such as restaurant meals or cars, will suffer more.

Profit In a boom, it is easier for even inefficient businesses to make a profit. Markets are buoyant and there is often little pressure to lower prices.

In a recession, inefficient businesses or those making products that are not necessities can often make losses.

Business start-ups, expansion and closures In a boom, with sales and profits relatively easy to make, there is likely to be a high number of business starts-ups. Existing businesses might expand.

In a recession, businesses are forced to close down or abandon investment and expansion plans. Many businesses will contract in size, closing unprofitable areas. In a prolonged recession, there will be far more businesses closing down than starting up.

Employment In a boom, businesses will tend to take on workers to cope with expanding demand. However, recruitment may be difficult because unemployment is low and there are fewer workers looking for jobs. There will also be pressure on businesses to raise wages to stop staff leaving for better paid jobs.

In a recession, businesses will tend to reduce their workforces. Staff leaving may not be replaced, a process known as **natural wastage**. There may also be a need for compulsory redundancies.

Stocks and investment In a boom, stock levels and investment will be high, as explained above.

In a recession, both will fall, typically at a faster rate than the fall in demand.

Strategic responses to economic growth

Over time, the UK economy is growing in size at an average rate of 2.5 per cent. This presents businesses with considerable opportunities. On average, their sales and profits should be increasing by 2.5 per cent a year after inflation has been taken into account. Unfortunately, the situation facing businesses is far more complex. Over time, the pattern and structure of the economy is also changing.

- Rising incomes lead to demand for some products rising by far more than the average whilst for others they can lead to a fall in demand. For example, sales of jam have been falling for the past thirty years. With more income to spend, consumers prefer to buy other foods. On the other hand, demand for computer equipment has risen by far more than the average over the past 20 years.
- The structure of the economy is changing. Most of the UK's manufacturing industry has disappeared over the past 50 years because goods can be produced more cheaply overseas. New products and new production processes have also transformed what is produced and how it is produced.

Companies have a variety of possible strategies they can use in these circumstances.

- They can move from slow growing markets to fast growing markets in the hope of raising sales. For example, they can buy companies in fast growing markets and sell those parts of their existing business that are in slow growing markets. Or they can expand their own operations into fast growing markets and cut back on investment in those parts of the business which are in slow growing areas.
- Companies can stay in a slow growing market but hope that their competitors will leave it. Or they can take over some of their competitors. Either way, they can increase

both sales and market share. It could also give them greater control of the market and allow them to raise prices and profit margins. So the strategy is for the company to grow at a fast rate whilst the market as a whole is growing slowly.

- Where companies are coming under pressure from cheap foreign competition, they need to reduce their own costs. One way is to increase sourcing of services, components and finished goods from overseas. A UK company then retains high value added processes in the UK.

Over time, companies find it difficult to make the changes needed to cope with profound, long-term changes in the economy as a whole. Most of the top 100 companies quoted on the London Stock Exchange today, for example, will have ceased to exist in 50 years time. They will have shrunk in size, been taken over, been split up or maybe even have disappeared completely.

Strategic responses to the business cycle

When fluctuations in the level of economic growth are very small, most businesses are unlikely to need to make any strategic response. This is because small changes in economic growth don't have much impact on sales for most businesses.

However, if the economy were to go into a severe recession, then many businesses would have to act decisively in order to survive. Sharp downturns in sales should be met by cuts in output and stocks. The business may need to make workers redundant. Companies may have to close down factories, offices and other facilities. Budgets, such as those for marketing and research, may have to be cut because of cash flow problems.

Some businesses, like grocery supermarkets, may feel relatively little impact of a recession because they sell necessities which consumers will continue to buy when their incomes fall. Other businesses, like house builders or furniture manufacturers, may see very sharp falls in orders. This is because consumers will make sharp reductions in purchases of what they see as luxuries like moving house or buying new furniture. Businesses which rely on consumers to buy their goods on credit could also be badly affected because in a recession consumers will be reluctant to take on new debt.

Recessions can be a business opportunity as well as a threat.

- Companies that have the cash may be able to buy up assets at a cheap price. Share prices of other companies are likely to be low. So it might be a good time to expand through acquisitions.
- Businesses which maintain their marketing spending through a recession may be able to gain a competitive advantage over rivals who have been forced to cut their marketing spending.
- Maintaining spending on research and development and on staff training can also give a competitive advantage over rivals which have been forced to cut their spending.
- Some businesses may collapse and exit the market. This is an opportunity for another business to step in and gain the customers that have been abandoned.

KEYTERMS

Boom – the peak of the business cycle, when the economy is growing fast and unemployment is low but when there could be problems with rising inflation.

Business cycle or trade cycle or economic cycle – regular fluctuations in the level of output of the economy, going from boom through recession and depression to recovery.

Destocking – when a business reduces its levels of stock held.

Downturn or downswing or economic slowdown – when the rate of economic growth begins to fall and unemployment begins to rise.

Economic growth – the change in the productive potential of the economy; it is usually measured by changes in national income and in particular GDP.

Gross Domestic Product (GDP) – the commonest way in which national income is measured.

National income – the value of total income in the economy; it is also equal to the value of total spending and total production or output.

Recession or depression or slump – the bottom of the business cycle when economic growth is negative and there is high unemployment. Recession may also be used to describe a period of very slow economic growth.

Recovery or upswing – when the rate of economic growth begins to increase following a recession or depression and unemployment begins to fall.

KNOWLEDGE

1. What is the link between GDP and economic growth?
2. What are the differences between (a) a boom and a depression, (b) a recession and a recovery?
3. What impact might the business cycle have on (a) sales and (b) business start-ups?
4. A company is in a slow growing sector the economy. What might be its strategic response?
5. A company is faced with intense price competition from overseas competitors despite strong growth in the economy as a whole. What should be its strategic response?
6. Explain how a business manufacturing furniture might respond if the economy went into a deep recession and sales of furniture nationally fell by 20 per cent.