The Business Cycle - An Explainer

This short note will cover the following:

- What is the business cycle?
- What are the stages of the business cycle?
- How can fiscal policy affect the business cycle?

What is the Business cycle:

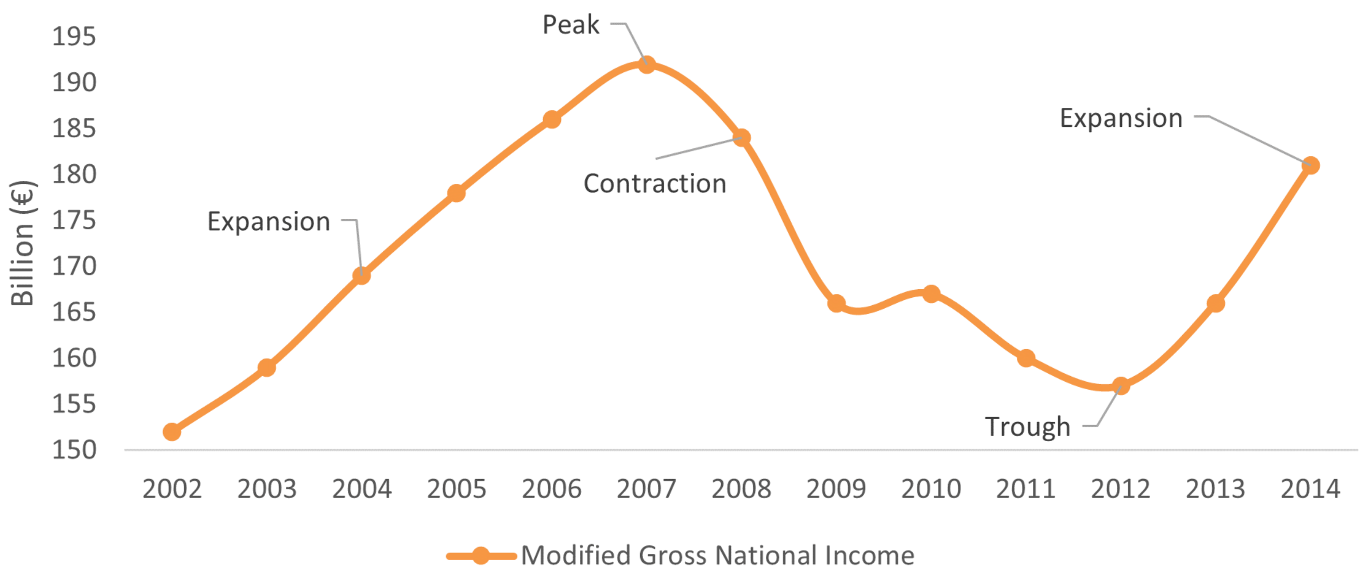
The Business cycle is an alternating series of economic expansions (Booms) and contractions (Busts). These fluctuations are normal and the length of each varies. Economic cycles can be measured using Gross Domestic Product (GDP) or Modified Gross National Income (GNI*).[1] Most governments aim to "smooth out" the business cycle, to avoid booms and busts and instead have a stable long term growth rate. Predicting peaks and troughs of the business cycle has proven to be extremely difficult as there are a multitude of factors to consider which can directly impact GDP/GNI*.[2]

Stages of the Business cycle:

Figure 1 below provides an example of the Irish economy following the business cycle from 2002-2014 using GNI*. There are four distinct stages to the business cycle:

1. **Expansion:** The economy is growing, GNI* is rising **(Celtic Tiger era,1995- 2007)**
2. **Peak:** GNI* has been growing consecutively and has reached its highest point **(2007)**
3. **Contraction:** GNI* starts to fall due to a change in macroeconomic conditions **(Recession, 2008)**
4. **Trough:** GNI* has been falling continuously and reached its lowest point from the peak **(2012)**

Figure 1: The Business Cycle



Source: CSO, Modified GNI.

[1] GNI* is a measure of the level of the Irish economy and excludes globalisation effects. The globalisation effects that are excluded from GNI to estimate GNI* are: - Factor income of redomiciled companies - Depreciation charged on capitalised R&D service imports and trade in Intellectual Property (IP) - Depreciation of the aircraft owned by Irish aircraft leasing companies.

[2] Given the large presence of multinational firms in Ireland, GNI* is sometimes used as a preferred measure of the economy. The multinational sector accounts for a disproportional amount of Irish GDP and may not provide an accurate view of economic trends. GDP may be more appropriate for other countries that are less dependent on multinational companies.

Expansion:

In this phase, GDP or GNI* grows for two or more consecutive quarters. Expansion is typically accompanied by a rise in employment, consumer confidence, and equity markets.

Peak:

The peak is the highest point of an economic expansion before GDP or GNI* starts to decline and enters the contraction phase. A negative change in macroeconomic conditions (e.g., rising interest rates) causes GDP or GNI* to shrink, and the business cycle declines.

Contraction:

This is the opposite of an expansionary period. During this phase, GDP or GNI* declines and the economy produces fewer goods and services. This phase is typically associated with a recession.

Trough:

A trough marks the lowest point in the business cycle. The government may take steps in this situation to stimulate a recovery. Next, the economy enters the expansion phase.

How can fiscal policy affect the Business Cycle?

Fiscal policy is how the government adjusts its spending and tax revenue to influence the economy. There are two main methods of doing this:

1. **Counter-cyclical fiscal:** These are policy measures that counteract the effects of the economic cycle. For example, if an economy is slowing down, the government would increase spending or decrease taxes to stimulate economic growth.[3]

2. **A pro-cyclical fiscal policy:** These are policy measures which encourage the current economic cycle. For example, if the is economy growing and the government wants to accelerate this growth, it can increase spending and reduces taxes. The opposite is also true if the economy is slowing, and the government could decreases spending and increases taxes.

It should be noted that while the government can intervene and assist the economy, this is often done by increasing government debt. This has other long-term consequences which should be considered before any action is taken.

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[3] Eurostat (2023) Counter-cyclical fiscal measures