Edexcel (B) Economics A-level

Theme 2: The Wider Economic Environment

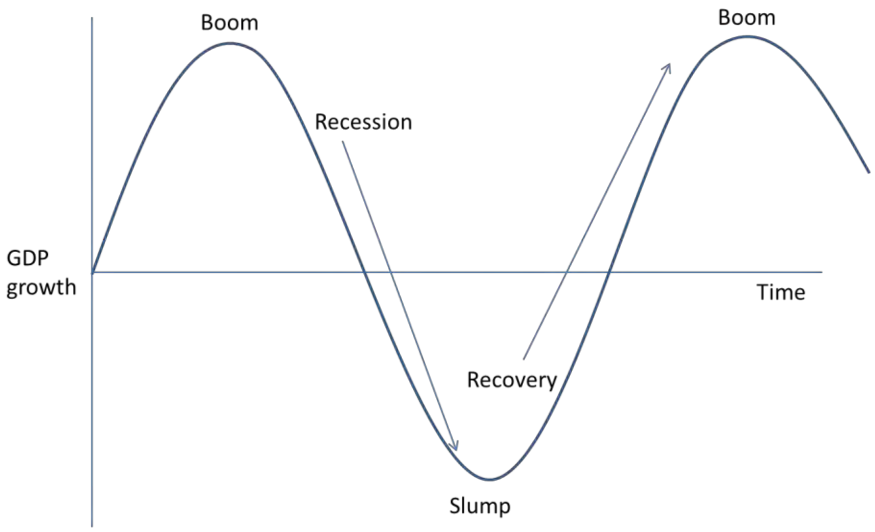
2.5 The Economic Cycle

2.5.1 The economic cycle

Notes

The economic cycle:

- This refers to the stage of economic growth that the economy is in.
- The economy goes through periods of booms and busts.



- Real output increases when there are periods of economic growth. This is the recovery stage.
- The boom is when economic growth is fast, and it could be inflationary or unsustainable.
- During recessions, the real output in the economy falls, and there is negative economic growth.
- During recessions, governments might increase spending to try and stimulate the economy. This could involve spending on welfare payments to help people who have lost their jobs, or cutting taxes.
- During periods of economic growth, governments may receive more tax revenue since consumers will be spending more and earning more. They may decide to spend less, since the economy does not need stimulating, and fewer people will be claiming benefits.

Characteristics of a boom:

- High rates of economic growth
- Near full capacity or positive output gaps
- (Near) full employment
- Demand-pull inflation

- Consumers and firms have a lot of confidence, which leads to high rates of investment
- Government budgets improve, due to higher tax revenues and less spending on welfare payments

Characteristics of a recession:

- In the UK, a recession is defined as negative economic growth over two consecutive quarters. The characteristics are:

- Negative economic growth
- Lots of spare capacity and negative output gaps
- Demand-deficient unemployment
- Low inflation rates
- Government budgets worsen due to more spending on welfare payments and lower tax revenues
- Less confidence amongst consumers and firms, which leads to less spending and investment

Implications for firms of fluctuations in economic activity

When the average level of income in an economy changes, businesses are affected and they might have to take action. They will have to consider how a fall or rise in the average income level will affect their sales, which is dependent on the income elasticity of demand of their products. In response to this, businesses will have to plan the quantity they want to sell and the price they want to sell their products at.

The income level changes if the economy improves or worsens or if there is a change in government policy. For example, economic growth will cause a general rise in disposable income, whilst an increase in the income tax rate will cause a general fall in disposable income. During economic growth, demand for luxury products is likely to increase, whilst demand for inferior goods and services is likely to fall.

During periods of prosperity, such as economic growth when real incomes are rising, firms might switch to producing more luxury goods and fewer inferior goods, because demand for luxury goods will be increasing.