TOPIC OF THE DAY

BUSINESS CYCLES IN TRANSITION COUNTRIES

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What Is an Economic Cycle?

Business cycles in the broader sense of the term mean recurring periodical fluctuations of economic activity indicators (usually measured by economic growth). Generally, one cycle covers a period of time during which economic activity passes through the expansion and contraction phase.

The periodical fluctuations of economic activity have been one of the most interesting topics for researchers throughout history. The study of business cycles began already at the end of the 18th and in the first half of the 19th century, when representatives of the classical school of economics focused on the ability of the capitalist economic system to achieve a spontaneous balance between demand and supply and to maintain it. The best-known hypothesis of this period is Adam Smith's 'invisible hand.' Later, economists have studied the recurrence of cycles over time, their duration, reasons, economic policies in different phases of the cycle, etc. The study of business cycles is topical also today.

The classifications of business cycles have been constantly changing over time. Generally, these depend on the methods used for studying the cycles and the aim of such studies. In theoretical literature, business cycles are most commonly classified according to their length and primary cause.

Today, the classification of business cycles is more and more often based on whether the potential economic growth of the country or region changes during the cycle or not (often it is also called the change of economic trend growth). Therefore, distinction is made between **short- and long-term business cycles**. The latter denote such change in economic activity indicators that accompany the change of the potential economic growth of a country or a region. This means that the maximum level of economic growth, which does not lead to the demand side price pressure, changes. A long-term business cycle can last decades. Short-term cycles are related to temporary and short-term external and/or domestic changes in the demand for the goods of a particular country. This means that a short-term business cycle does not bring along such relocation, increase or decrease of production inputs that would change the potential growth level of a given country or a region.

Nowadays, analysis of business cycles is mostly focused on the studying of short-term cycles and determining the economic activity of a country, a region or the whole world according to the phase of the cycle. Given the ever-growing integration of the global economy (tightening of trade and financial relations between countries), more attention is being devoted to the spillover effects and correlation of business cycles between countries and economic regions (see Figure 1).

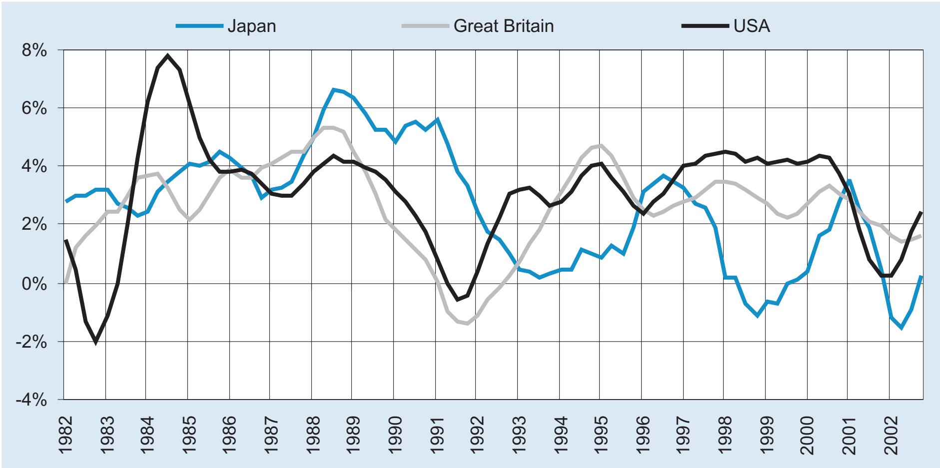

Figure 1. Real growth of GDP in Japan, Great Britain and USA

Business Cycles in Transition Countries

After the fall of the iron curtain, all former planned economy countries passed the so-called transitional recession in early 1990s. This was related to the rearrangement of the economic system of these countries and reorientation towards the market economy. Rapid structural changes led to the constant relocation of resources and change of growth potential in these countries. Therefore, the study and evaluation of the business cycles of these countries was extremely complicated until the second half of the 1990s.

The subject of the business cycles of transition countries became more topical due to the successful accession negotiations with the European Union and the evaluation of the suitability of the economies of these countries for joining the euro area. More and more studies were launched of the correspondence of future member countries to the conditions of optimum currency area and how abandoning independent monetary policy would affect their economy. As a result, several studies have been carried out in recent years of the relations of the business cycles of the transition countries and the euro area. The analyses include the transmission of euro area economic activity through trade as well as financial channels.

By today, such research has been conducted by a number of economists who have used various theoretical approaches. Although quite different results have been reached in different works, the overwhelming view seems to be that smaller and more open accession countries are already integrated with the euro area economy at least as closely as some outlying member countries before they joined the European Union (see Figure 2).

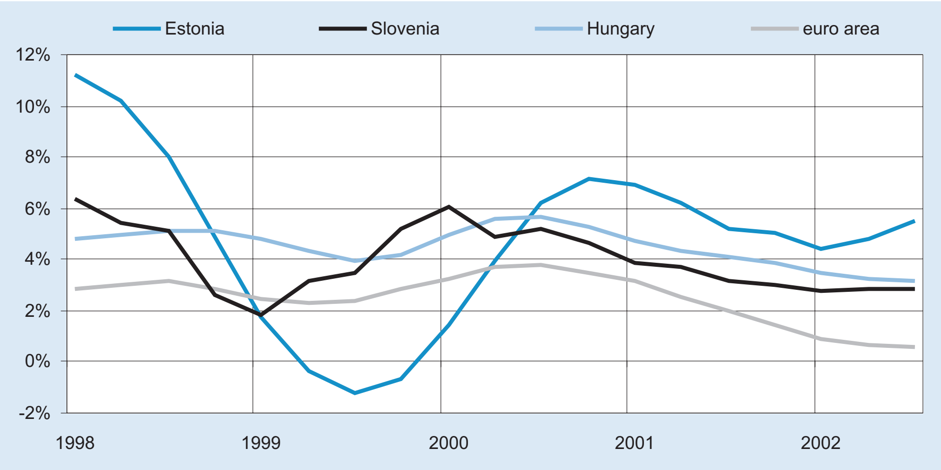

Figure 2. Real growth of GDP in euro area countries and in Estonia, Slovenia and Hungary

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The following two articles are based on the results of studies on the relations between the short-term business cycles of Estonia and the euro area countries and the spillover of euro area economic development into the Estonian economy. The third article discusses the growing effect of business cycles in the financial sector and the possibilities of limiting the procyclical reaction.