CHAPTER 11

UNDERSTANDING BUSINESS CYCLES

1. (A) **A commercial bank that has a large quantity of fixed-rate mortgages in its loan portfolio.**

Explanation

If an economy experiences inflation, the losers are those who hold long-term contracts in which they are to receive fixed payments. A bank that has a large quantity of fixed-rate mortgages in its loan portfolio (i.e., they are investments for the bank) is receiving fixed-rate payments. Both remaining choices are investors who are either making fixed rate payments (the homeowner) or receiving floating-rate payments (the investor in variable rate bonds).

(Study Session 3, Module 11.2, LOS 11.g)

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2. (B) **the highest level of economic output during the cycle.**

Explanation

The peak phase of a business cycle represents the highest level of economic output (real GDP) reached during that cycle. Inflation pressure that built during the expansion may continue into the early part of the contraction that follows the peak. Employment typically does not begin to decline until sometime after the peak.

(Study Session 3, Module 11.1, LOS 11.a)

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3. (C) **typically results from a significant price increase in a production input.**

Explanation

Cost-push inflation typically results from a significant price increase in a production input that causes a decrease in short-run aggregate supply.

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4. (C) **reducing overtime.**

Explanation

As a cyclical indicator, an increase in the inventory-to-sales ratio is a sign of slowing economic growth. When decreasing their utilization of labor in response to a slowing economy, firms typically first reduce overtime. Firms tend to be slow to lay off workers until it is clear that an economic contraction is underway.

(Study Session 3, Module 11.1, LOS 11.c)

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5. (B) **increased by a predictable rate annually.**

Explanation

Monetarists believe that to keep aggregate demand stable and growing, the central bank should follow a policy of steady and predictable increases in the money supply. Furthermore, monetarists believe that recessions are caused by inappropriate decreases in the money supply.

(Study Session 3, Module 11.1, LOS 11.d)

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6. (A) **Not in the labor force..**

Explanation

The labor force includes all people who are either employed or actively seeking employment. As such, Bradley is not counted as part of the labor force.

(Study Session 3, Module 11.2, LOS 11.f)

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7. (B) **When the plant was modernized, Jones lost her job because she did not have the skill needed to operate the new equipment.**

Explanation

Structural unemployment exists when changes in the economy eliminate some jobs while generating new job openings for which unemployed workers are not qualified.

(Study Session 3, Module 11.2, LOS 11.f)

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8. (B) **deflation.**

Explanation

Deflation is a sustained decline in the price level, which is reflected in a negative inflation rate. Disinflation refers to a decrease in the inflation rate over time but does not imply a negative inflation rate. Hyperinflation is an extremely high and accelerating inflation rate.

(Study Session 3, Module 11.2, LOS 11.g)

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9. (B) **Increasing Increasing**

Explanation

Starting from conditions of long-run equilibrium, unintended decreases in inventory levels suggest that aggregate demand has increased. Producers will respond in the short run by increasing output and prices, so economic growth and inflation will increase.

(Study Session 3, Module 11.1, LOS 11.c)

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10. (B) **Sample selection**

Explanation

The three sources of bias associated with CPI data are: new goods, quality changes, and substitution.

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11. (B) **Neoclassical Keynesian**

Explanation

The neoclassical economists believe that shifts in both aggregate demand and aggregate supply are primarily driven by changes in technology over time. Keynesian economists believe that aggregate demand can be increased through monetary policy (increasing the money supply) or through fiscal policy (increasing government spending, decreasing taxes, or both). They do not focus on aggregate supply. Monetarists believe that the main factor leading to business cycles and deviations from full-employment equilibrium is monetary policy.

Presentation Not Found

(Study Session 3, Module 11.1, LOS 11.d)

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12. (C) Structural.

Explanation

Structural unemployment is due to structural changes in the economy that eliminate some jobs while generating job openings for which unemployed workers are not qualified. Cyclical unemployment is when the economy is operating at less than full capacity.

(Study Session 3, Module 11.2, LOS 11.f)

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13. (C) Inflation is a persistent increase in the general price level of goods and services.

Explanation

Inflation is defined as a persistent increase in the price level over time. Inflation indicates that there has been a general decline in the purchasing power of a currency. Fixed-rate borrowers gain at the expense of lenders when inflation is greater than expected.

(Study Session 3, Module 11.2, LOS 11.g)

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14. (C) an increase in the inventory-to-sales ratio.

Explanation

As the economy approaches its peak, sales growth begins to slow, unsold inventories begin to accumulate, and the inventory-to-sales ratio increases.

(Study Session 3, Module 11.1, LOS 11.c)

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15. (A) be calculated for stages of processing.

Explanation

Stages of processing are components of producer price indexes. Consumer price indexes compare the current prices of a typical consumption basket to prices in a base year.

(Study Session 3, Module 11.2, LOS 11.h)

Related Material

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16. (C) An economy experiences inflation when there is a persistent increase in the prices of almost all goods and services.

Explanation

Inflation is a persistent increase in the price level over time. Inflation occurs when there is a sustained increase in the prices of almost a//goods and services. Inflation indicates a decline in the purchasing power of a currency.

(Study Session 3, Module 11.2, LOS 11.g)

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17. (A) **energy prices.**

Explanation

Demand-pull inflation can result from any factor that increases aggregate demand, including increases in the money supply, increases in exports, and increases in government purchases. Increases in the prices of productive inputs would result in cost-push inflation as aggregate supply decreases.

(Study Session 3, Module 11.2, LOS 11.j)

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18. (B) **Decrease.**

Explanation

The unemployment rate is the number of unemployed divided by the labor force. Because the labor force is the sum of employed and unemployed, a decrease in the labor force with the number of employed held constant represents a decrease in the number of unemployed, and will decrease the unemployment rate.

For Further Reference:

(Study Session 3, Module 11.2, LOS 11.f)

CFA® Program Curriculum, Volume 2, page 236

Related Material

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19. (B) **Disagree Disagree**

Explanation

Walker should disagree with both statements. Price changes resulting from increases in the quality of goods, do not represent inflation. However, the Consumer Price Index is affected by biases from product quality, as well as new goods and substitution, causing it to overstate the rate of inflation. As a result, increases in wages that are based on CPI will more than compensate for actual increases in the cost of living.

(Study Session 3, Module 11.2, LOS 11.f)

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20. (B) reducing overtime hours.

Explanation

Early in an economic contraction, firms typically reduce output by using capital and labor less intensively than during an expansion (e.g., by reducing overtime). When they believe a contraction is likely to persist, firms decrease capacity by laying off workers and reducing their physical capital, often by deferring maintenance or not replacing worn-out equipment.

(Study Session 3, Module 11.1, LOS 11.c)

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21. (A) working-age population who are working or actively looking for work.

Explanation

The labor-force participation rate is the percentage of the working-age population who are employed or actively seeking employment. The labor-force participation rate can be calculated as: (the labor force / working-age population) x 100.

(Study Session 3, Module 11.2, LOS 11.f)

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22. (B) government intervention in the economy.

Explanation

In Austrian school business cycle theory, cycles are caused by government intervention that reduces interest rates below what they would be without government intervention, which leads to an artificial economic boom that must eventually collapse because the economy lacks the physical capital to support it.

(Study Session 3, Module 11.1, LOS 11.d)

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23. (B) leading indicator.

Explanation

Initial claims for unemployment insurance are considered a leading indicator.

(Study Session 3, Module 11.2, LOS 11.e)

Related Material

SchweserNotes - Book 1

24. (B) People of working age who are either employed or seeking employment.

Explanation

The labor force includes people of working age (16+) who are either employed or seeking employment. People who are not employed or seeking employment (e.g., homemakers, full-time students, "discouraged" workers) are not counted as part of the labor force.

(Study Session 3, Module 11.2, LOS 11.f)

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25. (A) **frictional unemployment.**

Explanation

Frictional unemployment exists because workers and employers do not have perfect information and must expend time and resources on search activities.

(Study Session 3, Module 11.2, LOS 11.f)

Related Material

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26. (C) **steady, predictable money growth is the best monetary policy.**

Explanation

Monetarists believe that the Fed's tools are powerful and should *not* be used to moderate fluctuations in prices and outputs. Thus, steady, predictable growth is the best monetary policy. They believe in the power of the money supply, not fiscal policy, to affect prices and outputs.

(Study Session 3, Module 11.1, LOS 11.d)

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27. (B) **excessive optimism or pessimism among business managers.**

Explanation

In Keynesian business cycle theory, business cycles are caused primarily by changes in expectations about economic growth. Business managers overinvest when they are excessively optimistic and underinvest when they are excessively pessimistic.

(Study Session 3, Module 11.1, LOS 11.d)

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28. (C) **Paasche price index.**

Explanation

A Paasche index uses the current consumption weights for each good and service in its market basket. A Laspeyres index is calculated using base period consumption weights for each good and service in the market basket. Hedonic pricing is a technique used to adjust a price index for upward bias from quality changes of goods in its market basket.

(Study Session 3, Module 11.2, LOS 11.i)

Related Material

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29. (B) **overstate the inflation rate, because its market basket is fixed.**

Explanation

A Laspeyres price index tends to overstate the inflation rate because it uses fixed market basket weights from a base period. This does not consider that consumers will substitute away from goods that have risen dramatically in price.

(Study Session 3, Module 11.2, LOS 11.i)

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30. (A) **inflation pressures are typically decreasing.**

Explanation

An economic contraction (recession) is typically characterized by decreasing inflationary pressures, increasing unemployment, and low or negative real GDP growth.

(Study Session 3, Module 11.1, LOS 11.a)

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31. (B) **incorrect because not all increases in the price level indicate inflation.**

Explanation

Lebow is incorrect because a one-time increase in the price level is not necessarily inflation. Inflation is an on-going process, not a one-time increase in the price level.

(Study Session 3, Module 11.2, LOS 11.g)

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32. (A) **coincident indicator.**

Explanation

Manufacturing and trade sales are a coincident indicator that generally reflects the current phase of the business cycle.

(Study Session 3, Module 11.2, LOS 11.e)

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33. (C) **Wholesale price index.**

Explanation

Wholesale or producer price indexes typically include sub-indexes for finished goods, intermediate goods, and raw materials or crude goods.

(Study Session 3, Module 11.2, LOS 11.h)

Related Material

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34. (A) **increasing employment.**

Explanation

Employment and inflationary pressures are typically decreasing during the expansion phase of a business cycle. The rate of economic growth changes from negative to positive in the trough phase.

(Study Session 3, Module 11.1, LOS 11.a)

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35. (B) **Index of consumer expectations.**

Explanation

Consumer expectations are a leading indicator. Industrial production is a coincident indicator. Average duration of unemployment is a lagging indicator.

(Study Session 3, Module 11.2, LOS 11.e)

Related Material

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36. (C) **lagging indicator**

Explanation

The inventory-to-sales ratio for manufacturing and trade is considered a lagging indicator because it peaks after the economy does, even though it is sometimes used in forecasting economic activity.

(Study Session 3, Module 11.2, LOS 11.e)

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37. (C) **excludes food and energy prices, while headline inflation includes them.**

Explanation

Core inflation excludes food and energy prices, which tend to be the most volatile components of headline inflation.

(Study Session 3, Module 11.2, LOS 11.h)

Related Material

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38. (B) **The net effect of built-in biases in the CPI is to underestimate inflation.**

Explanation

The CPI is generally believed to overestimate inflation by about 1% per year. Upward biases include quality improvements (price increases due to improving quality do not represent inflation but are reflected in the CPI), new and more expensive goods replacing older and less expensive goods, and commodity substitution (consumers substitute less expensive goods for more expensive ones, rather than continuing to consume a fixed basket of goods).

(Study Session 3, Module 11.2, LOS 11.i)

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39. (A) demand-pull inflation.

Explanation

A decrease in taxes, other things equal, will increase personal disposable income and the consumption spending component of aggregate demand. An increase in aggregate demand from a position of long-run equilibrium is the most likely cause of demand-pull inflation.

(Study Session 3, Module 11.2, LOS 11.j)

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40. (A) Seasonal.

Explanation

There are three types of unemployment: frictional, cyclical, and structural.

- Frictional unemployment is due to constant changes in the economy that prevent
  qualified workers from being immediately matched with existing job openings.
- Cyclical unemployment is when the economy is operating at less than full capacity.
- Structural unemployment is due to structural changes in the economy that eliminate some jobs while generating job openings for which unemployed workers are not qualified.

(Study Session 3, Module 11.2, LOS 11.f)

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41. (A) Frictional.

Explanation

Frictional unemployment will prevent qualified workers from being immediately matched with existing job openings. Two causes are imperfect information and the job search conducted by both employers and employees.

(Study Session 3, Module 11.2, LOS 11.f)

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42. (B) number of employed individuals

Explanation

The unemployment rate of a country is the percentage of people in the labor force who are unemployed. It is calculated as: unemployment rate = (number of unemployed / labor force) x 100. The labor force includes those individuals who are employed or are actively seeking employment. The working-age population includes individuals not in the labor force.

(Study Session 3, Module 11.2, LOS 11.f)

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43. (C) increase in imports.

Explanation

When the domestic economy is expanding, demand for imports is likely to increase as domestic incomes increase. Exports tend to be independent of domestic economic growth and are more closely related to trading partners' economic growth.

(Study Session 3, Module 11.1, LOS 11.c)

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44. (B) percentage change in the CPI from a year ago.

Explanation

The inflation rate is the percentage change in the price index from a year earlier.

(Study Session 3, Module 11.2, LOS 11.h)

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