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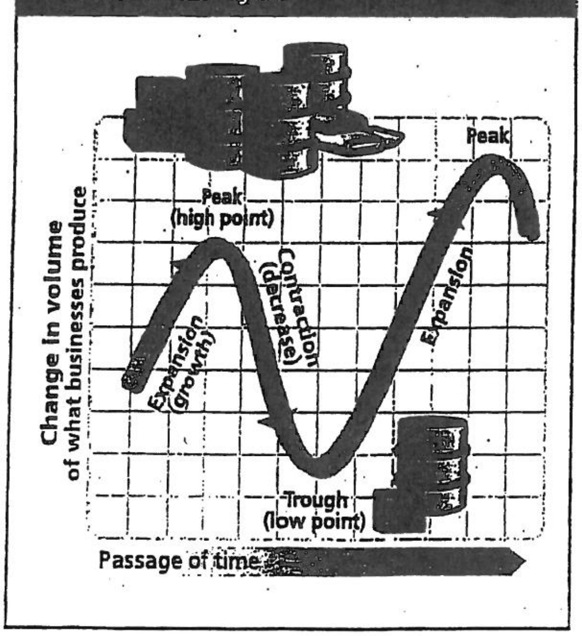
Understanding the Business Cycle

A national economy goes through periods of good and bad performance. Taken together, these periods are called the "business cycle."

In good times, the economy grows. Businesses produce more goods and services. Consumers buy more, which convinces businesses to produce even more. Wages go up, and so do profits.

In bad times, businesses cut back on production. Instead of hiring workers, they lay workers off. With less money, consumers spend less. Eventually, the economy stops growing. That is, the total value of goods and services produced in the country does not increase from one month to the next. If this happens six months in a row, economists say that the economy is in a recession. If the lack of growth lasts longer and goes deeper, it is called a depression. You can follow this pattern on the graph shown here.

The Business Cycle



Two factors affect the business cycle:

- **Purchases:** Increased spending leads to growth. Less spending means no growth. Consumer spending has this effect. So does spending by the government.
- * See below **Interest rates:** Banks can help growth by lowering interest rates on loans. If loans cost less than before, businesses and consumers are more likely to borrow money. Higher interest rates slow growth down. As interest rates go up, businesses and consumers borrow less money.

INTEREST RATE *The cost of borrowing money.* Interest is calculated as a yearly percentage, or rate, of the money borrowed. A 10 percent interest rate, therefore, would require a borrower to pay $10 per year for every $100 borrowed.

When interest rates are low, people will borrow more, because the cost of borrowing is lower. However, they will save and invest less, because the return on their savings or investment is lower. With high interest rates, people save and invest more but borrow less. Because interest rates affect the economy, the government takes steps to control them through the Federal Reserve System, the nation's central banking system.

During Reconstruction, the United States went through the worst depression that it had experienced up to that time. The depression started with the Panic of 1873. What caused this panic? During and after the Civil War, there was a great boom in railroad building. Most of that building was funded by loans. Serious problems lurked beneath the surface, though.

First, railroads and other businesses borrowed far more money than was healthy for the size of the American economy at the time. Second, there was no government regulation of industry. Business owners pursued profits in any way possible.

These factors, along with financial problems in Europe, combined to cause chaos in late 1873.

The depression that resulted lasted for six years. Thousands of businesses went bankrupt, and many banks closed. Millions of Americans lost their jobs. Farm prices fell. With little income, workers and farmers cut back on spending. This slowed business production even more.

* Today, a governmental body called the Federal Reserve Board has a major influence on the interest rates that banks charge for loans.

The Business Cycle
Questions

Read the sheet and answer the questions using what you learn.

1. The "periods of good and bad performance" in business over time are called:

2. List the events which describe a **growing economy.**

    1.______________________________

    2.______________________________

    3.______________________________

    4.______________________________

3. Explain what is meant by the term "the economy stops growing"

4. When do economists say the country is in a <u>recession</u>?

5. What is meant by the term "depression"?

6. List the two factors that affect the business cycle.

    1.
    2.

7. Explain how low interest rates can help the economy grow.

8. How does the Federal Reserve Board influence loans from banks?

9. Who is the current chairman of the Federal Reserve Board? (not on sheet)