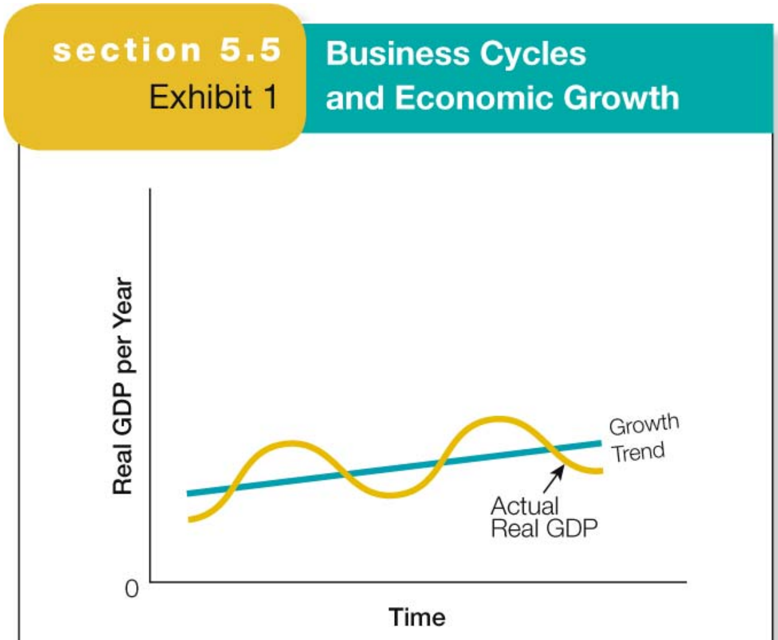
SECTION 5.5 ECONOMIC FLUCTUATIONS

- **Business cycles** refer to the short-term fluctuations in economic activity, not to the long-term trend in output, which in modern times has been upward.

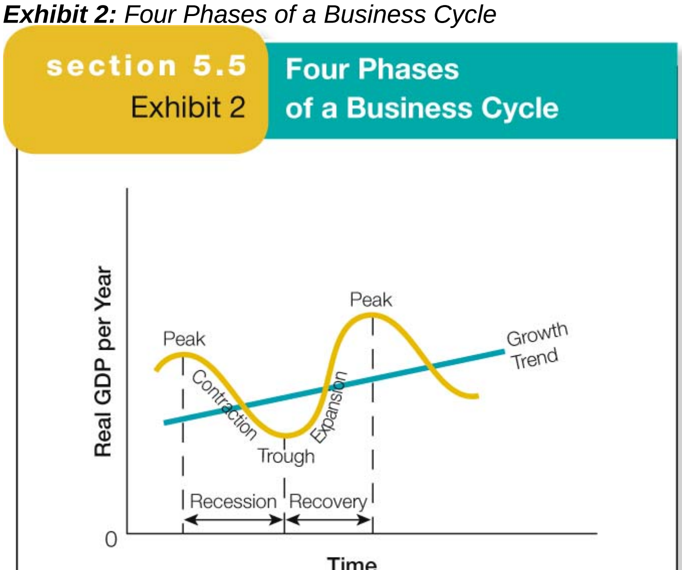
Exhibit 1: *Business Cycles and Economic Growth*



In a growing economy, business downturns are temporary reversals from a long-term trend of economic growth.

- A business cycle has four phases: expansion, peak, contraction, and trough. The expansion phase usually is longer than the contraction, and in a growing economy, output (real GDP) will rise from one business cycle peak to the next.

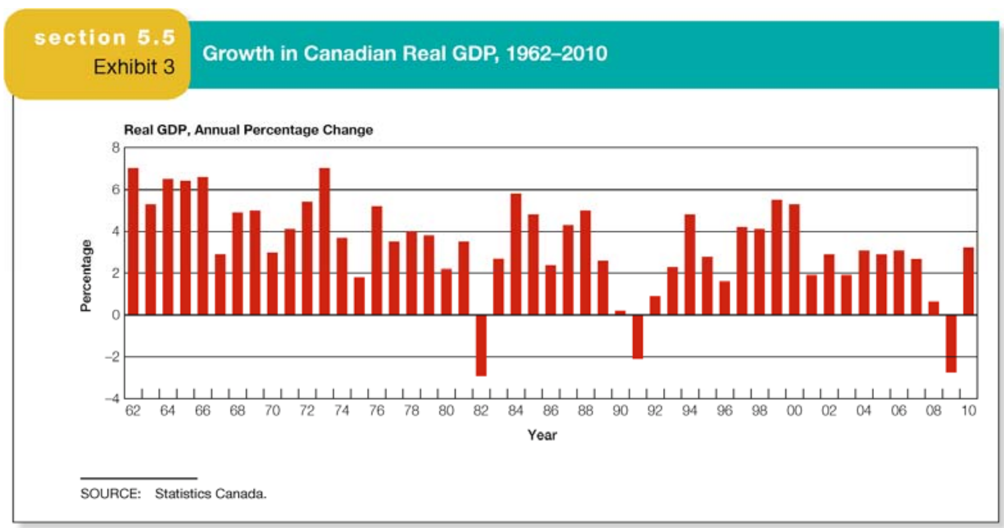
Exhibit 2: *Four Phases of a Business Cycle*



Business cycles have four phases: expansion, peak, contraction, and trough. The expansion phase usually is longer than the contraction, and in a growing economy, output (real GDP) will rise from one business cycle peak to the next.

- **Expansion** is when output is rising significantly, unemployment is falling and both consumer and business confidence is high. Thus, investment spending by firms is rising, as well as expenditures for expensive durable consumer goods, such as automobiles and household appliances. The **peak** is when the expansion comes to an end, when output is at the highest point in the cycle. The **contraction** is a period of falling real output, and is usually accompanied by rising unemployment and declining business and consumer confidence. Investment spending by firms and expenditures on consumer durable goods fall sharply in a typical contraction. A recession is a period of significant decline in output and employment (lasting at least six months). The **trough** is the point in time when output stops declining; it is the moment when business activity is at its lowest point in the cycle. Unemployment is relatively high at the trough, although the actual maximum amount of unemployment may not occur exactly at the trough. Often, unemployment remains fairly high well into the expansion phase.
- There is no uniformity to a business cycle's length. In the 1930s, there was a long contraction and in the 1960s the economy grew steadily at a rapid pace for a lengthy period.
- The contraction phase is one of recession, a decline in business activity. Severe recessions are called **depressions**. Likewise, a prolonged expansion in economic activity is sometimes called a **boom**.

Exhibit 3: *Growth in Canadian Real GDP, 1962-2010*



- Businesses, government agencies, and, to a lesser extent, consumers, rely on economic forecasts to learn of forthcoming developments in the business cycles.

- Economists gather statistics on economic activity in the immediate past, and, using past historical relationships between these factors and the overall level of economic activity (which form the basis of the economic theories used), they formulate *econometric models*. Statistics from the immediate past are plugged into the models and forecasts are made.

- Human behavior changes, and we cannot correctly make assumptions about certain future developments, economists' numbers are imperfect and their econometric forecasts are not always accurate. But while they are not perfect, they are helpful.

- One less sophisticated but very useful forecasting tool is watching trends in **leading economic indicators**, which tend to change before the economy as a whole changes. Statistics Canada has identified ten such leading indicators that are compiled into a composite index of leading indicators. If this index rises sharply for two or three months, it is likely (but not certain) that increases in the overall level of activity will follow.

- While the economic indicators do provide a warning of a likely downturn, they do not provide accurate information on the depth or duration of the downturn.