



CFA LEVEL 1

MARATHON SERIES

ECONOMICS



Question 1:

For this question, assume that GBP is the domestic currency and INR is the foreign currency. If the consumer price index (CPI) in the United Kingdom rises more than the CPI in India, the real INR/GBP exchange rate most likely:

- A. will decrease, and the purchasing power of the INR will increase.
- B. will increase, and the purchasing power of the INR will decrease.
- C. will decrease, and the purchasing power of the INR will decrease.

Solution:**A is correct.**

Purchasing power refers to the amount of goods or services a currency can purchase. Changes in purchasing power are inversely related to changes in relative price levels, which are commonly measured by the consumer price index (CPI). As a country's price level (CPI) rises, its currency's purchasing power falls.

Real exchange rates measure the purchasing power of one currency relative to another. All else equal, the real exchange rate moves as a function of changes in the ratio of the foreign CPI to the domestic CPI (assuming no movements in the nominal exchange rate). This is demonstrated with a simple example:

If the nominal INR/GBP exchange rate = 10, and the Indian CPI rises by 2% while simultaneously the UK CPI rises by 5%, the expected real exchange rate will be $10 \times (1.02 /$

1.05) \approx 9.7142. This means that fewer INR (9.7142 vs. 10) are needed to purchase GBP 1 worth of goods and services: GBP purchasing power has decreased, and INR purchasing power has increased. The smaller increase in the Indian price level (relative to the UK increase) leads to a decrease in the INR/GBP real exchange rate, and thus an increase in the INR purchasing power relative to the GBP purchasing power (Choices B and C).

Note:

Changes in price levels affect real exchange rates, which affect currency purchasing power. The real exchange rate moves in the same direction as changes in the ratio of the foreign price level to the domestic price level. When real exchange rates decrease, the purchasing power of the domestic currency decreases, and vice versa.

Question 2:

The energy market has experienced a sharp decrease in prices due to intense competition for market share among energy-exporting economies. As a result, the real GDP for an energy-importing economy has risen above its previous full-employment equilibrium level of output. Which of the following statements is most likely true about this situation?

- A. The increase in real GDP is due to an increase in consumer demand for goods and services in the energy-importing economy.
- B. The increase in real GDP is due to an increase in short-run aggregate supply in the energy-importing economy.
- C. The increase in real GDP is due to an increase in long-run aggregate supply in the energy-importing economy.

Solution:**B is correct**

The sharp decrease in energy prices enables firms in the energy-importing economy to produce more output for the same total cost, leading to an increase in short-run aggregate supply. This increase in output results in lower selling prices, which leads to an increase in the quantity demanded and ultimately a short-run equilibrium GDP above the full-employment (ie, long-run) equilibrium. Therefore, Option B is the correct answer.

Option A is incorrect because a decrease in energy prices causes an increase in the quantity demanded, not an increase in demand. The factors affecting aggregate demand, such as current spending power and expectations about future spending power, are not directly impacted by temporary declines in energy prices.

Option C is incorrect because a price war between producers to improve market share would not affect long-run aggregate supply, so there is no impact on full-employment equilibrium GDP.

Question 3:

You are a portfolio manager evaluating geopolitical risks for your investment portfolio. Which of the following actions by a country is most likely to increase geopolitical risk?

- A. The country is initiating export subsidies to boost its domestic companies.
- B. The country is eliminating capital controls to encourage foreign investment.
- C. The country is coordinating standardized rules with its trading partners.

Solution:**A is correct.**

Geopolitical risk is the potential impact of political and economic events on investments, such as government policies or geopolitical tensions. When evaluating geopolitical risks, investors can consider two questions:

1. how cooperative is a country towards strategic, economic, or cultural coordination?
and
2. how much is a country focused on economic nationalism versus globalization?

Initiating export subsidies is a change towards non-cooperative behavior that increases geopolitical risk because it favors internal companies at the expense of foreign competitors. This move represents a shift towards economic nationalism, which may lead to trade tensions and potential conflicts. In contrast, eliminating capital controls and

coordinating standardized rules are cooperative actions that support globalization, promote trade, and encourage foreign investment, leading to a reduction in geopolitical risk.

Therefore, the correct answer is A - The country is initiating export subsidies to boost its domestic companies, which is most likely to increase geopolitical risk.

Question 4:

Which of the following factors is most likely to motivate a country to seek geopolitical cooperation?

- A. A recent discovery of significant oil reserves in its territory.
- B. An increase in the number of tourists visiting its cities.
- C. A high level of cross-border financial transactions.

Solution:**C is correct.**

Geopolitical cooperation refers to a country's willingness to work with other nations in order to achieve its strategic, economic, or cultural goals. In general, cooperation is more likely when a country believes that it can achieve its goals more effectively through joint action with other nations than through unilateral action.

One factor that can motivate a country to seek geopolitical cooperation is a high level of cross-border financial transactions. This is because cross-border transactions often involve complex legal and regulatory issues that can be more efficiently resolved through international cooperation. By working with other countries to standardize protocols and procedures for cross-border transactions, a country can reduce transaction costs, improve transparency, and promote economic growth.

(Option A) The discovery of significant oil reserves is more likely to motivate a country to adopt a more assertive or independent foreign policy, as it seeks to maximize the economic benefits of its natural resources. This could lead to increased geopolitical risk and tension with other nations, rather than cooperation.

(Option B) An increase in tourism is unlikely to motivate a country to seek geopolitical cooperation, as tourism is a largely domestic industry and does not involve complex international issues.

Note:

A high level of cross-border financial transactions can motivate a country to seek geopolitical cooperation in order to standardize protocols and procedures, reduce transaction costs, improve transparency, and promote economic growth.

Question 5:

Global Trade Partners (GTP) is a multinational company that specializes in the production of consumer electronics. The company operates in several countries and relies heavily on international trade to access raw materials and reach its customer base. The company's CEO is interested in learning about the different archetypes of globalization and cooperation to determine which one would benefit GTP the most.

Which archetype of globalization and cooperation provides the greatest contrast to multilateralism?

- A. Autarky
- B. Hegemony
- C. Bilateralism

Solution:**A is correct.**

Globalization involves some level of cooperation across countries to promote the exchange of goods, services, technology, and jobs. Countries adopt different archetypes of globalization and cooperation to suit their interests. Multilateralism involves countries cooperating with each other and adopting beneficial trade terms to facilitate international business.

In contrast, Autarky is an archetype that involves a country adopting nationalistic policies and seeking self-sufficiency through limited trade and little cooperation. Autarky is the opposite of Multilateralism, where countries seek to cooperate and benefit from globalization.

Hegemony, on the other hand, describes countries that are open to globalization but less cooperative. Hegemonic countries exert significant economic and political influence worldwide, and they are often powerful global leaders. Bilateralism involves two countries cooperating with each other, and it is characterized by regionalism. Countries that practice Bilateralism typically have customized relationships with each partner.

In the case of GTP, Multilateralism would be the most suitable archetype of globalization and cooperation as it would allow the company to access resources, markets, and profits across borders. Autarky, the correct answer, would not benefit GTP as it involves limited trade and little cooperation, which would hinder the company's operations in different countries.

Question 6:

The government has announced a significant increase in train travel prices due to rising costs of maintenance and upgrades to the rail infrastructure. How will this affect the demand for air travel in the region?

- A. The demand for air travel will increase due to a leftward shift in the demand curve.
- B. The demand for air travel will increase due to a movement along the demand curve.
- C. The demand for air travel will increase due to a rightward shift in the demand curve.

Solution:**C is correct**

The scenario suggests that there will be an increase in the price of train travel, which is a substitute for air travel. When the price of a substitute good increases, consumers tend to switch to other alternatives. Therefore, there will be a change in the demand for air travel.

Option A is incorrect as it suggests a leftward shift in the demand curve, which represents a decrease in demand. However, an increase in the price of a substitute good leads to an increase in demand for other alternatives, so the demand for air travel should increase, not decrease.

Option B is also incorrect as it suggests a movement along the demand curve, which is caused by a change in the price of the good, not a change in the price of a substitute.

Option C is the correct answer as it suggests a rightward shift in the demand curve. When the price of train travel increases, consumers will demand more air travel, causing the demand curve to shift to the right.

Therefore, the correct answer is C.

Question 7:

If the price of good Y decreases, the quantity consumed also decreases. Therefore, we can say that for good Y:

- A. the negative substitution effect overpowers the positive income effect. It is a Giffen good.
- B. the negative substitution effect overpowers the positive income effect. It is a normal good.
- C. the positive income effect overpowers the negative substitution effect. It is a Giffen good.

Solution:**C is correct.**

Good Y is an example of Giffen goods. Giffen goods are inferior goods whose price effect outweighs the substitution effect. Consumers are unable to afford the next level of consumption. Therefore, they will have to buy a good even with an increase in the price of the good. The Miller and Jensen rice study in China is the perfect example of Giffen goods. The rice price increased, yet consumers' demand for rice increased because they could not afford the next level of consumption, which was meat.

For Giffen goods, the positive income effect is so strong that it overpowers the negative substitution effect. Therefore, when prices rise, the quantity demanded rises and vice versa.

Note: The negative substitution effect occurs when there are few substitutes for a product or when the substitutes are of low quality.

Question 8:

A small farm in a developing country produces rice and sells it in a perfectly competitive market. The market price for rice is currently \$5 per kilogram. The farm's total cost is \$6 per kilogram, with variable costs of \$4 per kilogram. The farm is currently producing and selling rice at a rate of 1,000 kilograms per month.

One day, the market price for rice drops to \$3 per kilogram. What should the farm do?

- A. Keep producing and selling rice, since it is still earning a profit.
- B. Produce and sell less rice, but continue operating at a loss.
- C. Shut down immediately, since it is no longer profitable to produce and sell rice.

Solution:**C is correct.**

In this scenario, the farm is operating at a loss even at the original market price of \$5 per kilogram. When the market price drops to \$3 per kilogram, the farm's revenue per kilogram is less than its variable cost per kilogram, meaning that the farm is losing money on every unit it produces and sells.

Since the farm is operating at a loss, it should shut down immediately. Continuing to produce and sell rice would only increase the farm's losses. Shutting down would allow the farm to avoid further losses and conserve its resources for future opportunities.

Question 9:

A study was conducted on the economy of a country, and it was found that the value of the GDP calculated using the income approach was different from the GDP calculated using the expenditure approach. Which of the following terms best describes the adjustment made to account for the differences between the two calculations?

- A. Capital consumption allowance
- B. Statistical discrepancy
- C. Transfer payments

Solution:**B is correct.**

In national income accounting, it is not uncommon to find discrepancies between the GDP calculated using the income approach and the GDP calculated using the expenditure approach. These discrepancies arise due to differences in the methods of calculation and incomplete data sources. The adjustment made to reconcile the two values is known as the statistical discrepancy. Therefore, option B is the correct answer.

Note: The capital consumption allowance is a measure of the depreciation of capital assets over time, and transfer payments are payments made by the government to individuals or other governments without receiving any goods or services in return.

Question 10:

A country has been experiencing a declining birth rate and an aging population. To counteract the effects of this demographic shift, the government has decided to encourage immigration. Which of the following is the most likely effect of this policy on the country's economy?

- A. The policy will result in reduced aggregate demand due to the increased competition for jobs.
- B. The policy will reduce aggregate supply and lower real GDP per capita.
- C. The policy will lead to increased aggregate supply and growth in real GDP.

Solution:**C is correct.**

When a country experiences an increase in immigration, it can result in an increase in the labour supply, which in turn increases the aggregate supply of the economy. This means that the economy can produce more goods and services, resulting in an increase in real GDP. Additionally, immigrants can contribute to economic growth by bringing new skills, innovation, and entrepreneurship. While there may be short-term effects on the labour market and wages, the long-term benefits of increased immigration generally outweigh the costs. Moreover, immigrants also tend to increase aggregate demand by increasing consumption, which further contributes to economic growth.

Therefore, the most likely effect of an increase in immigration on a country's economy is an increase in aggregate supply and an increase in real GDP per capita.

Question 11:

A recession has hit the economy and the government is keen to monitor indicators that might signal a recovery. Which of the following is most likely to indicate that the economy is recovering from the recession?

- A. The number of building permits issued and manufacturer's new orders for capital goods has decreased.
- B. Average weekly hours worked has increased and the number of weekly unemployment insurance claims has decreased.
- C. The average duration of unemployment has decreased and consumer credit outstanding to personal income has decreased.

Solution:**B is correct.**

Average weekly hours worked and the number of weekly unemployment insurance claims are leading indicators of the business cycle. During a recession, companies may cut back on hours worked and lay off employees, resulting in a decrease in average weekly hours and an increase in weekly unemployment insurance claims. Therefore, an increase in average weekly hours worked and a decrease in weekly unemployment insurance claims are likely to indicate that the economy is recovering from the recession. A decrease in building permits issued and manufacturer's new orders for capital goods, as well as a decrease in consumer credit outstanding to personal income, may indicate a slowdown in economic activity but not necessarily a recovery from a recession.

Question 12:

The Central Bank of ENGLAND wants to increase the supply of money. The economy is experiencing low inflation and low economic growth. The central bank is considering three policies to increase the money supply: increasing the policy rate, decreasing the reserve requirement, and selling securities on the open market.

Which of the following policies will most likely achieve the central bank's objective while minimizing the risk of inflation?

- A. Increasing the policy rate.
- B. Decreasing the reserve requirement.
- C. Selling securities on the open market.

Solution:**B is correct.**

Decreasing the reserve requirement will increase the capacity of banks to lend money. Banks will be able to create more loans and therefore, increase the money supply in the economy. This policy will increase the supply of money without affecting the interest rates. Therefore, it is less likely to cause inflation.

A is incorrect. Increasing the policy rate (also known as the bank rate) reduces the money supply by making it more expensive for banks to borrow from the central bank. This policy can reduce inflation but may also reduce economic growth.

C is incorrect. Selling securities on the open market reduces the money supply by decreasing the amount of reserves that commercial banks have. This policy can also reduce inflation but may lead to a decrease in economic growth

Question 13:

ABC Corporation is a small company based in Country X that specializes in producing high-quality leather goods. The company's CEO is interested in expanding its business by exporting its products to other countries. The company is considering two different trade models to determine its comparative advantage: the Heckscher-Ohlin model and the Ricardian model.

Based on the information provided, which of the following factors of production is most likely to be considered by the Heckscher-Ohlin model but not by the Ricardian model?

- A. Raw material.
- B. Capital.
- C. Labor.

Solution:**B is correct.**

The Heckscher-Ohlin model considers both capital and labor as variable production factors, while the Ricardian model only considers labor. Therefore, the factor of production that is most likely to be considered by the Heckscher-Ohlin model but not by the Ricardian model is capital. Since the ABC Corporation is a small company that specializes in producing high-quality leather goods, it is likely that capital (such as machinery, equipment, and buildings) is a significant factor in its production process.

Question 14:

The automotive industry in the United States has undergone significant changes in the last decade. An analyst notes that there are a large number of automobile assembly plants throughout the United States of America and they have become very similar in size and operations. The analyst wants to determine the output range in which these plants are operating.

Which of the following statements is true regarding the output range of these automobile assembly plants?

- A. The plants are operating in an output range of increasing returns to scale.
- B. The plants are operating in an output range of decreasing returns to scale.
- C. The plants are operating in an output range that minimizes long-run average costs.

Solution:**C is correct.**

The long-run average cost (LRAC) curve shows the lowest cost at which a firm can produce a given output in the long run. In a perfectly competitive market, firms seek to maximize profits and, as a result, will produce at the minimum point on their LRAC curve. This point is known as the minimum efficient scale (MES), which represents the output range that minimizes long-run average costs.

As the automotive industry has become more competitive, the firms have likely sought to minimize their costs by operating at the MES. Therefore, the large number of automobile assembly plants that have become very similar in size and operations in the United States likely indicates that they are operating in an output range that minimizes long-run average costs. Larger plants would face decreasing returns to scale, while smaller plants would face increasing returns to scale.

Question 15:

A fund manager is analyzing the current state of the business cycle and its implications for investment decisions. The economy has been expanding for several years, but the manager believes the expansion phase may be nearing its end. The manager wants to identify which economic indicators are likely to signal the transition from the late expansion phase to the next phase of the business cycle.

Based on the above information, which of the following is most likely to occur during the late expansion phase of the business cycle?

- A. Inflation is picking up.
- B. GDP growth is accelerating.
- C. Unemployment is decreasing.

Solution:**A is correct.**

During the late expansion phase of the business cycle, inflation typically picks up modestly. This is because the economy is operating close to full capacity, and rising demand for goods and services can push prices higher.

Option B is incorrect because GDP growth typically decelerates during the peak phase of the business cycle, not the late expansion phase.

Option C is also incorrect because unemployment usually continues to decrease during the late expansion phase, as employers struggle to find workers in a tight labor market.

Question 16:

The central bank of a country is considering adopting a target inflation rate of 0%. Which of the following is a potential risk associated with this policy?

- A. The country may experience persistent deflation that is difficult to correct.
- B. Consumers may become more confident and increase their spending, boosting economic growth.
- C. The policy may not be credible because people expect prices to increase over time.

Solution:**A is correct.**

If a central bank sets a target inflation rate of 0%, there is a risk of creating persistent deflation that is difficult to correct. Japan is an example of a country that has experienced this problem. Consumers may delay spending if they believe prices will continue to fall, leading to a decrease in aggregate demand and potentially slowing economic growth.

Option B is incorrect because a target inflation rate of 0% is not expected to have a positive effect on consumer confidence.

Option C is incorrect because the credibility of the policy does not depend on people's expectations of prices increasing over time.

Question 17:

The toothpaste industry is characterized by a few large manufacturers who produce a variety of similar products and compete primarily through advertising and product differentiation. Which of the following market structures best describes this industry?

- A. Monopolistic competition
- B. Oligopoly
- C. Perfect competition

Solution:**B is correct.**

The toothpaste industry is an example of an oligopoly, where a small number of large firms dominate the market. Although toothpaste could be considered a commodity, the market is characterized by product differentiation and advertising, rather than price competition. The market is dominated by a few large firms, such as Procter and Gamble, that produce a variety of similar products.

Question 18:

The economy of country X has been experiencing a surge in demand for goods and services. As a result, prices have been steadily increasing, and workers have begun asking for wage increases to keep up with the higher cost of living. This phenomenon is best described as:

- A. Cost-pull inflation.
- B. Cost-push inflation.
- C. Demand-pull inflation.

Solution:**C is correct.**

Demand-pull inflation occurs when the increase in demand for goods and services leads to a general rise in prices. As a result, workers begin asking for wage increases to compensate for the higher cost of living. This creates a cycle of price and wage increases, as producers pass on the increased labor costs to consumers in the form of higher prices. Therefore, the situation described in the question is an example of demand-pull inflation.