DE GRUYTER OPEN
Studia commercialia Bratislavensia Volume 9; Number 35 (3/2016); pp. 302-312
DOI: 10.1515/stcb-2016-0029 ISSN 1339-3081

Open Your Eyes Alice and Start Following the Economic Cycle Instead of the White Rabbit: Influential Behaviour of the Economic Cycle [1]

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Abstract

Economics represents a social science, directly concerning the factors and determinants of commerce, production, distribution, government, management and naturally consumption of goods and services, but unlike the natural sciences, it is unique in the area of hardly finding a broad consensus, whether we talk about rules, methodology, economic processes or basic axioms. Economic cycle would not exist in an economically ideal world where the prices of goods and factors of production are very flexible, people have full information about what is happening in the economy, government and unions do not regulate prices, and so on. Since the real world differs from an economically ideal world, economic cycle presents inevitable reality in every market economy. The aim of our research paper is to analyse essential monetary determinants and the practical aspects of the theory of the business cycle. Moreover, we focus on the instruments of central banks and their impact on the economic cycle, inextricably affecting the socio-economic development and the state of business environment and commerce.

Key words

Business environment, economic growth, interest rate

JEL Classification: M21, P10, P43

Introduction

Every entity has a certain perceived value, but that value cannot always be easily or accurately measured and compared, meaning that the perceived value is individual, because it does not exist as an integral part, but it is rather a state of our minds as purely subjective perception. Theory of value[4] is therefore a basis for the formation of

[1] This research is part of VEGA nr. 1/0224/15 *Consumer behavior and individual consumption in the periods of unemployment and relative deprivation of population: implications for decision taking bodies and businesses*, and part of the project of University of Economics in Bratislava for young researchers and PhD. students number I-16-106-00.

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[4] A generic term, also in the philosophical sense, that encompasses all the concepts within economics and business environment, divided into labor theory of value and subjective theory of value, that endeavor to interpret the exchange value or price of goods and services in the sense of why goods and services are priced at a specific level, how to evaluate and calculate their value in the framework of normative value theories, naturally of course if such a value exists.

market prices. Prices do not arise randomly, but according to how people generally value selected properties based on their perception of value. For the acquisition of certain good or service, everyone must sacrifice something, such as money and they are willing to spend only when it constitutes the potential benefits of the acquisition of this good is worth more than the potential loss. On the same principle as we perceive certain value, we also perceive costs and therefore subjectively and differently from other people, for example whether we talk about costs as people spent their time and effort in achieving satisfaction of certain needs. Furthermore, this issue is closely related to the subject of existence of the interest rate, interconnected with the time-preferences of people. The fact that people prefer to give priority to immediate consumption before consumption in the future is only one of the many axioms as a natural part of economic and business cycle and is the essence that states the price for which people are willing to sacrifice present consumption in favour of future consumption. Interest rate is therefore not to be regarded as something immoral, since it is a fair return for provided personal time and each individual has a completely different preference of time. While some prefer to give priority to immediate consumption, others are willing to postpone their immediate consumption later with the prospect of a profit in the form of interest (Hayek, 2012).

Overall, time is a factor of great importance. Not only concerning the formation of interest rate, affected by personal and business preference. It also explains the structure of capital, which is fundamental catalyst of proper functioning of business environment and commerce in the sense of allocation, investments and managerial – business forecasting. It is important to emphasize that its essence is not only in the production of other goods, but also in the length of time required for the production of final consumption of goods. Each manager in every business environment and therefore also manufacturer has to answer the question whether he is willing to sacrifice more time to produce high quality products that will last longer or prefer to produce slightly less quality products with a shorter lifespan, but in much less time. Here, however, we can argue that there is no simple right answer, because once again it depends only on the time preferences of both producers and consumers. Therefore, it is crucial to think about managers not only on how much they appreciate the product, but also on how much they appreciate the effort and time that needed to expend to their production.

1 Methodology

Our article represents in terms of research a social and business-economics contribution applying general scientific methods, with emphasis on analysis and synthesis, at all levels of solutions and secondly the method of induction and deduction in combination with philosophical methods of knowledge and scientific abstraction. The aim of this research paper is summarizing and bringing a different perspective through research of problems of the economic cycle, with emphasis on everyday use in business and commerce, seeking to clarify the operation of the fundamental factors as the current market environment in order to facilitate business activities in the form of theoretical background knowledge that should be applied by managers in their business decisions into practice in order to proceed in their operations and decisions more effectively. Our research is based on the hypothesis that the economic cycle is a crucial and natural part of market economy, directly influencing business environment, consumers and government decisions.

In order to accomplish our aim, we have constructed the following research questions:

- Does the element of time affect consumption and individual or business decisions?
- How does the economic cycle work?
- How does the economic cycle affect business environment and their production and subsequently commerce decisions?
- What role do banks play in interaction between businesses and consumers?
- Do the monetary expansions affect business and consumers in the same way? What affect do they have on commerce?

2 Results and Discussion

2.1 Factor of time as the key element of current consumption before the future consumption

The essential step towards business and later commerce operations is the production of goods, which takes place in time, when companies or manufacturers (we will refer to them as businesses) produce goods and this production of course takes some time. However, businesses also realize that if their time was used for exploration, development and investments into new technologies, they could produce more goods. Indeed, such solutions would mean increasing of productivity and time, which would be saved in a future production process. On the other hand, businesses also realize that during the development or obtaining of technology, they would produce fewer goods, if any, and their revenues would therefore decrease. Therefore, their usual or normal option in situation like this is to reduce consumption at present, while only some of the money saved will be then in the future used during the development of more efficient, new technology or production investments. They thus have to choose between two options as they can produce common goods, or be modest and devote their time to developing new technologies. Businesses therefore decide for one or the other depending on what relation do these options represent to their potential benefits. Simply put, if the expected benefit from the technology investment is higher than the loss of the benefit from a reduction in consumption, businesses decide to invest in it, meaning that the expected future satisfaction in case of realization of the investment is higher than the instant gratification.

However, when we look at this from the perspective of consumers, in general, they logically prefer current consumption before the future consumption[5]. This behaviour is based on the fact that in order for consumers to satisfy their needs, they must

[5] This reality is known as the Time preference or Delay temporal discounting, which is a normal and basic part of the human nature, as the part of the relative valuation compared during present and future time period, since in human behavior is no absolute distinction between separating the high and low time preference aspect, but only individual or aggregate comparisons.

necessarily consume goods. The exception will only occur when it is certain that a partial restriction of consumption would bring them greater satisfaction in the future, so they are therefore acting with a purpose to decide whether to restrict consumption depends on the amount of their time preference. If consumers are at a high time preference, they prefer the current need before the future and vice versa. Given that the market processes occur within time preference and within the temporal existence of individual preferences of economic entities or in our case consumers, therefore the natural interest rate is created. This interest rate can be thus described as the market price of present goods in relation to future goods. The interest rate is therefore not the of cost money, since the price of money is determined by the purchasing power, of course among other important aspects. Moreover, increase or decrease in the time preferences of consumers are also reflected in the increase or decrease in interest rates. This fact is crucial for understanding market processes, whether we talk about consumers, businesses or commerce in general, since markets are inter-timely coordinated, and just using the interest rate, which determines their time preferences.

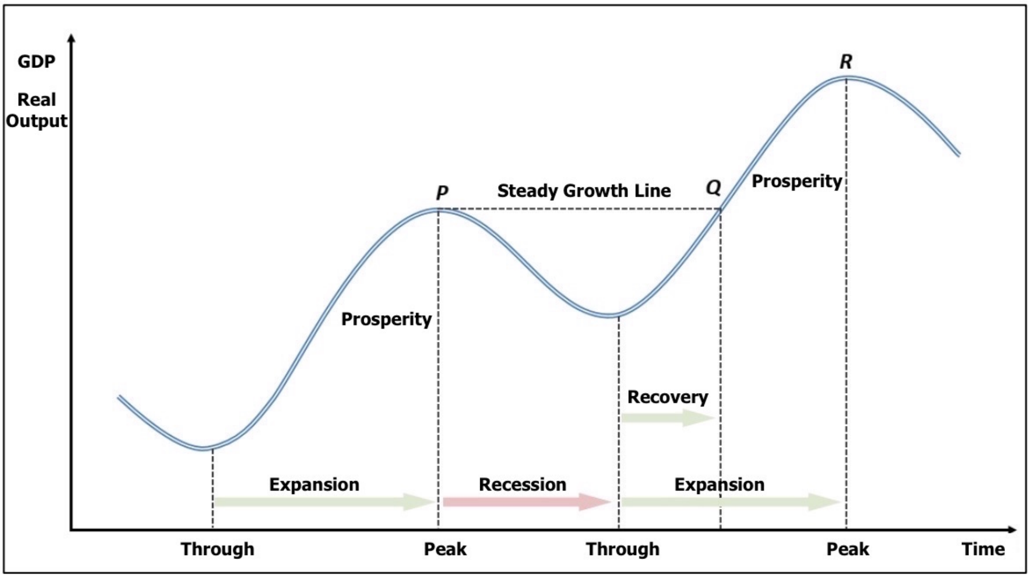
The interest rate therefore transmits the information to businesses on whether the investment will be profitable or not. Expected future cash income thus can be converted to the interest rate on the current value and compared with the current cost of the investment (Czesaný, 2006). According to this comparison, businesses determine whether to focus on the short or long production process. However, businesses may decide to reduce consumption, and instead they will produce more goods every day, in order to earn a higher income, and could thus in future have more free time, but in order to produce more goods every day businesses firstly need to have free time to sacrifice. Since we live in a world where resources are scarce, every investment must always precede the formation of savings at the expense of lower consumption since if, after all, there was a simultaneous growth of investments and consumption in a world of scarce resources, this situation would no long be an option.

Moreover, we also have to take into an account that economy takes the form of ever-changing stages, which form the shape of the production structure of businesses. On the one hand, capital availability often depends on business decisions of companies, however form and level of investment depends on the time structure of the overall production. On the other hand, this form is highly heterogeneous in nature, since it is designed to restore different capital equipment, while capital increase results in an extension of time, which is needed to increase production. It is necessary to distinguish the production time from the time during which the factors of production are invested. Increase in capital stock does not necessarily mean a technical change in production, but merely a reallocation of factors of production. In other words, the time of their use is extended, but the time of production remains unchanged. For example, the length of the use of certain production factor is prolonged, while larger amounts of another are shortened and therefore, the investments will largely matter depending on capital of companies. If we take into the account that manufacturers operate on the uncertainty principle, where the persistence of funds as well as potential investments is under the influence of time structure of production and the ability to meet future capital needs. It means that the overall success rate of currently realized investments will depend on whether companies can actually manage to realize future investments (Hayek, 2010).

2.2 Cyclical fluctuations as a government garden of Eden where it all starts

Cyclical fluctuations are considered to be an integral part of economies, as a phenomena partially or artificially induced by bad interference of state institutions in order to keep the economy functioning. These government interventions aimed at stimulating economy and business environment are at the beginning of economic cycle working as so-called boom, which is a state where the economy is growing, although not on solid foundations and thus follows the inevitable bust, which is represented again by a drop.

Graph 1 Phases of Economic – Business cycle



Source: Author

The boom period occurs when the interest rate cuts by the monetary expansion are below the natural interest rate that does not reflect the time preference of economic entities. This time preference indicates how much people are willing to save and invest versus how much they intend to spend. The more people are willing to save, the lower is the interest rate, since there are more funds for investment. Otherwise, when people are not willing to save, interest rate is rising because economy needed resources for investment on such scale are missing (Mises, 2013). In any case, neither of the above-mentioned interest rates cases are necessary better or worse in terms of their impact on the economic cycle, since they both represent a natural market interest rate that reflects the time preference of the people and business decisions. The problem arises when the central bank artificially lowers key interest rate at which banks provide free financial resources from newly printed money that are not covered with gold. Although the change in the interest rate does not change the time preferences of people, who have no need to save more in order to respond to increased demand for new discount loans. Thus arises a situation where there is more borrowing and investing than saving, and all because of the creation of new money by the central bank.

The same effect could signify a situation where there is a significant improvement of the outlook for earnings growth, or when there is a sudden drop in the savings rate, which in turn pushes growth of interest rates upwards, while banks are reluctant to raise interest for the provision of credit and lending continues at the current interest and rate, allowing to satisfy higher demand for loans despite the same or decreasing the amount of savings. Furthermore, another source of new money that needs to be taken into an account is the flow of new money through fractional banking. Since banks are required to hold only a small portion of their clients' deposits to their accounts and the rest can be offered to other clients, for example in the form of a loan and thus emitting into circulation more money. These clients can also use the money necessary for the payment and send the money to someone else's account and the money from the banks are again required to hold only a portion and the rest can be further provided. In the way the market gets nothing more flat money and in the event that suddenly all the clients wanted to cash their deposits, banks do not have enough funds to satisfy them. The interest rate fall causes long-term and costly investment, which previously seemed to be unprofitable, but now suddenly becomes a cost-efficient manner, and companies are starting to invest in projects that were before disadvantageous.

Generally we can say that investors and business respond to these signals, as in the case of increased amount of savings, since in this period of boom and low interest rates they can firstly invest in obtaining capital goods (e.g. plant and equipment, industrial buildings and halls, raw material) rather than to the actual physical production and subsequently into the new commerce ideas and research. Therefore, in the period of boom, sector-producing capital goods grow faster compared to retail sector. Low interest rates and excess of funds at the same time are attracting investments[6], but likewise the problem occurs in a situation where banks are starting to realize that even if the loan will provide clients with a higher default risk[7] and loss caused by the loss of lent money to offset it by the sale of properties (as used in our example) whose prices are constantly increasing. In this situation, banks have lost any inhibitions to provide mortgages to anyone and they gradually accumulate the toxic debts. As we have previously explained, during the period of boom the investment and commerce sector[8] of the economy is expanding, as companies invest more in production of capital goods, which requires higher levels of capital and labour in the sector. Quite logically therefore follows the wage growth in the economy in order to respond to the rise in the price level, since it has caused a decline in real wages (Shimer, 2010). Downturn in

[6] For example, in real estate, where sudden monetary expansion, interest-rate fall and increased volume of loans leads into a growing demand for buying real estate at a rate that causes the so-called price bubble. Many investors see the source of profit in increased property values and their elementary goal is not to buy the property and enjoy it, but primarily to speculate on its appreciation.

[7] Situation when companies or individuals are unable to their required payment duties on their debt obligations and because of that lenders and investors are subject to default risk basically in virtually all types of credit extensions. To partially mollify the influence of default risk, lenders charge rates of return, which equal to their estimated level of default risk, where the higher level of risk is mean a higher demanded return.

[8] In a relationship between companies, businesses and industries however not in the consumption or consumer sector. Conversely, in the consumption sector occurs during the boom completely different situation. Resources that could be invested and used in the consumption sector are moved to industry investment, and thus there is less capital and labor than there would be in a normal situation. Consequence of loss of capital and labor are obviously transformed into an increase of the prices of consumer goods.

economic activity is starting to show when the price level rises, which is an inevitable process to previous expansion[9].

Price growth has a direct impact on the interest rate, which rises, returning to its previous level. After the rising of price level and interest rate, the demand for loans is declining since the implementation of long-term investments is no longer valid. In the worst case, business go bankrupt or yet are stuck with unfinished projects, since they are no longer viable, because of a higher interest rate. During the economic slowdown, it also clearly shows how much optimism there was in some earlier investments in capital goods, and many companies and businesses have tendency to get into financial problems or bankrupt. Subsequently, they may withdraw the entire economy into recession, but even those companies that had before accurately forecasted their growth and were not too indebted may get into problems since having difficulties with their investments projects. Poor investment course leads to a waste of capital, which has been produced for the production of certain products, while it cannot be used for production of something else that would be currently in demand on a market. The economic downturn also has a negative impact on price bubbles. Once the bubbles reach a price level, which are already unsustainable, and prices start abruptly, getting clients and banks then banks to the financial problems. Accordingly, banks are tightening the lending in order to prevent their own ruin, and the market does not receive much money sources[10]. The basis for the termination of cyclic variations and fluctuations in economy is the natural market interest rate, since interventions of central bank are artificially stimulating growth, which in turn leads to a decrease (Knoop, 2015). This decrease represents a naturally market correction, when a bad investment bankrupt and the economy gets where it should be, since the previous lower interest rates, while subsidizing certain sectors of the economy only leads to more bad allocation of resources, and only delays the arrival of the boom.

2.3 Artificial increase of money as the interaction between business and consumers and monetary expansion

Although the central banks' driving force is that they can create credit expansion, de facto when it comes to decision-making in the context of lending money to consumers and businesses, commercial banks play a very important role. Thus we could argue that lending resources primarily arise in commercial banks, where appearance and disappearance of the money is specifically focused in granting loans, interest bearing on bank deposits, checking accounts and other liabilities, the purchase of properties or services, payment of salaries and bonuses from businesses to their employees and statutory bodies or payment of dividends and bonuses to shareholders of banks. Relocation occurs during repayment of loan, sale of property or services by banks to non-bank entities. Money arise at the moment the amount is credited to the account of the client, and extinguished by their debiting. Banks can therefore provide money in theoretically unlimited range, but they often provide loans only to a certain extent because, the excessive credit increases the risk of not getting their resources back. In

[9] Also known as monetary.

[10] For example, the early 2000s recession, late-2000s financial crisis or the late-2000s recession, Greek government-debt crisis, Ukrainian 2014 economic crisis, Russian 2015 financial crisis, Chinese stock market crash.

many case, however, there were failures when some banks have lend more money than they were able to excessively withdrawal of deposits and thus, this issue is nowadays, in the hands of central banks. Additionally, consequence of an artificial increase of money represents a multiplication effect, since after the central bank creates the money, they simply multiplies or put through the interaction between commercial banks, businesses and consumers (Mankiw, 2014). The main stimulus is going through a partial plus reserves that the bank maintains, and has more money available to borrow, but the money supply is increased through open market operations and their subsequent expansion of the economy.

Monetary expansion brings in the long-term consequences in the form of higher price levels, since the extension of credit leads to changes in prices of goods and factors of production for both business and consumers, where during trade operations, the more are those entities that are involved in the production of capital goods of higher orders, while the lower value is obtained by those who attend this production. These capital goods themselves also receive higher prices compared with consumer goods, which negatively affect commerce in the eyes of consumers. Due to credit expansion this processes thus disrupts the pricing structure, respectively more valued are goods and factors of production which would normally not be evaluated as much (Holcombe, 2014).

When we think about commerce, businesses and consumer decisions, the problem lies in the fact that entities in the economy are not receiving the new money at the same time, but they get into economy gradually. Businesses initially receive money in the form of cheap loans, and then perform investments and from these new investments, they gain money. From these gained money they retain a specific portion while another portion is paid out to the owners of factors of production[11], who participated in the production of capital goods. These owners of factors of production now have more money to buy goods. Due to the increased demand for goods will thus start to raise prices in the economy. Money that businesses get from merchants (traders) and owners of the factors of production will be again used for the purchase of other goods, but these goods will now be merchants buying at higher prices. Therefore, this commerce process implies that during credit expansion, those who came with the new money earlier get benefits, at the expense of those who came later (got they money later). Moreover, in the short term, merchants mistakenly believe that quantity of their obtained goods from businesses (manufacturers), demanded by consumers only grows, and therefore they increase prices. In the long term, however, the growth in prices occurs globally throughout the economy.

Furthermore, consumers can buy for their new money more goods and services, but at higher prices. Credit expansion is therefore only affect of nominal variables, not real variables, because the quantity of goods that consumers can buy did not increase. This fact has led some theorists to conclude that money is neutral[12] in the long run, since the expansion of the money supply leads to a proportional increase in the general price level, respectively nominal values will increase but the real values remain constant over time. We can see that although consumers are buying more goods, but

[11] The amounts of the various inputs or resources that were used in the production processes in order to produce outputs, namely land, labor and capital, while these factors often entitled as consumer goods.

[12] They believe (for example Milton Friedman) that inflation is a monetary phenomenon affecting all sectors uniformly and proportionately.

at higher prices, since there is also an inter-temporal market violation of discoordination, distortion and disruption of the capital pricing structure of goods and factors of production. This fact shows us that the ineffectiveness of monetary policy, questions the issue of neutrality of money. Consequence of monetary expansion are logically also evident in costs of prices. Microeconomic result of manipulation of the interest rate means confusion for businesses when deciding about the amount of investments that they are going to perform, business when deciding on investments include in their calculation also the interest rate. Due to its artificial reduction the result of the calculations becomes misleading, and some projects and investments therefore appear to be profitable, which does not reflect the reality.

Businesses are confident that production is worthwhile in the essence of profitability, and higher costs will repay future investment earnings. However, to produce more they need additional resources, if a large number of businesses need for their production additional resources, the price of these resources, due to increased demand, will gradually increase. Moreover, in the long run, prices are growing much faster, because the real power of the economy has not increased, and the economy can hypothetically encounter at some level its maximum, so naturally business are not able to find additional resources for other operations to proceed, and therefore this will only increase their prices. The market interest rate is also gradually rising, because the increased demand for loans is not compensated with a corresponding increase in savings, which businesses could borrow. Money is thus gradually coming into the economy through specific paths of public spending and credit expansion, thus begins the process of redistribution of income, where entities who get the new money first will gain more compared to those who come later. Consequences of monetary expansion are in the form of higher price levels, which are hard to remove due to the inflationary and wage spiral (Knoop, 2015). Failure to do further credit expansion, means cuts in employment and output in response to higher wages and prices, while this state is as long and painful as for how long and to what extent was the artificial credit expansion implemented. After elimination of erroneous pricing information, economy gets into its original state.

Conclusions and policy implications

Economic crises, recessions, but also long periods of vital growth and prosperity are part of economic cycles and our everyday lives, whether we talk about governments, consumers or businesses and their day to day operations, decisions and processes that certainly affect the lives of every member of society. Major impacts as the Great Depression of 1930s, financial crisis of 2007- have become historically significant and certainly historically important to the current state of economies, influencing the course of the economic cycle dominated more potentially damaging impact over the positive, especially in recent years, portrayed as the decline in gross domestic product, an increase in unemployment, deepening indebtedness of states, artificial credit expansion and the like, just a couple of years ago. As we have analysed in our research paper, the course of the economic cycle should not work on the principles of artificially prolonging its downward phase as pumping money into the economy, thus delaying the inevitable economic collapse. Moreover, artificial credit expansion cannot last for-ever, since it is not accompanied by a natural increase in voluntary savings and is sooner or later always doomed to a burst.

So in terms of influence, compliance with certain conditions, to influence the downward phase of the cycle, i.e. the crisis and depression towards overcoming them is to a certain amount a positive aspect, but indebtedness of the state or large businesses by implementing new investments to support recovery in is then necessary to ensure a consistent mechanism and thus the subsequent repayment of the debt, since economies may take longer than they once did in a growth phase and it takes certain amount of time to decrease their indebtedness. Incentives for the development of economic cycles might therefore come from both external and internal environment. The actual pulse can then influence a number of reactions that can cause an increase in economic activity, sometimes up to cross the threshold above the level of potential output, or vice versa, the effect of a series of pulses may result in a gradual slowdown in economic activity. We have to realize that there are possibilities as we have analysed in our research paper to influence the course of the economic cycle, but not without additional harmful consequences, and therefore it is necessary to forecast, think ahead of future development and always think carefully about the potential consequences and their impact on entities around us.

In conclusion, the economic cycle is for market economy natural phenomenon, essentially followed through the market mechanism, which reflects the interaction of aggregate demand and supply, reflecting the aggregated individual decisions of individual economic entities. Economy in terms of market mechanism can be compared to a living organism that has been impacted by many factors. Economic development therefore cannot naturally have only constant upward trend, but it is a combination of alternating phases of growth and decline, thus the frequency of recurrent growth and decline can be considered as the general economic regularity that under market mechanism is a natural phenomenon in the form of a healing process.

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