Reading 13

UNDERSTANDING BUSINESS CYCLES

1. (A) **Credit cycles are a potential cause of asset price bubbles.**

   Explanation

   Credit cycles tend to amplify business cycles and are a potential cause of asset price bubbles. Credit cycles have tended to be longer, on average, than business cycles.

   (Module 13.1, LOS 13.b)

2. (A) **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.

   (Module 13.1, LOS 13.c)

3. (B) **coincident indicator.**

   Explanation

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

   (Module 13.1, LOS 13.c)

4. (A) **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.

   (Module 13.1, LOS 13.c)

5. (B) **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.

   (Module 13.1, LOS 13.c)

6. (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.

(Module 13.1, LOS 13.c)

7. (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.

(Module 13.1, LOS 13.c)

8. (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.

(Module 13.1, LOS 13.c)

9. (C) **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.

(Module 13.1, LOS 13.a)

10. (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.

(Module 13.1, LOS 13.c)

11. (C) **just before a peak in the economic cycle.**

Explanation

Just before a peak in the economic cycle, sales slow, but production and inventory levels still reflect expectations of continued rapid growth. Inventory accumulates as sales slow, increasing the inventory-sales ratio until firms reduce production in response to decreased or declining sales growth.

(Module 13.1, LOS 13.c)

12. (A) **increasing employment.**

Explanation

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

(Module 13.1, LOS 13.a)

13. (B) **leading indicator.**

Explanation

Initial claims for unemployment insurance are considered a leading indicator.

(Module 13.1, LOS 13.c)

14. (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.

(Module 13.1, LOS 13.a)