

Enquiry 3 Will total output change?

1 The ups and downs of the economy

Making the restaurant pay

During the late 1980s Michael and Glynis Jones bought a large house in a beautiful valley in North Wales and created a flourishing hotel and restaurant business. They put all their savings into the business and also took out a substantial bank loan. Michael was a talented chef and the hotel provided the facilities for gourmets to stay overnight. The economy was growing strongly and customers were plentiful. Every indication suggested that this was a business with long-term prospects of profitability.

In 1989 the UK economy started to falter after a period in which it had been growing strongly. By 1990 output was falling generally, recession had set in. Redundancies and rising unemployment meant that many people were experiencing falling incomes. This kind of trend is not good news for restaurateurs. People who are worried about their job security can easily cut back on meals out.

By 1991 sales revenue from Michael and Glynis's business was down by 18 per cent. Meantime interest rates had risen, increasing their monthly payments to the bank. Within a short space of time, cash flow had become negative.



Economies do not usually grow at a steady rate for more than a few years at a time. The tendency is for there to be a repeating cycle of recovery, boom, recession and sometimes slump or depression. This business cycle afflicts all developed countries to some degree. Governments have often promised to

The Joneses were still optimistic. The recession would not last for ever and if the bank would be prepared to allow them to pay just the interest outstanding each month, they could get by. There was no possibility of their repaying the loan without increased business, but they reckoned they could survive if the bank could be patient.

The bank was not. The bank manager wrote to the Joneses saying they would have to continue repaying the loan at the agreed rate, despite the increase in interest rates. This was impossible. The business closed almost immediately, even though the Joneses thought the long-term outlook was excellent. Yet within 18 months, other restaurants in the area were reporting increasing numbers of customers.

Your agenda



- 1 Use supply and demand analysis to show what happened to the Jones's business.
- 2 What consequences would follow upon the closing of the restaurant?
- 3 What other types of business might be particularly vulnerable to a period of recession in which personal incomes were tending to fall?

end the cycle of 'boom and bust'. Mostly, to date, they have not been very successful in this, although there have been times when the seriousness of the problem has been somewhat reduced.

Up to the 1990s, no UK government ever did this. But as the millennium approached, it became clear that the UK economy had indeed had quite a long period of steady economic growth, from 1994 onwards.

This steady growth continued up to 2005 with only minor hiccups. Then the growth rate slowed to 1.7%. At the time of writing (early 2006) we do not know whether growth will pick up again or whether recession is around the corner. There is no guarantee that the threat of recession has gone for ever. Other European countries (especially Germany) and Japan had very sluggish growth in the decade to 2005. So we still

need to understand the way the business cycle works and the policies that governments and businesses need to deal with difficult times.

Figure M3.12 shows how economies move through the cycle. A period when output grows rapidly is followed by a period of slower growth, or recession. Sometimes slow growth develops into a slump. This can be defined as a time when output actually falls. Slumps may last for several years, but in time demand increases, bringing recovery. If and when output begins to grow faster, the economy enters a new boom phase.

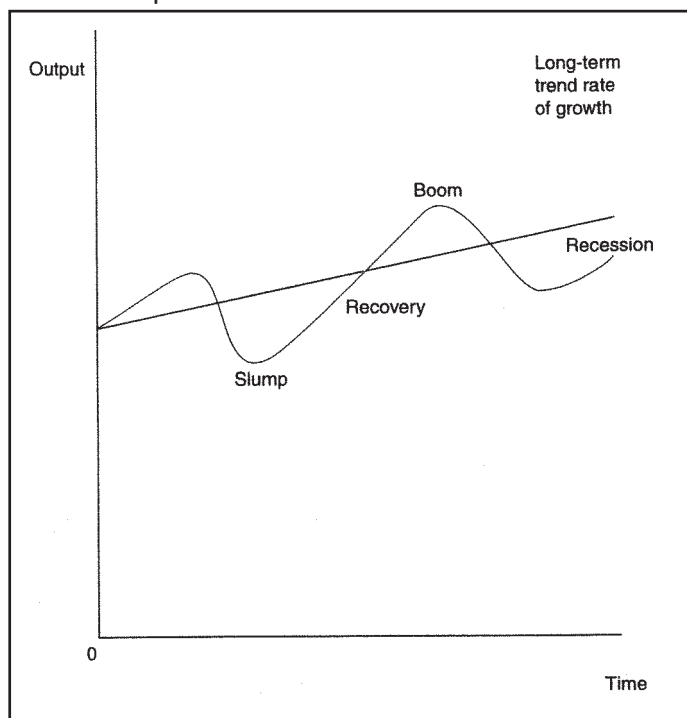


Figure M3.12 The business cycle

Underlying these short-term fluctuations, there is a long-term trend rate of growth. In the UK, this is generally assumed to be about a 2 per cent increase in total output each year. It results from increasing productivity brought about either by investing in improved plant and machinery, or by developing better management strategies, or by increasing use of education and training. Figure M3.12 shows how, over the course of the business cycle, total output growth fluctuates around this trend. Long-term growth is looked at in more detail on page 232.

Very often the time when a failing business finds it must make an exit from the market place is during recession. Similarly, the conditions for entry into new markets are most favourable when the economy is booming. The impact of the business cycle on the business depends on the nature of the

product. Those with high income elasticity of demand are likely to encounter larger fluctuations in demand over the course of the business cycle.

During a boom, output grows rapidly. Most businesses will experience increasing demand for their products.

The sections that follow show what happened during past booms and recessions and the effect that the changes had on people and businesses. Up to 2005, the economy remained fairly stable for a decade. Perhaps we have learnt some lessons about how the economy works.

Essentials



The **recovery phase** of the business cycle occurs when demand and output begin to grow again after a period of decline or stagnation.

Essentials



The **boom phase** of the business cycle occurs when output is growing fast.

Essentials



The **recession phase** of the business cycle begins when output grows more slowly after a period of rapid growth.

Essentials



A **slump** occurs when output actually falls for two quarters in a row because of lack of demand in the economy.

Essentials



The **business cycle** is the sequence of recovery, boom, recession and slump, which creates significant fluctuations in the demand for many products.

2 The effect of recovery and boom

Laura Ashley survives

During the 1980s fashion and home furnishings chain Laura Ashley grew fast and invested heavily in retail outlets. When interest rates rose and the recession came, the company found itself with excess capacity. People whose incomes fell spent less on clothes. The fall-off in house purchases meant less spending on furnishings. Put simply, the company was producing more than it could sell.

Having invested heavily in shops and factories, the company found itself with very heavy interest payments. In a major restructuring operation it closed down some of its factories.

It kept most of its shops but slashed its workforce by almost half from its 1990 peak. This enabled Laura Ashley to survive the recession albeit with profits far below what they had been in the late 1980s.

The recession was not the only problem for Laura Ashley. All the company's interests are in fields where fashion is a major factor in the market, so it must adapt to market change as well as the business cycle. As with so many businesses, the recession brought problems to a head.

Your agenda



- 1 How did Laura Ashley survive the recession?
- 2 How were the employees affected by the survival strategy?
- 3 What impact would factory closures at Laura Ashley have on the local and national economy generally?

The initial experience of recession is of demand for many products growing more slowly. This will affect most businesses, but some more seriously than others.

Depending on its individual circumstances, each business will react to recession in a slightly different way. Module 2.1 explored a number of ways in which firms can cut costs. For some firms these may spell survival. Others may be unable to adopt such strategies. They may have no alternative but to close down or they may be able to discontinue just some sides of their business while developing others.

The worst-case scenario arises where the attempt

to keep going has led to substantial borrowing. The business may become insolvent. If the firm's creditors no longer believe that it will eventually pay off its debts, then they may force it into bankruptcy. This means that the owners of the business are no longer in control, the Official Receiver's office takes over. The receiver will be an accountant whose objective will be to pay back creditors as much of the debt as is possible. The business may or may not continue, depending on its viability. If it has been badly managed, the receiver may find a buyer who will reorganise it.

In general, recession produces changes in levels of investment, liquidity and stocks. Each of these has knock-on effects.

- **Investment** When future sales are uncertain, many firms will question their investment plans. If demand is falling, they may decide that they do not need new capacity. Their estimates of future sales and profitability may cause them to postpone their expansion plans or cancel them altogether. Firms that sell capital goods may then experience very sharp falls in demand: the construction and engineering industries are especially vulnerable. Sometimes firms may react to recession by investing in labour-saving machinery, as a way of cutting costs, but, in general, low expected profits and a gloomy outlook will make the decision to invest less likely. The low level of profitability will usually imply that there is less retained profit available to finance the investment.
- **Liquidity** Clearly, a fall in demand will reduce cash flow and may make firms very reliant on bank loans. If interest rates rise, whatever loans firms already have will cost more to service. This increases costs and reduces liquidity further. In some cases it means that firms have to increase their borrowing just to pay the interest charges.
- **Stocks** When sales are falling, or growing more slowly than expected, stocks of finished goods will rise. When firms cut production in response, stocks of inputs will rise. Stocks cost money: they have to be paid for, and storage may be expensive. One way of cutting borrowing needs is to run the stocks down, sometimes called de-stocking. This means that suppliers may face a period of very low orders while stocks are run down.

■ *Human resources* In the search for cost-cutting strategies, employees are deeply affected; redundancies are likely. Who should go if redundancies are inevitable? Obviously, firms will tend to make redundant those people they can best do without. These are often the people who will find it hardest to find alternative jobs. Key workers will be kept on as long as possible. Nevertheless, it is common to observe large numbers of skilled employees being made redundant in a recession. There may be cuts in overtime working too.

Another possibility has been to aim for the adoption of more flexible working practices. Often people will accept new ways of working because they are afraid for their jobs. This can lead to increased productivity, but that, in turn, can entail more job losses.

Trade union bargaining power is much reduced in a recession, the strike threat is worthless if the effect of the strike would be to bring about the firm's closure. People may be forced to accept working conditions that are unfavourable in order to have a job at all. The effects of this can be seen in the increased numbers of people working without contracts, which would give them some protection and an element of job security.

■ *Pricing Policy* Poor trading conditions can give a business the spur it needs to strengthen and develop its marketing strategies. Hotels can be badly hit by recessions. They may create all sorts of special offers, mini-breaks and activity weekends. Some will negotiate their prices. People may bargain, striking a deal much as they might in an oriental market place. (This links to contribution costing, page 68.) In a boom hotels will often be fully booked and no such opportunity arises.

Work in progress



- 1 Divide the following list of products into those which are vulnerable to recession and those which are not, giving reasons in each case: cauliflowers, yachts, hair-cuts, cars, restaurant meals, factory buildings, winter coats, cat food, pension plans, lorries, and kitchen units.
- 2 Are there things that the recession-vulnerable products, which you have identified, have in common?
- 3 If a manufacturer responds to falling demand by reducing stocks of finished goods, what will the effect be on the firm? If the same firm reduces stocks of inputs, what will happen to their suppliers? Identify all the effects you can think of. What will the end result be?
- 4 What other cost-cutting measures may help businesses facing falling demand for their products?

Businesses face falling demand for many reasons besides recession. Stiffening competition can create problems at any time. Many of the strategies for dealing with falling or slow-growing sales are the same, regardless of cause.

3 The effects of recovery and boom

Making comparisons

	2000	2004
Consumer spending	641	720
Gross fixed investment	161	184
Exports	265	283
Total output (GDP)	972	1066

Figure M3.13 Spending and output, £ billion, 2001 prices

Source: National Institute Economic Review, 2005 (NIER)

Your agenda



- 1 Using M3.13, what happened between 2000 and 2004?
- 2 What can you say about the long-term trend rate of growth of output for the period?
- 3 On the basis of the figures, what do you think might have happened since 2004? Does your prediction fit what you know actually did happen?

In times of expansion, companies are encouraged to increase their output. High levels of profitability encourage firms to employ more resources of all kinds. This leads to extra people being employed, more overtime on offer to the workforce, unsold stocks being run down and investment in new machinery and productive capacity.

Investment and finance

As confidence in the economy increases, firms think it is the ideal time for expansion. They will invest in new equipment and perhaps also introduce new technologies. High levels of profitability help to generate internal finance from retained profits, and make it easy to get bank loans. Productivity may rise as output rises.

There may be areas of less good news. Financial markets may be imbued with confidence and may willingly finance an amount of investment which really goes beyond what is needed to meet long-term demand. Because banks are confident about future profitability, they may lend to firms whose capacity to manage efficiently in the long run is

really suspect. Because firms are not worried about cash flow, accounting procedures may be less stringent. Haphazard management approaches may become a feature of some firms. They do not have to try very hard to make a profit.

Easily obtainable bank loans encourage firms to borrow and, at first, there will probably be no problem with this. However, if interest rates rise, the effect is to increase debt service charges, and if demand for the product then begins to fall, cash flow will be subjected to a swift and serious squeeze.

People, skills and trade unions

As firms expand they need more people. They may be hard to find. (This situation is sometimes described as a bottleneck.) Although in recent years there has usually been a large pool of unemployed people, many of them have reasons why they cannot move to another area or another type of job. So boom years are likely to be characterised by skill shortages, as firms compete for the available people. Employee power will increase, as will trade union bargaining power, particularly for those unions representing skilled workers.

Maintaining motivation in the workforce may require special efforts. The threat of redundancy is absent. Employees may be offered higher wages by competing firms. Indeed, negotiating higher wages may be quite easy: if the profits are good, paying more may seem like simple good sense.

Work in progress



- 1 When a skill shortage develops, how will firms seek to recruit? What is the likely effect on wage rates?
- 2 If wage rates rise, what will happen to costs? What will happen to prices?
- 3 How might firms tackle the need for measures to improve motivation?

4 Analysing economic change

What next?

Government spending cuts bite

Output grows by 3% this year

Investment falls by 9 per cent

Consumer spending flat for second quarter

EXPORTS UP BY 9%

Savings rates fall

Imports at all time high

Chancellor promises not to increase UK taxes

rising demand will translate into rising output and rising incomes.

In order to analyse the way spending in one part of the economy affects other parts, we use the idea of the circular flow of money. This is shown in Figure M3.14. Every time we buy a product, we make a payment to the producer. So money flows from households to firms, in return for the goods and services bought by the households. This is consumption spending.

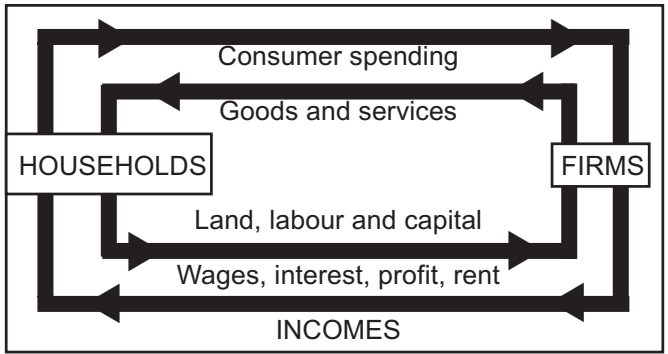


Figure M3.14 The circular flow of money



Essentials

Consumption consists of spending by consumers on goods and services. These may be for immediate use or they may be consumer durables, i.e. equipment that lasts for a period of years.

Meanwhile, firms are using factors of production to make the products consumers want. They pay for the services provided by these factors of production. Wages are paid in return for labour. Interest is paid on borrowed money (capital). Profits go to the owners of the business. Rent is paid to owners of property. All these together make up the flow of income that goes from firms to households.

Your agenda



- 1 Some of the items mentioned in the headlines above involve figures for different types of spending. Which of these will directly affect the demand for UK-produced goods and services?
- 2 Which items will have an indirect effect on demand for UK products?
- 3 Trace the effect of an increase in exports on:
 - a businesses producing for export;
 - b their employees;
 - c other businesses in the same area.

Nothing succeeds like success – or fails like failure.

- ◆ An increase in demand in one part of the economy can lead to increasing demand in other sectors elsewhere.
- ◆ Falling demand for the products of one business tends to lead to falling demand for others. These individual changes can add up to a trend that affects the whole economy, i.e. a macro-economic change.
- ◆ Changes in demand soon become changes in income. Falling demand means falling sales, then falling output and falling incomes. Equally,

Work in progress



- 1 Supposing consumers decide to cut back their spending for a while. What will happen next? Use the sequence of events in the circular flow of money to explain the consequences of this fall in consumption.
- 2 Now think about what happens if businesses generally decide to spend more money on equipment, i.e. they invest more. Trace the sequence of events through the circular flow of money.

Changes in spending

Consumers who decide to spend less may be saving more. An increase in saving reduces the amount of money moving through the circular flow via consumption spending. If tax rates are raised the same thing happens: a likely consequence is that consumption falls. Or consumers may decide to buy more imports. This usually means they are going to buy fewer domestically produced goods.

All three changes – in savings, tax and spending on imports – have the same effect. They reduce demand for domestically produced goods. They are therefore termed leakages (or sometimes withdrawals) from the circular flow of money. You can see what happens in Figure M3.15. Leakages reduce the amount of spending on goods and services. Firms receive less from households than they did previously.

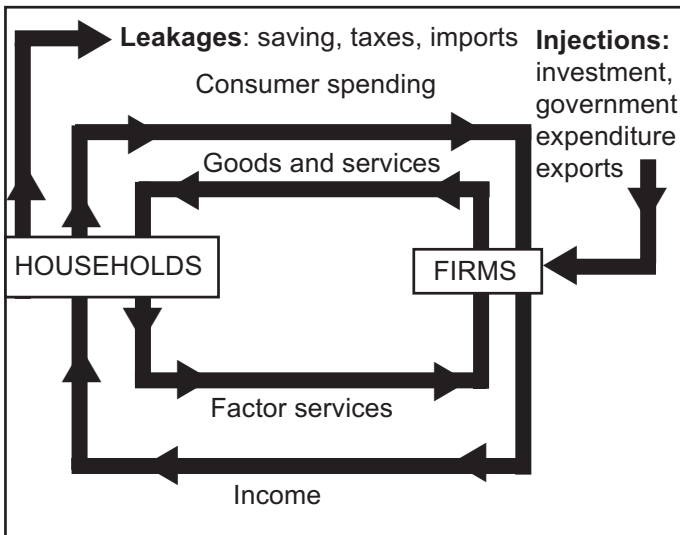


Figure M3.15 Injections and leakages

This would seem like a gloomy picture for businesses but, in fact, leakages are balanced by injections into the circular flow. What will happen if firms increase investment? Or if the government increases its expenditure? Or if demand for exports increases? As far as businesses are concerned, these are sources of demand for their products. They increase the amount of money they can earn by satisfying that demand. More money will then be paid out in wages and profits. The extra demand adds to the circular flow of money.

Work in progress



- 1 Show what happens to the circular flow of money if the Chancellor of the Exchequer cuts taxes on Budget day. What happens next? Show how businesses and individuals will be affected, tracing any secondary effects through the circular flow of money.
- 2 In the same way, show the effects of an increase in demand for imports.

Essentials



Saving means keeping back some income, rather than spending all of it, so that the money is available to spend later.

Essentials



Leverages reduce the demand for domestically produced goods and services, by diverting part of people’s incomes into savings, taxes and spending on imports.

Essentials



Injections – investment, government spending and exports – increase demand for domestically produced goods.

Essentials



Investment consists of spending now that generates income in the future. So it could be spending on buildings to be used for production purposes or on plant and machinery, which will be used in manufacturing.

5 What is actually happening?

The business cycle in the UK

- 1979: Conservative government elected, making strong promises to control inflation. Immediately raises interest rates. Unemployment rises from 4.7 per cent in 1979 to 11.8 per cent in 1983. Inflation peaked at 17 per cent in 1980.
- 1980-1: Slump. 14 per cent fall in manufacturing output. Inflation falls.
- 1982-6: Recovery. Steady growth of output. Inflation stable at around 5 per cent.
- 1987-9: Boom. Output grows unsustainably fast, by nearly 5 per cent in 1988. Unemployment falls to 6.3 per cent in 1989. Severe skill shortages.
- 1989-90: Recession. Output grows much less fast. Inflation peaks at 9.5 per cent in 1990.
- 1991-2: Slump. Output falls. Unemployment rises to 10.4 per cent in 1993.
- 1993-6: Recovery. Steady growth. Inflation stable at around or below 3 per cent.
- 1997: Boom. Output growing at around 3 per cent. Unemployment falls to 5.1 per cent. Evidence of skill shortages developing. New labour government pledges to end cycle of boom and bust.
- 1998-9: Recession in manufacturing sector. Services still growing strongly. Inflation edging up from 3.5 per cent to 4.0 per cent but fell back to 1.1 per cent. Gradual recovery in manufacturing.
- 2000-4: GDP growing at rates of 2-3%, unemployment low and falling very slightly (around 5% by LFS measure or 3% by claimant count). Inflation in range 1.5-3.0%.
- 2005: Growth falling to 1.7%, inflation (CPI) 2.1%, unemployment steady.

Your agenda



- Using the Internet, obtain charts for the UK for GDP growth, inflation and unemployment since 1979. (Use Google, ONS, I'm feeling lucky and select 'economy'. Use the links to get time series.)
- Compare your charts to the descriptions above and comment on your findings. Remember that there have been some changes in the way the data is collected and expressed.

- During a period of slump, people lack confidence in their future because of the threat of unemployment. They may start to cut down on their spending, saving as much money as possible in case they are next to be made unemployed. This fall in spending causes the situation to get worse as **aggregate demand**, the sum total of all demand for consumer and investment goods, falls.
- During the recovery period, industries and services that have survived the slump begin to increase their output. Not everyone has been made unemployed in the slump and these people will wish to purchase goods to make up for the period when they were saving more. One reason for the change in consumers' attitudes is confidence.
- During the boom, the sum total of what companies can produce, **aggregate supply**, will not be enough to satisfy the growing aggregate demand. Companies try to take on more employees in order to expand output but skill shortages develop. This causes companies to offer higher wages, trying to attract the people they need. This begins to fuel inflationary expectations and other employees seek further pay rises. There may be large increases in imports.

Essentials



Aggregate demand is the sum total of demand from all sources in the economy. It includes consumption, investment government spending and export demand.

Essentials



Aggregate supply is the total output from all sources in the economy.

The boom situation is not sustainable in the long run because aggregate supply is reaching **full capacity output**, the most that can be supplied with all suitable resources working flat out. Pay rises lead to accelerating inflation and this will provoke increases in interest rates. Firms will revise their investment plans. This fall in injections will cause both demand and income to grow more slowly.

The process is cumulative and recession occurs as companies readjust their output levels to the new lower levels of demand. Falling output means rising unemployment, which in turn means falling income and further falls in demand, leading into the next slump. Figure M3.16 summarises the phases of the business cycle.

	Slump	Recovery	Boom	Recession
Employment	Low	Low, rising	High	High, falling
Skill shortages	None	Beginning	Frequent	Diminishing
Inflation	Reduced	Stable	Accelerating	Falling
Confidence	None	Low, rising	High	Low, falling
Investment	Very little	Slow growth	Growing faster	Little

Figure M3.16 The four phases of the business cycle

Essentials



Full capacity output is the maximum level to which aggregate supply can increase given the available resources and levels of productivity.

Expectations and confidence

Expectations are an important factor in the business cycle. If firms expect demand to rise, they will feel more confident about expanding. Often business confidence is based on an accurate assessment of the data and events, but there can be a strong psychological element in confidence – if some people are feeling optimistic, so will others, and vice versa. You may be able to see this working on the Stock Exchange, where a bull market (i.e. one with growing share prices) may persist for some time because the mood of optimism is infectious, rather than because long-term prospects of profit are really good.

Business confidence can change quite fast and have important implications for the fortunes of both businesses and people. Individuals also may vary in confidence over time. If they feel their employment is insecure, they may postpone some consumption plans and save more.

Work in progress



- 1 Why does output tend to grow more slowly after a period of boom conditions?
- 2 Consider how well the UK economy has performed over the past few years. Make a list of the evidence you would need to research before you could comment objectively on the success/failure of the economy.
- 3 Think about how the UK economy has been influenced by external events. Have these had some impact on the business cycle?
- 4 How confident are people in business at the present time?