Purely Monetary Theory of Trade Cycle: by R.G. Hawtrey! R.G. Hawtrey describes the trade cycle as a purely monetary phenomenon, in this sense that all changes in the level of economic activity are nothing but reflections of changes in the flow of money. Thus, he holds firmly to the view that the causes of cyclical fluctuations were to be found only in those factors that produce expansions and contractions in the flow of money — money supply. Hence, the ultimate cause of economic fluctuations lies in the monetary system. According to Hawtrey, the main factor affecting the flow of money — money supply — is the credit creation by the banking system. To him, changes in income and spending are caused by changes in the volume of bank credit. The real causes of the trade cycle can be traced to variations in effective demand which occur due to changes in bank credit. Therefore, “the trade cycle is a monetary phenomenon, because general demand is itself a monetary phenomenon.” He points out that it is the rate of progress of credit development that determines the extent and duration of the cycle, thus, “when credit movements are accelerated, the period of the cycle is shortened.” This implies that if credit facilities do not exist, fluctuation does not occur. So, by controlling credit, one can control fluctuations in the economic activity. He further maintains that although the rate of progress of cycles may be influenced by non-monetary causes, these factors operate indirectly and through the medium of the credit movement. For example, a non-monetary factor such as optimism in a particular industry can affect activity directly, but it cannot exert a general influence on industry unless optimism is allowed to reflect itself through monetary changes, i.e., through increased borrowing. On these grounds, Hawtrey regarded trade cycle as a purely monetary phenomenon. The gist of Hawtrey’s theory is that the inherent instability in bank credit causes changes in the flow of money which in effect leads to cyclical variations. An economic expansion is caused by the expansion of bank credit and the economic crisis occurs no sooner the credit creation is stopped by the banking system; thus, a contraction of credit leads to a depression. The Monetary Sequence of a Trade Cycle: Basically, Hawtrey’s theory dwells upon the following postulates: 1. The consumers’ income is the aggregate of money income=national income or community’s income in general. 2. The consumers’ outlay is the aggregate of money spendings on consumption and investment. 3. The consumers’ total outlay constitutes community’s aggregate effective demand for real goods and services. Thus, general demand is a monetary demand. 4. The wholesalers or traders have strategic position in the economy. They are extremely sensitive in their stock hoarding business to the changes in the rate of interest. 5. The changes in the flow of money are usually caused by the unstable nature of bank credit. Hence, bank credit has a unique significance in Hawtrey’s cyclical model. According to Hawtrey, changes in business activity are due primarily to variations in effective demand or consumers’ outlay. It is the total money income that determines consumers’ outlay. The stability of the whole economic system follows from the establishment of monetary equilibrium. Under monetary equilibrium: (i) Consumers’ outlay = consumers’ income; (ii) Consumption = production; (iii) Cash balances of consumers and traders remain unchanged; (iv) Bank credit flow is steady; (v) Market rate of interest = the profit rate; (vi) Wages (as money costs) and prices on the whole are equal (this means normal profit margin and the normal rate of productive activity); and (vii) There is no net export or import of gold. Hawtrey contends that such a monetary equilibrium situation is one of extremely delicate balance, which can be easily dislocated by any number of causes and when disturbed, tends to move into a transitional period of cumulative disequilibrium. He emphasised that primarily it is the unstable nature of the credit system in the economy that causes changes in the flow of money and disturbs the monetary equilibrium. In this connection he feels that the discount rate or interest rate exerts a great influence. The Expansion Phase: A typical expansion phase, according to Hawtrey, might proceed along the following lines. The expansion phase of the trade cycle is brought about by an increase of credit and lasts so long as the credit expansion goes on. A credit expansion is brought about by banks through the easing of lending conditions along with a reduction in the discount rate, thereby reducing the costs of credit. By lowering their lending rates, banks stimulate borrowing. Such a reduction in the interest rate is a great stimulus to wholesalers (or traders). According to Hawtrey, traders are in a strategic position as they tend to carry their large stocks primarily with borrowed money. Moreover, traders usually mark their profits as fraction of the value of a large turnover of goods. Hence, a small change in the interest rate affects their profits to a disproportionately large extent. Thus, they are very sensitive to change in the rate of interest. Traders are induced to increase their stocks — inventories— when the interest rate falls. Hence, they give large order to the producers; the increased orders of traders cause the producers to raise their level of production and employment. This in turn leads to an increase in income and monetary demand. “Thus the whole amount of the funds created by the bank is received as income, whether profits, wages, rents, salaries, or interest, by those engaged in producing the commodities.” Evidently, the increased production leads to an expansion of consumers’ income and outlay. This means increased demand for goods in general, and traders find their stocks diminishing. These result in further orders to producers, a further increase in productive activity, in consumers’ income and outlay, and in demand, and a further depletion of stocks. Increased activity means increased demand, and increased demand means increased activity.” This leads to a cumulative expansion, set up, fed and propelled by the continuous expansion of bank credit. Hawtrey further states: “Productive activity cannot grow without limit. As the cumulative process carries one industry after another to the limit of productive capacity, producers begin to quote higher and higher prices.” Thus, when prices rise, traders have a further incentive to borrow and hold more stocks in view of the rising profits. The rising prices operate in the same way as falling interest rates and the spiral of cumulative expansion is accelerated further. This means that there are three important factors which influence credit expansion by banks. These are: (i) the rate of interest charged by the banks (ii) traders’ expectations about the price behaviour (iii) the actual magnitude of their sales The rate of interest is determined by the banks. Traders’ expectations depend on general business conditions and their psychology. Actual magnitude of sales depends on the net effect of the first two upon the consumers’ outlay. In short, “Optimism encourages borrowing, borrowing accelerates sales, and sales accelerate optimism.” Financial Crisis (Recession): According to Hawtrey, prosperity comes to an end when credit expansion ends. As banks go on increasing credit, their cash funds deplete and they are forced to curtail credit and raise interest rates in order to discourage the demand for new loans. Due to the shortage of gold reserves, the central bank — as lender of the last resort — has to set a limit on the accommodation to commercial banks. Eventually, the central bank will start contracting credit by raising the bank rate. Thus, the drain of cash from the banking system ultimately results in an acute shortage of bank ‘reserve’, so that the banks not only refuse to lend any more, but actually are compelled to contract. It is interesting to note that in Hawtrey’s view a drain upon the cash reserves of the banking system is caused by the public. For a rise in consumers’ income generally would lead to an increase in the cash holding (unspent margins) by the public. This happens when the wages rise and consequently wage-earners’ demand for cash rises. Thus, what ultimately limits the expansion of credit is the absorption of money in circulation, mainly by wage earning classes. Moreover, under the international gold standard, if expansion is taking place rapidly in a country, it will lose gold to other countries due to excessive imports. Eventually, the central bank will have to adopt a restrictive policy. Contraction Phase (Depression): The recessionary phase merges with depression due to the growing shortages of credit. The contraction of credit exerts a deflationary pressure on prices and profits and on consumers’ income and outlay. High rate of interest charged by banks discourages traders to hold large stocks and their demand for credit decreases. Prices start falling, profits also drop. Accordingly, traders further reduce stocks and stop ordering goods. Producers in turn will curtail output and employment. The income of the factors of production will decline. When consumers’ income and outlay decrease, effective demand decreases, stocks and output decrease, prices fall, profits fall and so on — a cumulative downswing develops. In a nutshell, it is the contraction of effective demand reflected in reduced outlay by consumers and increased holding of cash balances in view of a large credit curb that causes a vicious circle of deflation leading to severe depression. Recovery: During a depression, as traders experience slackening in the demand for their goods, they will try to dispose of goods at whatever low price they get and repay bank’s loans. When loans are liquidated, money gradually flows from circulation into the reserves of bank. As depression continues, banks will have more and more idle funds. The credit creating capacity of banks increases and in order to stimulate borrowing, banks lower the interest rate. Traders will now be stimulated to increase their inventories and the whole process of expansion will be once again set in motion. The central bank now helps by lowering the bank rate and adopts open market purchases of securities so that cash is pumped into banks improving their lendable resources. And when the purchase of securities is carried far enough, the new money will find an outlet. Hawtrey believes that the ordinary measures of monetary instruments such as bank rate policy and open market operations may help in bringing about a revival. In Hawtrey’s view, this cyclical behaviour is fundamentally a monetary phenomenon. He does not deny that non-monetary causes (such as invention, discovery, bumper crops, etc.) may affect productive activity but he feels that their effects will be synchronised only with monetary effects. Non-monetary causes have no periodicity; the periodicity that appears in trade cycles is due to monetary effects, and it can be surmounted by an appropriate banking policy. According to Hawtrey, it is only the inherent instability of bank credit that causes fluctuations in business and turn them into rhythmic changes. Abolish the instability of bank credit by an appropriate bank policy and the trade cycles will disappear. A Critical Appraisal: No doubt, Hawtrey’s theory is perfectly logical in its basic concept of a self-generating cycle of cumulative process of expansion and contraction. One of the most striking features of Hawtrey’s theory is his explanation of the period of a cycle, i.e., his explanation of the turning points of expansion and contraction. Hawtrey, in his analysis, however, exaggerates the significance of wholesalers, ignoring the capital goods industries and all other sectors of the economy. Some critics have pointed out that monetary inflation and deflation are not causes, as Hawtrey expounds, but the result of trade cycles. In fact, credit expansion follows business expansion, and once it takes place, it would accelerate business activity. So monetary deflation is preceded by business contraction. The role of bank credit in the economic system is over-emphasised by Hawtrey. It is true that finance is the backbone of business and bank credit plays an important role in it, but it does not mean that banks are always the leaders of economic activity. Hawtrey asserts that changes in the flow of money are the sole and adequate cause of economic fluctuations. But, a trade cycle, being a complex phenomenon, cannot be attributed to a single cause. There are various nonmonetary indigenous and exogenous factors, besides monetary factors which influence economic activity. Thus, it is incorrect to say that trade cycles are a purely monetary phenomenon. 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Non-monetary causes have no periodicity; the periodicity that appears in trade cycles is due to monetary effects, and it can be surmounted by an appropriate banking policy. According to Hawtrey, it is only the inherent instability of bank credit that causes fluctuations in business and turn them into rhythmic changes. Abolish the instability of bank credit by an appropriate bank policy and the trade cycles will disappear. A Critical Appraisal: No doubt, Hawtrey’s theory is perfectly logical in its basic concept of a self-generating cycle of cumulative process of expansion and contraction. One of the most striking features of Hawtrey’s theory is his explanation of the period of a cycle, i.e., his explanation of the turning points of expansion and contraction. Hawtrey, in his analysis, however, exaggerates the significance of wholesalers, ignoring the capital goods industries and all other sectors of the economy. Some critics have pointed out that monetary inflation and deflation are not causes, as Hawtrey expounds, but the result of trade cycles. In fact, credit expansion follows business expansion, and once it takes place, it would accelerate business activity. So monetary deflation is preceded by business contraction. The role of bank credit in the economic system is over-emphasised by Hawtrey. It is true that finance is the backbone of business and bank credit plays an important role in it, but it does not mean that banks are always the leaders of economic activity. Hawtrey asserts that changes in the flow of money are the sole and adequate cause of economic fluctuations. But, a trade cycle, being a complex phenomenon, cannot be attributed to a single cause. There are various nonmonetary indigenous and exogenous factors, besides monetary factors which influence economic activity. Thus, it is incorrect to say that trade cycles are a purely monetary phenomenon. The British economist Ralph G. Hawtrey regards trade cycle as a purely monetary phenomenon. According to him, non-monetary factors like wars, earthquakes, strikes and crop failures may cause partial and temporary depression in particular sectors of an economy. However, these non-monetary factors cannot cause full and permanent depression involving general unemployment of the factors of production in a trade cycle. On the other hand, changes in the flow of money are the exclusive and sufficient cause of changes in trade cycle. In Hawtrey’s opinion, the basic cause of trade cycle is the expansion and contraction of money in a country. According to Hawtrey, changes in the volume of money are brought about by changes in the rate of interest. For instance, if banks reduce their rate of interest, producers and traders will be induced to borrow more from banks so as to expand their business. Borrowing from banks will lead to more bank money and rise in the price level and business activity. On the other hand, if banks raise their rate of interest, producers and traders will reduce their borrowing from banks. This will reduce the price level and business activity. Thus, in Hawtrey’s analysis, changes in interest rates lead to changes in borrowing from banks and, therefore, changes in the supply of money. Changes in the supply of money lead to changes in business activity.Trade Cycle in Just Inflation and Deflation Hawtrey argues that the trade cycle is nothing but small-scale replica of an outright money inflation and deflation. The upward phase of a trade cycle, such as revival, prosperity and boom is brought about by an expansion of money and bank credit and also by increase in circulation of money supply. On the other hand, the downward swing of money supply is nothing but a monetary deflation.Expansion of bank loans is made possible by fall in rate of interest, which induces the merchants to increase their stocks since banks grants loan more liberally. Therefore, merchants begin to place more orders and increase production by employing more resources. There is greater demand for factors of production all round and consequently higher income and employment leading to further increased demand of goods. In course of time, a cumulative upward trend is set in motion. As the volume of business expands and factors of production arc rendered fully employed, prices rise further and further induce upward business expansion, resulting in inflationary conditions or boom conditions. However, the boom crashes when the banking authorities suspend their policy of credit expansion.Why the Boom Crashes Suddenly?The banks suspend credit and call on the borrowers to return the loans, either because banks have reached the maximum point beyond which they cannot give any more loans or they are afraid that the phase of business expansion has reached a saturation point and hence a downward trend may set in the immediate future. Now the sudden suspension of credit facilities by the banks comes as a shock to entrepreneurs and merchants. Until now entrepreneurs and merchants were enjoying liberal policy of the banks and now, contrary to their expectations, they receive sudden notices of immediate call-back of loans to dispose of their stocks at any price in order to repay bank loans. This general desire of businessmen to dispose of their stocks will definitely depress the market and bring down the prices. With every fall in prices, the desire to dispose of the stocks as quickly as possible will lead to confusion and collapse of the market. Marginal and average firms may even go into liquidation, thus worsening the position still further and making the banks extremely nervous. Banks will proceed to further contraction and like the period of expansion, it will become cumulative. Producers curtail output and consumers income and outlays decrease and contraction spirals in a downward direction, until it touches the lowest level possible.How the revival takes place?When the economy is working at the level of depression, the rate of interest is low and the banks will have large cash reserves. On one hand, low interest rates make it profitable to borrow and invest. On the other hand, large cash reserves induce banks to lend. This starts the phase of revival, which because of its cumulative character, leads to prosperity and boom conditions. This, according to Hawtrey, the inherently unstable nature of the modem monetary and credit system is the mother or economic fluctuations. This monetary explanation of the trade cycle has received powerful support from Milton Friedman, who says, “In every deep depression, monetary factors play a critical role.” According to Freidman, there is a direct relation between the volume of money supply and the level or business activity in a country. If the money supply increases at a rate faster than the economy’s real output of goods and services, prices will decline and the economy is bound to contract. Thus, there is direct relation between the level of income and economic activity, on the one side and the volume of money supply on the other. If the economy has to be stable, monetary expansi9n and contraction has to be avoided.Weaknesses of the Monetary ExpansionThe weakness of monetary expansion is as follows: Finance is the soul of commerce and trade in modern times and the banking system plays quite an important part in financing trade activities. However, it is correct to say that banks cause business crises. Hawtrey’s theory would have been all right in those days when the gold standard was universal and when the volume of money supply was fixed to gold reserves. Currency and credit could expand only when gold reserves increases. These days, gold standard does not exist and, therefore, Hawtrey’s theory is really weak. Borrowing and investment will not depend upon the rate of interest, as Hawtrey believes. A high rate of interest will not deter people from borrowing for investment, and a low rate of interest will always induce people to borrow and invest. Expansion and contraction of money alone cannot explain prosperity and depression. According to Hawtrey, expansion and boom are the result of expansion of bank credit, but it is pointed out that the mere expansion of bank credit by itself cannot initiate a boom. Further, according to Hawtrey, a depression is marked by contraction of bank loans and advances but actually, the contraction of bank credit is the result of depression. . Lowering of interest rate and willingness of banks to give loans and advances cannot be a sufficient reason to stimulate the economy to revive. Businessmen will not borrow and invest unless they are convinced that the economy will definitely survive. The conclusion, which follows, is that the banking system can accentuate a boom or a depression but it cannot originate one. In other words, expansion and contraction of bank credit can be a supplementary cause but not the main cause of trade cycles.Credit: Managerial Economics-MGU MBA Managerial EconomicsEconomics Concepts, International Economics R. G. Hawtrey states that the trade cycles as a purely monetary phenomenon so the ups and downs of economic activity is being controlled by the money flow of the situation. In this sense that all that occurred changes in the level of economic activity are nothing but reflections of changes in the flow of money. Thus, Hawtrey holds positively to the view that the causes of cyclical fluctuations were to be found only in those factors that produce expansions and contractions in the flow of money — money supply. Hence, the ultimate cause of economic instabilities lies in the monetary system. According to Hawtrey, the main reason affecting the flow of money — money supply — is the credit creation by the banking system. To him, changes in income and spending are produced by changes in the volume of bank credit. The real causes of the trade cycle can be traced to variations in effective demand which happen due to changes in bank credit. Therefore, by his words “the trade cycle is a monetary phenomenon, because general demand is itself a monetary phenomenon.” In his opinion, the duration and the extent of the trade cycle are determined by the rate of progress of credit development. Thus, “when credit movements are fast-tracked, the period of the cycle is shortened.” This suggests that if credit facilities do not be present, variability does not occur. So, by governing credit, one can regulate fluctuations in economic activity. He further continues that although the rate of progress of cycles may be subjected to non-monetary causes, these factors operate indirectly and through the medium of the credit movement. For example, a non-monetary feature such as optimism in a particular industry can touch activity directly, but it cannot employ a general influence on the industry unless optimism is allowed to echo itself through economic changes, i.e., through increased borrowing. On these grounds, Hawtrey viewed trade cycle as a purely monetary phenomenon. The core of the pure monetary theory is that the inherent instability in bank credit grounds changes in the flow of the money which in effect leads to cyclical deviations. Economic expansion is caused by the expansion of bank credit and the economic catastrophe rises no sooner the credit creation is stopped by the banking system; thus, a contraction of credit leads to a recession. Hawtrey’s sequence of the trade cycle is based upon following postulates: 1.The consumers’ income is the aggregate of money income=national income or community’s income in general. 2.The consumers’ expenditure is the aggregate of money spending’s on consumption and investment 3.The consumers’ total expenditure creates the community’s aggregate effective demand for real goods and services. Thus, general demand is a monetary demand. 4.The suppliers or traders have a strategic position in the economy. They are exceedingly sensitive in their stock hoarding business to the changes in the rate of interest. 5.The changes in the flow of money are generally caused by the unsteady nature of bank credit. Hence, bank credit has an exclusive significance in Hawtrey’s cyclical model. According to Hawtrey, changes in business activity are due mainly to differences in effective demand or consumers’ expenditure. It is the total money income that regulates consumers’ expenditure. The steadiness of the whole economic system follows from the establishment of monetary equilibrium. Under monetary equilibrium Consumers’ expenditure = consumers’ income; Consumption = production; Cash balances of consumers and dealers remain unchanged; Bank credit flow is stable; The market rate of interest = the profit rate; Wages (as money costs) and prices, on the whole, are equal (this means normal profit margin and the normal rate of productive activity); and There is no net export or import of gold. Hawtrey opposes that such a monetary equilibrium situation is one of extremely delicate balance, which can be easily disrupted by any number of causes and when disturbed, tends to move into a transitional period of cumulative disequilibrium. He highlighted that primarily it is the unbalanced nature of the credit system in the economy that causes changes in the flow of money and disturbs the monetary equilibrium. In this connection, he senses that the discount rate or interest rate exerts a great influence. The Expansion Stage: A classic expansion phase, according to Hawtrey, might proceed along the following lines. The expansion phase of the trade cycle is carried about by an increase of credit and lasts so long as the credit expansion goes on. Credit expansion is carried about by banks through the easing of loaning conditions along with a drop in the discount rate, thereby reducing the costs of credit. By dropping their lending rates, banks encourage borrowing. Such a reduction in the interest rate is a great stimulus to wholesalers (or traders). According to Hawtrey, traders are in a tactical position as they have a habit to carry their large stocks largely with borrowed money. Furthermore, traders usually mark their profits as a fraction of the value of a large turnover of goods. Hence, a small change in the interest rate affects their profits to a disproportionately large extent. Thus, they are very sensitive to change in the rate of interest. Traders are encouraged to increase their stocks — inventories— when the interest rate falls. Hence, they give large order to the producers; the increased orders of traders cause the producers to raise their level of production and employment. This in turn leads to an increase in income and monetary demand. “Thus the whole amount of the funds generated by the bank is received as income, whether profits, wages, rents, salaries, or interest, by those engaged in producing the commodities.” Evidently, the increased production leads to an expansion of consumers’ income and outlay. This means increased demand for goods in general, and traders find their stocks shrinking. These result in further orders to manufacturers, a further increase in productive activity, in consumers’ income and expenditure, and in demand, and further depletion of stocks. Improved activity means better demand, and better demand means increased activity.” This leads to a cumulative expansion, set up, fed and propelled by the continuous expansion of bank credit. He continuously argues, “Productive activity should be confined and it cannot grow without limit. As the increasing process brings one industry after another to the limit of productive capacity, manufacturers begin to quote greater and greater prices.” Thus, when prices rise, dealers have a further incentive to borrow and hold more stocks in view of the increased profits. The cumulative expansion will be accelerated further because the rising prices operate in the same way as falling interest rates. This means that there are three significant factors which influence credit expansion by banks. These are: ♦The rate of interest charged by the banks ♦Traders’ expectations about the price behavior ♦The real magnitude of their sales The interest rates will be decided by banks. Dealers’ expectations depend on general business situations and their psychology. The real magnitude of sales depends on the net effect of the first two upon the consumers’ expenditure. In brief, “optimism leads to take borrowing, borrowing give acceleration to sales, and sales quicken optimism”. Financial Crisis (Recession): design by slidebazaar Hawtrey says that richness comes to an end when credit expansion ends. As banks go on increasing credit, their cash funds exhaust and they are forced to limit credit and raise interest rates in order to discourage the demand for new loans. Because of the shortage of gold reserves, the central bank — as a financier of the last resort — has to fix a limit on the accommodation to commercial banks. Finally, the central bank will start contracting credit by raising the bank rate. Thus, the drain of cash from the banking system eventually results in an acute shortage of bank ‘reserve’, so that the banks not only refuse to lend any more but actually are compelled to contract. According to Hawtrey, a problem upon the cash reserves of the banking system is caused by the public. For an increase in buyers’ income generally would lead to an increase in the cash holding by the public. This happens when the wages rise and so wage-earners’ demand for cash rises. Thus, what finally limits the expansion of credit is the absorption of money in circulation, mainly by wage-earning classes. Besides, under the international gold standard, if expansion is taking place quickly in a country, it will lose gold to other countries due to too many imports. Eventually, the central bank will have to implement a defensive policy. The declining phase merges with depression due to the growing shortages of credit. The contraction of credit exerts a deflationary force on prices and profits and on consumers’ income and expenditure. The high rate of interest charged by banks discourages traders to hold large stocks and their demand for credit drops. Prices start falling, profits also fall. Recovery Search for different types of arrow PowerPoint templates During a recession, as traders experience break in the demand for their goods, they will try to dispose of goods at whatever low price they get and repay bank’s mortgages. When loans are settled, money gradually flows from the circulation into the reserves of the bank. As the recession continues, banks will have more and more idle reserves. The central bank now supports by lowering the bank rate and accepts open market purchases of securities so that cash is pumped into banks improving their lendable resources. In Hawtrey’s view, this cyclical action is basically a monetary phenomenon. He does not refute that non-monetary causes (such as discovery, innovation, bumper crops, etc.) may affect productive activity but he feels that their effects will be synchronized only with monetary effects. Non-monetary causes have no periodicity; the periodicity that seems in trade cycles is due to fiscal effects, and it can be overcome by proper banking policy. Conclusion Hawtrey’s theory is flawlessly logical in its basic concept of a self-generating cycle of a cumulative process of expansion and contraction. One of the most prominent features of Hawtrey’s theory is his description of the period of a cycle, i.e., his explanation of the turning points of expansion and contraction. Central bank’s monetary policies have a massive impact on the nation’s economic condition because of credit availability. These also determined by the price mechanisms. However, Hawtrey’s theory is not beyond criticism, he always exaggerating the importance of wholesalers, not mentioning the capital goods industries and all other sectors of the economy. Some opponents have pointed out that monetary inflation and deflation are not causes, as Hawtrey explains, but the result of trade cycles. In fact, credit expansion follows business expansion, and once it takes place, it would quicken business activity. So, monetary deflation is led by business contraction. The role of bank credit in the economic system is the predominant aspect of Hawtrey’ss theory. It is true that finance is the pillar of business and bank credit plays a significant role in it, but it does not mean that banks are always the leaders of economic activity. Hawtrey states that changes in the flow of money are the sole and adequate cause of economic variations. But, a trade cycle, being a compound phenomenon, cannot be attributed to a single cause. There are numerous nonmonetary native and international factors, besides monetary factors which influence economic activity. Thus, it is incorrect to say that trade cycles are a purely monetary phenomenon. Purely Monetary Theory of Trade Cycle: by R.G. Hawtrey! R.G. Hawtrey describes the trade cycle as a purely monetary phenomenon, in this sense that all changes in the level of economic activity are nothing but reflections of changes in the flow of money. Thus, he holds firmly to the view that the causes of cyclical fluctuations were to be found only in those factors that produce expansions and contractions in the flow of money — money supply. Hence, the ultimate cause of economic fluctuations lies in the monetary system. According to Hawtrey, the main factor affecting the flow of money — money supply — is the credit creation by the banking system. To him, changes in income and spending are caused by changes in the volume of bank credit. The real causes of the trade cycle can be traced to variations in effective demand which occur due to changes in bank credit. Therefore, “the trade cycle is a monetary phenomenon, because general demand is itself a monetary phenomenon.” He points out that it is the rate of progress of credit development that determines the extent and duration of the cycle, thus, “when credit movements are accelerated, the period of the cycle is shortened.” This implies that if credit facilities do not exist, fluctuation does not occur. So, by controlling credit, one can control fluctuations in the economic activity. He further maintains that although the rate of progress of cycles may be influenced by non-monetary causes, these factors operate indirectly and through the medium of the credit movement. For example, a non-monetary factor such as optimism in a particular industry can affect activity directly, but it cannot exert a general influence on industry unless optimism is allowed to reflect itself through monetary changes, i.e., through increased borrowing. On these grounds, Hawtrey regarded trade cycle as a purely monetary phenomenon. The gist of Hawtrey’s theory is that the inherent instability in bank credit causes changes in the flow of money which in effect leads to cyclical variations. An economic expansion is caused by the expansion of bank credit and the economic crisis occurs no sooner the credit creation is stopped by the banking system; thus, a contraction of credit leads to a depression. The Monetary Sequence of a Trade Cycle: Basically, Hawtrey’s theory dwells upon the following postulates: 1. The consumers’ income is the aggregate of money income=national income or community’s income in general. 2. The consumers’ outlay is the aggregate of money spendings on consumption and investment. 3. The consumers’ total outlay constitutes community’s aggregate effective demand for real goods and services. Thus, general demand is a monetary demand. 4. The wholesalers or traders have strategic position in the economy. They are extremely sensitive in their stock hoarding business to the changes in the rate of interest. 5. The changes in the flow of money are usually caused by the unstable nature of bank credit. Hence, bank credit has a unique significance in Hawtrey’s cyclical model. According to Hawtrey, changes in business activity are due primarily to variations in effective demand or consumers’ outlay. It is the total money income that determines consumers’ outlay. The stability of the whole economic system follows from the establishment of monetary equilibrium. Under monetary equilibrium: (i) Consumers’ outlay = consumers’ income; (ii) Consumption = production; (iii) Cash balances of consumers and traders remain unchanged; (iv) Bank credit flow is steady; (v) Market rate of interest = the profit rate; (vi) Wages (as money costs) and prices on the whole are equal (this means normal profit margin and the normal rate of productive activity); and (vii) There is no net export or import of gold. Hawtrey contends that such a monetary equilibrium situation is one of extremely delicate balance, which can be easily dislocated by any number of causes and when disturbed, tends to move into a transitional period of cumulative disequilibrium. He emphasised that primarily it is the unstable nature of the credit system in the economy that causes changes in the flow of money and disturbs the monetary equilibrium. In this connection he feels that the discount rate or interest rate exerts a great influence. The Expansion Phase: A typical expansion phase, according to Hawtrey, might proceed along the following lines. The expansion phase of the trade cycle is brought about by an increase of credit and lasts so long as the credit expansion goes on. A credit expansion is brought about by banks through the easing of lending conditions along with a reduction in the discount rate, thereby reducing the costs of credit. By lowering their lending rates, banks stimulate borrowing. Such a reduction in the interest rate is a great stimulus to wholesalers (or traders). According to Hawtrey, traders are in a strategic position as they tend to carry their large stocks primarily with borrowed money. Moreover, traders usually mark their profits as fraction of the value of a large turnover of goods. Hence, a small change in the interest rate affects their profits to a disproportionately large extent. Thus, they are very sensitive to change in the rate of interest. Traders are induced to increase their stocks — inventories— when the interest rate falls. Hence, they give large order to the producers; the increased orders of traders cause the producers to raise their level of production and employment. This in turn leads to an increase in income and monetary demand. “Thus the whole amount of the funds created by the bank is received as income, whether profits, wages, rents, salaries, or interest, by those engaged in producing the commodities.” Evidently, the increased production leads to an expansion of consumers’ income and outlay. This means increased demand for goods in general, and traders find their stocks diminishing. These result in further orders to producers, a further increase in productive activity, in consumers’ income and outlay, and in demand, and a further depletion of stocks. Increased activity means increased demand, and increased demand means increased activity.” This leads to a cumulative expansion, set up, fed and propelled by the continuous expansion of bank credit. Hawtrey further states: “Productive activity cannot grow without limit. As the cumulative process carries one industry after another to the limit of productive capacity, producers begin to quote higher and higher prices.” Thus, when prices rise, traders have a further incentive to borrow and hold more stocks in view of the rising profits. The rising prices operate in the same way as falling interest rates and the spiral of cumulative expansion is accelerated further. This means that there are three important factors which influence credit expansion by banks. These are: (i) the rate of interest charged by the banks (ii) traders’ expectations about the price behaviour (iii) the actual magnitude of their sales The rate of interest is determined by the banks. Traders’ expectations depend on general business conditions and their psychology. Actual magnitude of sales depends on the net effect of the first two upon

the consumers’ outlay. In short, “Optimism encourages borrowing, borrowing accelerates sales, and sales accelerate optimism.” Financial Crisis (Recession): According to Hawtrey, prosperity comes to an end when credit expansion ends. As banks go on increasing credit, their cash funds deplete and they are forced to curtail credit and raise interest rates in order to discourage the demand for new loans. Due to the shortage of gold reserves, the central bank — as lender of the last resort — has to set a limit on the accommodation to commercial banks. Eventually, the central bank will start contracting credit by raising the bank rate. Thus, the drain of cash from the banking system ultimately results in an acute shortage of bank ‘reserve’, so that the banks not only refuse to lend any more, but actually are compelled to contract. It is interesting to note that in Hawtrey’s view a drain upon the cash reserves of the banking system is caused by the public. For a rise in consumers’ income generally would lead to an increase in the cash holding (unspent margins) by the public. This happens when the wages rise and consequently wage-earners’ demand for cash rises. Thus, what ultimately limits the expansion of credit is the absorption of money in circulation, mainly by wage earning classes. Moreover, under the international gold standard, if expansion is taking place rapidly in a country, it will lose gold to other countries due to excessive imports. Eventually, the central bank will have to adopt a restrictive policy. Contraction Phase (Depression): The recessionary phase merges with depression due to the growing shortages of credit. The contraction of credit exerts a deflationary pressure on prices and profits and on consumers’ income and outlay. High rate of interest charged by banks discourages traders to hold large stocks and their demand for credit decreases. Prices start falling, profits also drop. Accordingly, traders further reduce stocks and stop ordering goods. Producers in turn will curtail output and employment. The income of the factors of production will decline. When consumers’ income and outlay decrease, effective demand decreases, stocks and output decrease, prices fall, profits fall and so on — a cumulative downswing develops. In a nutshell, it is the contraction of effective demand reflected in reduced outlay by consumers and increased holding of cash balances in view of a large credit curb that causes a vicious circle of deflation leading to severe depression. Recovery: During a depression, as traders experience slackening in the demand for their goods, they will try to dispose of goods at whatever low price they get and repay bank’s loans. When loans are liquidated, money gradually flows from circulation into the reserves of bank. As depression continues, banks will have more and more idle funds. The credit creating capacity of banks increases and in order to stimulate borrowing, banks lower the interest rate. Traders will now be stimulated to increase their inventories and the whole process of expansion will be once again set in motion. The central bank now helps by lowering the bank rate and adopts open market purchases of securities so that cash is pumped into banks improving their lendable resources. And when the purchase of securities is carried far enough, the new money will find an outlet. Hawtrey believes that the ordinary measures of monetary instruments such as bank rate policy and open market operations may help in bringing about a revival. In Hawtrey’s view, this cyclical behaviour is fundamentally a monetary phenomenon. He does not deny that non-monetary causes (such as invention, discovery, bumper crops, etc.) may affect productive activity but he feels that their effects will be synchronised only with monetary effects. Non-monetary causes have no periodicity; the periodicity that appears in trade cycles is due to monetary effects, and it can be surmounted by an appropriate banking policy. According to Hawtrey, it is only the inherent instability of bank credit that causes fluctuations in business and turn them into rhythmic changes. Abolish the instability of bank credit by an appropriate bank policy and the trade cycles will disappear. A Critical Appraisal: No doubt, Hawtrey’s theory is perfectly logical in its basic concept of a self-generating cycle of cumulative process of expansion and contraction. One of the most striking features of Hawtrey’s theory is his explanation of the period of a cycle, i.e., his explanation of the turning points of expansion and contraction. Hawtrey, in his analysis, however, exaggerates the significance of wholesalers, ignoring the capital goods industries and all other sectors of the economy. Some critics have pointed out that monetary inflation and deflation are not causes, as Hawtrey expounds, but the result of trade cycles. In fact, credit expansion follows business expansion, and once it takes place, it would accelerate business activity. So monetary deflation is preceded by business contraction. The role of bank credit in the economic system is over-emphasised by Hawtrey. It is true that finance is the backbone of business and bank credit plays an important role in it, but it does not mean that banks are always the leaders of economic activity. Hawtrey asserts that changes in the flow of money are the sole and adequate cause of economic fluctuations. But, a trade cycle, being a complex phenomenon, cannot be attributed to a single cause. There are various nonmonetary indigenous and exogenous factors, besides monetary factors which influence economic activity. Thus, it is incorrect to say that trade cycles are a purely monetary phenomenon.