Real gdp fluctuates around potential gdp

Business cycle is calculated by fluctuations in real GDP around potential GDP. When real GDP is less than potential GDP, a number of resources are underused. For instance, labour is unemployed and capital is underutilized. When real GDP is greater than potential GDP, those resources are overused.

Therefore, business cycle is completed by going from a trough to another trough, which passes a peak, and the cycles are connected in the end of one point coincides with the beginning of another point. Every business cycle has four stages, which consist of two phases: a recession, an expansion, and two turning points: a peak and a trough.

Graph of Business Cycle.

A recession is a time period when real GDP decreases or declining, hence, recession growth rate is negative and the pace of economic activity is slowed down. During recession, potential GDP exceeds real GDP and creates a gap between them, the gap is called recessionary gap. Furthermore, aggregate supply is higher than aggregate demand at this stage, since there is less demand at the economy, output decreases; unemployment rate is increased due to company cutting staff in order to survive the recession period. For instance, Malaysia economy undergoes a recession in 1997-1998 due to Asian financial crisis. Government will implement expansionary fiscal policy during recession in order to encourage public to spend money so that real GDP can be increased. During the time when a recession ends, an expansion will begin; the turning point, when the economy hits bottom, is called a trough.

When the trough turns up, it symbolizes the recovery or the expansion of an economy activity, and there is an increase activity happening in the economic. For example, the rubber boom that happened, between 1942 and 1945 during the Second World War, due to the ability of rubber as a raw material to produce many things.

While an expansion is a period when real GDP increases and have a positive growth rate. Economic activity becomes active during this period and recovering. During expansion, real GDP exceeds potential GDP and creates a gap between them, the gap is called inflationary gap. In order to prevent inflation which occurs due to higher price level than average price level, government will implement contractionary fiscal policy to restrict public to spend lesser money. Besides, at expansion period, aggregate demand is higher than aggregate supply at this period, since there is a higher demand at the economy, output will increase; unemployment rate is also decreased due to company hiring more staff to keep the fast-pace activity of economy. For example, between early 1960s and 1990s, Taiwan, Hong Kong, Singapore and South Korea which is known as the Four Asian Tigers or Asian Tigers experienced high expansion of economy. When expansion ends, a recession begins, the turning point, when economy is at its highest point, is called a peak.

When the peak turns down, it symbolizes the start of a recession in an economic and there is a decrease activity in the economic. For instance, the dot-com bubble which is the internet boom between years 1995 to 2000, later bust to recession due to over speculation of stocks and high confidence from investors that it would acquire profit in the future.

The point where potential GDP intersects and equals Real GDP is the full-employment equilibrium, the resources are said to be fully utilised. At this point, aggregate demand equals to aggregate supply. Hence the demand meets the supply (or vice versa) and the economy is said to be growing in a steady and stable rate.

There are many factors that causes the up-and-down of business cycle to happen, for example, one of the factor is that an outburst of negative demand shock hits the economy and decreases the demand in economy, later, supply will be higher than demand and causes a recession. Then, real GDP will turn downwards and the turning point is the peak of business cycle. Recession will cause unemployment to rise, people have lower income due to recession, and this will make them to consume less, which is to spend less. Since people are cutting on the consumption, they will save more on their money. The real GDP will continue to move downward unless there is a positive demand or supply shock, government policy, or other factors to make the real GDP turns upward.

When real GDP hits the bottom and turns upward, the turning point is said to be the trough. During recession, government will implement some policies such as lowering the interest rate with expansionary policy. When interest rate is lowered, public will spend/consume more using their money, at the same time, investment is increasing due to the demand of capital from company. Demand of labour, wages, and output increases, the activity of economy now becomes active and the economic is said to be expanding and recovering. However, if price has been increased higher than average price level because of higher consumption and investment, inflation will occur.