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CFA LEARNING OUTCOMES DECODED

In our series *Learning Outcomes Decoded* we break down a single Learning Outcome Statement (LOS) from the CFA level 1 curriculum. This article is written by Nicki DeGroot, CFA. Nicki works as a finance consultant and tutors for Tutor.com.

ECONOMICS:
UNDERSTANDING BUSINESS CYCLES

LOS: Describe credit cycles

This LOS is key to understanding how borrowing impacts asset values and economic activity. Credit cycles influence business cycles and understanding the cycles can be key to making profitable investment decisions.

Credit cycles

Sometimes it is easier to get a loan, and at other times, it is harder to borrow money. This fluctuation in the availability of credit and the pricing to borrow money is known as the credit cycle. Obtaining credit, or borrowing money, is key for a business to grow or a household to make a large purchase, such as a home.

A "tight" credit cycle occurs when creditors make it harder to borrow money by reducing availability of funding and making borrowing more expensive. In contrast, when credit is easy to obtain, this is considered a "loose" credit cycle. The credit cycle is considered a subset of the broader financial cycle.

The availability of credit can contribute to overall economic expansion. When credit is easier, businesses can grow, and the economy expands. This contributes to higher asset values. When credit is easily available, buyers can more easily finance a higher purchase price.

Applications

The economic cycle is affected by the credit cycle, and vice versa. If the economy is strong, then creditors are more willing to lend, and the economy grows more as a result. On the other hand, when the economy is weak, creditors tighten standards and are less likely to lend money. This can lower asset values and lead to higher defaults.

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The business cycle is also affected by the credit cycle. If credit is tight at the same time an economy is in recession, then participants have a hard time borrowing money. Less money is spent, and recovery happens more slowly. This can make the recession longer and more severe. Peaks in credit cycles have also been shown to lead to banking crises.

While loose and tight credit cycles most often synchronize with economic expansion and contraction, that is not always true. The timing of each can vary. In addition, it is important to remember that cycles can differ from historical patterns. In general, credit cycles tend to be longer and deeper than business cycles.

Consequences

Loose credit cycles have been known to cause damage to an economy. When money is easy to find, borrowers are more likely to take risks with money that is not theirs. In addition, low interest rates may prompt investors to take more risk in pursuit of higher returns. The global financial crisis of 2008 was famously preceded by a loose credit cycle.

Familiarity with the credit cycle is a useful element of investment analysis. Asset values, particularly in real estate, are closely tied to credit. Knowing an economy's position in the credit cycle can drive asset valuations and investment decisions. More generally, the connection between the credit cycle and the business cycle makes the former a valuable tool for assessing the condition of the latter. Lastly, policymakers closely watch both the credit cycle and the business cycle, use their observations to make economic policy decisions.

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PRACTICE QUESTION

Two economists hold different views about credit cycles. Economist Asa expects creditors to make it harder to borrow funds and, therefore, expects a loose credit cycle. Economist Blake expects a tightening of credit conditions to lead to higher asset values. Which economist is correct?

A. Economist Asa is correct.

B. Economist Blake is correct.

C. Neither economist is correct.

C is correct. If Economist Asa expects creditors to make it harder to borrow funds, this would be considered a "tight" credit cycle, not a loose one. If Economist Blake expects a tightening of credit conditions, this generally leads to lower asset prices as it is harder to borrow money to purchase assets.