CFA LEVEL I STUDY SHEET · TOPIC 3

Economics

Chartered Financial Analyst (CFA®) Program Level I exam

6-9% of the exam · 8 learning modules · 2027 curriculum

Economics covers how firms set prices under different market structures, how economies move through business and credit cycles, how fiscal and monetary policy work, and how geopolitics, trade and exchange rates connect countries. Level I questions test definitions and cause-and-effect reasoning, with a few calculations on breakeven points, concentration, multipliers, currency changes, cross-rates and forward rates.

You should be able to: You should be able to identify a market structure and its pricing, place an economy in the cycle, judge fiscal and monetary stances, explain trade and geopolitical effects, and calculate currency changes, cross-rates and forward rates.

Every learning module: the key point and the trap

ECON.1 Costs, competition and market power

Every firm maximises profit where marginal revenue equals marginal cost; under perfect competition price equals marginal revenue.

Trap: The short-run shutdown point is minimum average variable cost, not minimum average total cost.

ECON.2 Expansions, recessions and credit cycles

The business cycle runs through recovery, expansion, slowdown and contraction, measured against the economy's potential output.

Trap: A still-rising unemployment rate is consistent with a recovery that has already begun, because unemployment lags output.

ECON.3 Government spending, taxes and deficits

Fiscal policy uses government spending and taxes; monetary policy uses interest rates and the money supply. Fiscal policy is set by the government, monetary policy by the central bank.

Trap: A deficit that widens in a recession with no change in policy reflects automatic stabilisers, not a discretionary expansion.

ECON.4 Central banks and interest rate policy

Central banks issue currency, act as bankers to the government and to banks, lend as a last resort, supervise banks and manage reserves; the main objective is usually stable prices.

Trap: Defending a weak currency means buying it with reserves, which tightens domestic money, not selling it.

ECON.5 Geopolitics, globalisation and investment risk

Geopolitics studies how geography, politics and power shape relations between countries; states range from cooperative to non-cooperative.

Trap: Do not confuse the three institutions: crisis lending is the IMF, development finance the World Bank, trade rules the WTO.

ECON.6 Gains from trade and trade barriers

Countries gain by specialising in goods where they have a comparative advantage, the lower opportunity cost, even if another country is better at producing everything (absolute advantage).

Trap: Only a large country can gain from a tariff through better terms of trade; a small country always loses welfare.

ECON.7 Currency markets, regimes and capital flows

An exchange rate is the price of the base currency in units of the price currency; in USD 1.10 per EUR, the EUR is the base.

Trap: A currency's appreciation and the other currency's depreciation are not mirror images in percentage terms.

ECON.8 Cross-rates and forward exchange rates

A cross-rate links two currencies through a third: (JPY / USD) x (USD / GBP) = JPY / GBP; arrange the quotes so the common currency cancels.

Trap: Put the price currency's interest rate in the numerator and the base currency's in the denominator, or the forward moves the wrong way.

Key terms

Shutdown point: Price equal to minimum average variable cost; below it the firm stops producing in the short run.

Herfindahl-Hirschman Index: The sum of squared market shares, a measure of concentration.

Leading indicator: A series that tends to turn before the economy as a whole.

Automatic stabiliser: A tax or spending feature that offsets the cycle without new decisions.

Fiscal multiplier: The change in output per unit change in government spending, 1 / [1 - MPC x (1 - t)].

Neutral interest rate: The policy rate that neither stimulates nor restrains the economy.

Quantitative easing: Large-scale asset purchases by a central bank to lower longer-term rates.

Comparative advantage: The ability to produce a good at a lower opportunity cost than another country.

Real exchange rate: The nominal exchange rate adjusted for relative price levels.

Cross-rate: The exchange rate between two currencies worked out through a third currency.

Covered interest rate parity: The forward rate that makes hedged returns in two currencies equal.

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