Learning Module 2: Understanding Business Cycles

Q.1012 The key indicators of the current phase of the business cycle are most likely:

A. Unemployment and GDP.

B. Inventory levels and GDP.

C. Unemployment and inventory levels.

The correct answer is **A.**

Unemployment and GDP are critical indicators of the current phase of the business cycle. The business cycle refers to the fluctuations in economic activity that an economy experiences over a period. These fluctuations are typically characterized by four phases: expansion, peak, contraction, and trough. Unemployment and GDP provide a comprehensive overview of the economic health and activity level within a country, making them essential for understanding where the economy stands in its cycle.

Unemployment rates reflect the percentage of the labor force that is without work but actively seeking employment. During periods of expansion, unemployment rates typically decrease as companies grow and hire more employees to meet increasing demand. Conversely, during periods of contraction, unemployment rates often increase as companies reduce their workforce in response to decreased demand. Therefore, monitoring unemployment rates can offer insights into the current phase of the business cycle.

Gross Domestic Product (GDP) measures the total value of all goods and services produced over a specific time period within a country. It is a broad indicator of economic activity and health. An increasing GDP indicates an expanding economy, often associated with the expansion phase of the business cycle. On the other hand, a decreasing GDP suggests a contracting economy, which corresponds to the contraction phase of the business cycle. Thus, GDP serves as a key indicator of the current economic phase.

B is incorrect. While inventory levels and GDP are important economic indicators, they do not provide as comprehensive a view of the business cycle's current phase as unemployment and GDP do. Inventory levels can indicate changes in production and demand, but they do not directly reflect the overall employment situation or the total economic output as measured by GDP. Therefore, while inventory levels have their place in economic analysis, they are not as pivotal as unemployment and GDP in determining the current phase of the business cycle.

C is incorrect. Although unemployment and inventory levels are relevant economic indicators, they do not offer a complete picture of the business cycle's current phase when considered together. Unemployment rates provide valuable insights into the labor market, and inventory levels can signal changes in production and demand. However, without the context of GDP, it is challenging to gauge the overall economic activity and health accurately. GDP's inclusion as a key indicator, alongside unemployment, provides a more holistic understanding of the economy's status within the business cycle.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles, LOS 2c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.1016 What happens during the peak of the business cycle?

A. Inflation increases; consumer spending and investment increase at an increasing rate.

B. Inflation increases; consumer spending and investment increase at a decreasing rate.

C. Inflation decreases; consumer spending and investment increase at an increasing rate.

The correct answer is **B.**

At the peak of the business cycle, the economy experiences its highest output, which is characterized by increased inflation, consumer spending, and investment. However, these increases occur at a decreasing rate. This phase marks the transition from expansion to the beginning of contraction. During the peak, consumer demand has typically driven prices up, leading to inflation. While consumer spending and investment continue to grow due to the momentum of the expansion phase, they do so at a slower pace because of the diminishing marginal utility and the increasing cost of borrowing money, which is often a result of higher interest rates aimed at controlling inflation.

A is incorrect. The economy is reaching its capacity limits, and further growth becomes more costly and difficult to sustain.

C is incorrect. This option posits that inflation decreases while consumer spending and investment increase at an increasing rate during the peak of the business cycle. This scenario is inconsistent with the characteristics of a business cycle's peak. Inflation typically increases at the peak due to strong demand outpacing supply, leading to higher prices. Additionally, while consumer spending and investment might still be growing due to the positive sentiment and momentum from the expansion phase, they do so at a decreasing rate, not an increasing one, as the economy begins to confront capacity constraints and higher borrowing costs.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles, LOS 2a: Describe the business cycle and its phase.

Q.3200 An analyst wishing to assess whether the economy has reached the peak of the business cycle would *most likely* be best advised to look for indications that:

A. Businesses have slowed their rate of hiring.

B. Businesses have begun to purchase heavy equipment.

C. The economy is showing moderate or possibly falling rates of inflation.

The correct answer is **A.**

An analyst looking to determine if the economy has reached the peak of the business cycle should observe if businesses have slowed their rate of hiring. This is because, during the expansion phase of the business cycle, companies typically increase their workforce to meet the growing demand for their products or services. As the economy approaches the peak, demand stabilizes or grows at a slower rate, reducing the need for additional labor. This slowdown in hiring is a lagging indicator that suggests the economy may not sustain further growth at the current pace, indicating a potential peak in the business cycle. The peak signifies the highest point of economic activity before a downturn or contraction phase begins. Therefore, a slowdown in hiring is a critical signal of the economy reaching or nearing its peak.

B is incorrect. This option suggests that businesses purchasing heavy equipment is an indicator of the economy reaching its peak. However, this interpretation is misleading. The acquisition of heavy equipment typically indicates that businesses are preparing for expansion, which is more closely associated with the recovery or early expansion phases of the business cycle. This type of investment is made in anticipation of future growth, not at the peak. At the peak, businesses are more likely to be assessing their current capacity and demand forecasts cautiously, rather than making significant capital investments. Therefore, the purchase of heavy equipment is not a reliable indicator of the economy reaching its peak but rather a sign of recovery or growth phase.

C is incorrect. The suggestion that moderate or possibly falling rates of inflation indicate the peak of the business cycle is not accurate. Inflation rates are influenced by a variety of factors and do not solely reflect the stage of the business cycle. While it's true that inflation can moderate or fall due to decreased demand at the peak or during the downturn of the business cycle, inflation rates can also be affected by supply-side factors, monetary policy, and external economic conditions.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles, LOS 2c: describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.3211 Which of the following would *most likely* provide the basis for an index of leading indicators if an economy were expected to begin an economic expansion?

A. Average duration of unemployment

B. Employees on nonagricultural payrolls

C. Average weekly hours for manufacturing workers

The correct answer is **C.**

Businesses often adjust the working hours of their existing employees as a first response to changes in economic conditions before making decisions on hiring new staff or laying off current workers. This makes the average weekly hours for manufacturing workers a leading indicator of economic activity. In periods leading up to an economic expansion, an increase in the average weekly hours can be observed as companies anticipate higher demand for their products and prepare by increasing production capacity. This adjustment in working hours happens before other signs of economic expansion become evident, such as increased hiring or capital expenditure. Therefore, monitoring the average weekly hours for manufacturing workers can provide early signals of an economic expansion, making it a valuable component of an index of leading indicators.

A is incorrect. Changes in the average duration of unemployment tend to occur after the economy has already entered a phase of expansion or contraction. During an economic expansion, unemployment rates generally decrease, but the average duration of unemployment may not immediately reflect this change. It often takes time for this metric to adjust, as it reflects the experiences of individuals who have been unemployed for varying lengths of time, including those who lost their jobs during the preceding economic downturn.

B is incorrect. The number of employees on non-agricultural payrolls is classified as a coincident indicator, not a leading one. Coincident indicators change at approximately the same time as the overall economy, providing information about the current state of economic activity. The number of employees on non-agricultural payrolls reflects the total employment situation in the economy's non-agricultural sectors, which includes most of the workforce. Changes in this metric are directly correlated with the current economic conditions, making it useful for assessing the economy's present state rather than predicting future economic activity.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles, LOS 2c: describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4744 To determine when the economy has reached its maximum output and employment, an analyst should *most likely* focus on which phase of the business cycle?

A. Peak.

B. Trough.

C. Expansion.

The correct answer is **A.**

The peak phase represents the zenith of economic activity in a business cycle, where output and employment rates are at their highest. This phase precedes an economic downturn and is critical for signaling the potential onset of a contraction.

B is incorrect. The trough phase is the lowest point in the economic cycle, characterized by reduced economic output and high unemployment, clearly distinguishing it from the peak.

C is incorrect. During the expansion phase, while the economy experiences growth, it has not necessarily reached its maximum output. Expansion is characterized by increasing economic activity but not the absolute peak of that activity.

CFA level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. Los a: Describe the business cycle and its phases.

Q.4746 As an economic analyst at a large financial firm, Grace is tasked with assessing the potential impact of recent changes in housing permits and construction data on future economic trends. Given the leading nature of these indicators, what conclusions might Grace *most likely* draw about the forthcoming economic conditions?

A. Stagnant construction data suggests a rapid economic turnaround is imminent.

B. The economy is likely to enter an expansion phase if housing permits and construction activities are increasing.

C. A decrease in housing permits indicates immediate improvements in consumer confidence and economic stability.

The correct answer is **B.**

Increases in housing permits and construction activities are leading indicators that typically precede economic expansion. These indicators suggest that developers are confident in future economic conditions, prompting them to invest in new projects, which can stimulate various sectors of the economy through increased employment and spending.

A is incorrect. Stagnant construction data more likely indicates uncertainty or a cautious approach among investors and developers, suggesting that the economy may not turn around quickly.

C is incorrect. A decrease in housing permits typically signals a lack of confidence in future economic conditions, not immediate improvements.

CFA level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4747 How can fluctuations in inventory levels during different phases of the business cycle *most likely* provide insights into future economic conditions?

A. High inventory levels in a contraction phase are a positive sign of economic recovery.

B. Rising inventories during a slowdown phase might indicate that businesses are anticipating increased future sales.

C. Decreasing inventories during an expansion phase generally signal a robust demand exceeding current production capacity.

The correct answer is **C.**

Decreasing inventories during an expansion phase typically indicates that consumer demand is outpacing supply, which can signal robust economic health and the potential need for increased production capacity. This scenario often prompts businesses to invest in expanding operations, which can perpetuate the growth phase of the cycle.

A is incorrect. High inventory levels in a contraction phase typically indicate reduced demand, not recovery, and can be a cause for concern among businesses needing to manage overstock and reduce costs.

B is incorrect. Rising inventories during a slowdown might instead indicate that businesses are overestimating demand, leading to surplus stock, which could exacerbate economic slowdowns if not adjusted.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4748 During which phase of the business cycle would an analyst *most likely* observe both a significant decrease in unemployment and an increase in economic output?

A. Trough.

B. Expansion.

C. Contraction.

The correct answer is **B.**

In the expansion phase, the economy is characterized by increased production and significant job creation as businesses anticipate greater demand.

A is incorrect. The trough phase marks the lowest levels of economic activity where any movement in employment and output is minimal and not typically increasing. The shift toward recovery might begin, but significant increases in output and decreases in unemployment are not typical of this phase.

C is incorrect. Contraction involves a decline in economic activity. During this phase, businesses typically reduce expenditures and employment, leading to increased unemployment, the opposite of what is described.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4749 If an analyst wants to predict the start of economic recovery, which business cycle phase should they *most likely* monitor closely?

A. Peak.

B. Trough.

C. Contraction.

The correct answer is **B.**

The trough phase marks the end of the declining phase of the business cycle and the point at which the economy begins to recover. It is crucial for forecasting because it signals the potential reversal from negative to positive growth.

A is incorrect. The peak represents the height of economic activity and is followed by a decline, making it an inappropriate phase to monitor for signs of recovery.

C is incorrect. During contraction, the economy is still in the process of decline, and while important for understanding the depth of a recession, it does not typically provide clear signals of immediate recovery.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS a: Describe the business cycles and its phases.

Q.4751 During which phase of the credit cycle are lenders *most likely* to tighten lending standards and increase interest rates?

A. When the economy is improving.

B. When the economy is at its peak.

C. When the economy is weakening.

The correct answer is **C.**

In a weakening economy, lenders often tighten their lending standards and increase interest rates to mitigate risk, leading to a contraction in credit availability.

A is incorrect. In a weakening economy, lenders often tighten their lending standards and increase interest rates to mitigate risk, leading to a contraction in credit availability.

B is incorrect. At the peak of the economy, while caution may begin to increase, it is not typically the phase where the most severe tightening occurs as seen in a weakening phase.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS b: Describe credit cycles.

Q.4752 Why do credit cycles *most often* last longer than business cycles?

A. Credit cycles are solely dependent on interest rate decisions by central banks.

B. Credit cycles are more influenced by global economic conditions than local events.

C. Credit cycles involve longer periods of expansion and contraction, influenced by extended credit conditions.

The correct answer is **C.**

Credit cycles generally outlast business cycles because they involve prolonged periods of credit expansion and contraction, which are influenced by the broader, more persistent conditions of credit availability and economic confidence.

A is incorrect. While central banks' interest rate decisions affect credit cycles, they are not the sole factor extending the duration of credit cycles.

B is incorrect. Although global conditions can influence credit cycles, the length comparison to business cycles is more about the nature of credit dynamics than the scale of impact.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS b: Describe credit cycles.

Q.4753 Which of the following is *most likely* a reason why investors monitor the stage of the credit cycle?

A. To predict short-term fluctuations in commodity prices.

B. To assess the immediate solvency of financial institutions.

C. To understand developments in the housing and construction markets.

The correct answer is **C.**

Investors monitor the credit cycle stages to gauge developments in sectors like housing and construction, which are significantly affected by credit availability.

A is incorrect. While commodity prices can be influenced by economic conditions, they are not directly tied to the stages of the credit cycle.

B is incorrect. Assessing the immediate solvency of financial institutions involves more specific financial metrics and regulatory assessments rather than the broader stages of the credit cycle.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS b: Describe credit cycles.

Q.4770 What *most likely* occurs to inventory levels as an economic expansion reaches its peak?

A. Inventory levels decrease to well below normal levels.

B. Inventory levels stabilize at a normal inventory-sales ratio.

C. Inventory levels increase, leading to a higher inventory-sales ratio.

The correct answer is **C.**

As an expansion reaches its peak, sales growth slows down, leading to unsold inventories accumulating and thus an increase in the inventory-sales ratio above normal levels. This can be a precursor to a subsequent economic recession as firms reduce production in response to unplanned inventory increases.

A is incorrect. Inventory levels typically increase as expansion peaks, not decrease.

B is incorrect. Inventory levels do not stabilize; they increase above normal levels as sales slow down, leading to inventory accumulation.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4771 During a recession and trough phase, how do low prices *most likely* influence consumer behavior and the business cycle?

A. Low prices discourage consumer spending, prolonging the recession.

B. Low prices lead to increased consumer purchases, boosting aggregate demand.

C. Low prices result in lower aggregate demand as consumers expect further price drops.

The correct answer is **B.**

Low prices characteristic of the recession and trough phases prompt consumers to buy more goods and services, leading to an increase in aggregate demand. This helps move the business cycle into the expansion stage as demand begins to exceed supply.

A is incorrect. Low prices during these phases actually encourage spending, not discourage it.

C is incorrect. While consumers might expect further price drops, the general trend is that lower prices boost purchasing behavior, increasing aggregate demand.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4772 How does the housing sector *most likely* respond to changes in interest rates?

A. Higher interest rates encourage more real estate purchases.

B. Lower interest rates generally stimulate more real estate purchases.

C. Lower interest rates discourage homebuying due to expected inflation.

The correct answer is **B.**

The housing sector is strongly correlated with interest rates; lower mortgage rates encourage consumers to purchase more real estate, as it becomes financially more accessible.

A is incorrect. Higher interest rates generally make borrowing more expensive, which can discourage purchasing real estate.

C is incorrect. Lower interest rates usually encourage homebuying, not discourage it.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4773 Which type of economic indicator is *most likely* used to predict future movements of the economy?

A. Leading indicators.

B. Lagging indicators.

C. Coincident indicators.

The correct answer is **A.**

Leading indicators, such as share prices and average weekly hours worked in the manufacturing sector, are designed to predict the future movements of the economy by providing early signals of economic cycles.

B is incorrect. Lagging indicators change after the economy has already begun to follow a particular trend and are thus used to confirm patterns rather than predict them.

C is incorrect. Coincident indicators occur simultaneously with economic activities and are used to assess the current state of the economy, not to predict future movements.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4774 Which economic indicator would an analyst *most likely* use to assess the current size of the economy?

A. Retail sales.

B. New orders for capital goods.

C. Gross national product (GNP).

The correct answer is **A.**

Retail sales are a type of coincident indicator, which means they change simultaneously with the economy's expansions or contractions and can thus be used to assess the current size of the economy.

B is incorrect. New orders for capital goods are a leading indicator, used primarily to forecast future economic activity.

C is incorrect. Gross national product (GNP) is a lagging indicator, which makes it more suitable for confirming past economic patterns rather than assessing the current size of the economy.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4775 What is a *major* limitation of using economic indicators for predicting economic trends? They:

A. are released too frequently to be useful.

B. provide exact data without need for interpretation.

C. often require correct interpretation and may contain inaccuracies.

The correct answer is **C.**

A major limitation of economic indicators is that they require careful interpretation and can often contain inaccuracies, making it challenging to derive precise forecasts from them.

A is incorrect. The release schedule of economic indicators is typically structured to provide timely information; it is not usually considered too frequent to be useful.

B is incorrect. Economic data often require interpretation and are not inherently exact; misinterpretation can lead to incorrect conclusions about the economy's direction.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.

Q.4776 Which indicator would an analyst *most likely* look at to confirm a pattern in the economy that has already occurred?

A. Interest rates.

B. Employment levels.

C. Average weekly hours worked in the manufacturing sector.

The correct answer is **A.**

Interest rates are a type of lagging indicator. They change after the economy has already followed a certain pattern, making them useful for confirming economic trends that have already occurred.

B is incorrect. Employment levels are a coincident indicator, which means they occur simultaneously with economic activities and are used to assess the current state of the economy.

C is incorrect. Average weekly hours worked in the manufacturing sector is a leading indicator, used to predict future economic movements rather than confirm past patterns.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 2 - Understanding Business Cycles. LOS c: Describe how resource use, consumer and business activity, housing sector activity, and external trade sector activity vary over the business cycle and describe their measurement using economic indicators.
