Economics

Understanding Business Cycles

Exam Focus

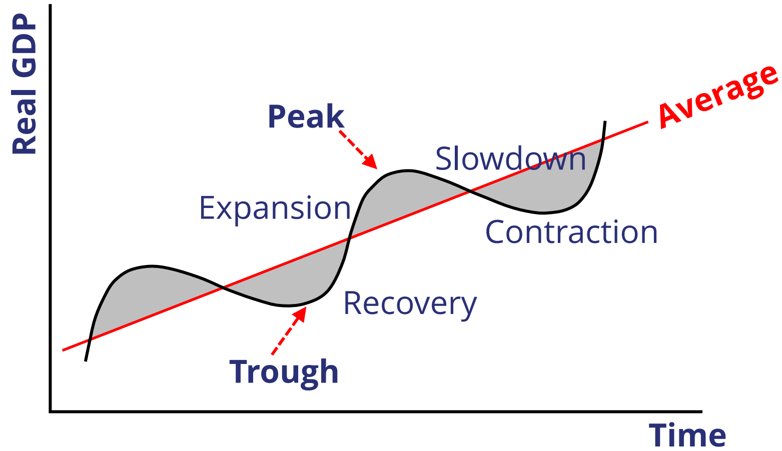
- Overview of business cycles
- Credit cycles
- Economic indicators

Business Cycle Overview

- *Business cycles* refer to repeating expansions and contractions in economic activity:
  - Classical cycle: fluctuations measured in GDP terms
  - Growth cycle: fluctuations around a long-term trend growth level (examines gap between actual and trend GDP)
  - Growth rate cycle: fluctuations in the growth rate of economic activity

Phases of the Business Cycle

- Four phases of the cycle: recovery, expansion, slowdown, contraction



Credit Cycles

- *Credit cycles* refer to availability and price of credit
- Strong economy leads to credit expansion and may lead to asset bubbles
- Extreme peaks in credit cycles may be followed by systemic banking crises
- Weak economy leads to credit contraction and declining asset prices
- Investors can use the stage in the credit cycle to predict severity of recession

Economic Indicators

- Leading: stock market, house prices, retail sales, interest spread, expectations
- Coincident: industrial production, personal incomes, manufacturing sales
- Lagging: duration of unemployment, inventory-sales ratio, inflation, etc.

- A diffusion index combines these indicators and measures the extent to which they move in the same direction.

Economic Indicator: Example

Inventories tend to rise when:

A. inventory–sales ratios are low.

B. inventory–sales ratios are high.

C. economic activity begins to rebound.

When the economy starts to , sales of inventories can , which results in inventory-sales ratios. Companies then need to more inventories to restore the ratio to a normal level.

-1

Diffusion Index: Example

A diffusion index:

A. measures growth.

B. reflects the consensus change in economic indicators.

C. is roughly analogous to the indices used to measure industrial production.

The diffusion indices are constructed to reflect the embedded in the movements of included in such an index.

-1

Solutions

Economic Indicator: Example

Inventories tend to rise when:

A. inventory–sales ratios are low.

B. inventory–sales ratios are high.

C. economic activity begins to rebound.

When the economy starts to recover, sales of inventories can outpace production, which results in low inventory-sales ratios. Companies then need to accumulate more inventories to restore the ratio to a normal level.

Diffusion Index: Example

A diffusion index:

A. measures growth.

B. reflects the consensus change in economic indicators.

C. is roughly analogous to the indices used to measure industrial production.

The diffusion indices are constructed to reflect the common trends embedded in the movements of all the indicators included in such an index.