

Level I of the CFA® Exam

Questions with Answers - Economics

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Learning Module 1: Firm & Market Structures

Q.1420 Which of the following return measures considers the implicit cost or opportunity cost of resources supplied to the firm by the owners?

- A. Total revenue.
- B. Economic profit.
- C. Accounting profit.

The correct answer is **B**.

Economic profit is calculated by subtracting both explicit and implicit costs from total revenue. Explicit costs are direct, out-of-pocket payments for resources like labor and materials, while implicit costs represent the opportunity costs of using resources that could have been employed elsewhere. This measure provides a more comprehensive view of a firm's profitability by accounting for the cost of all resources used in production, including those provided by the owners without a direct monetary payment. Economic profit is a crucial metric for understanding the true financial performance of a firm, as it reflects the actual surplus generated after accounting for the full cost of resources. It is particularly important for decision-making and assessing whether the firm is generating sufficient returns above all its costs, including the opportunity cost of capital.

A is incorrect. Total revenue refers to the total amount of money a firm receives from its business activities, such as sales of goods or services, before any costs or expenses are deducted. It does not account for any costs, let alone the implicit or opportunity costs of resources supplied by the owners. Total revenue is simply the starting point for calculating profitability and does not provide information on the efficiency or effectiveness with which a firm uses its resources. Therefore, it cannot be considered a measure that reflects the opportunity cost of resources supplied to the firm by the owners.

C is incorrect. Accounting profit is the difference between total revenue and explicit costs only. Explicit costs are those expenses that a firm pays directly, such as wages, rent, and materials. Accounting profit does not consider implicit costs, which are the opportunity costs of using resources in a particular way rather than in their next best alternative use. Since accounting profit overlooks the value of resources supplied by the owners for which there is no direct monetary payment, it does not fully capture the economic reality of a firm's resource utilization. Implicit costs, including the opportunity cost of the owners' capital, are crucial for understanding the true economic performance of a firm, making accounting profit an incomplete measure in this context.

CFA Level I, Economics, Learning Module 1: Firms and Market Structures. LOS a: Determine and interpret breakeven and shutdown points of production, as well as how economies and diseconomies of scale affect costs under perfect and imperfect competition.

Q.1440 In which of the following forms of market structures is it most important for a firm to consider price moves and other firms' strategies?

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

The correct answer is **A**.

In an oligopoly market structure, firms are highly interdependent, making it crucial for each firm to consider the pricing moves and strategies of other firms within the market. An oligopoly is characterized by a small number of firms that dominate the market, which means that any action taken by one firm, such as changing prices, introducing new products, or altering marketing strategies, can have a significant impact on the market share and profitability of the other firms. This interdependence requires firms to be strategic in their decisions, often leading to scenarios such as price wars, collusion, or strategic alliances to gain a competitive advantage. The need to consider competitors' actions makes oligopoly unique compared to other market structures, where such interdependence is either absent or significantly less pronounced.

B is incorrect. In a monopoly, a single firm dominates the market with no close substitutes for its product or service, granting it significant market power. This unique position allows the monopolist to make pricing and production decisions without having to consider the reactions of competitors, as there are none. The firm's focus in a monopoly is more on demand and regulatory constraints rather than on competitors' strategies.

C is incorrect. Monopolistic competition is characterized by many firms offering differentiated products or services, which means that while firms compete with each other, each firm has some degree of market power due to product differentiation. In monopolistic competition, firms focus on differentiating their products, advertising, and marketing to capture a larger share of the market. Although firms in monopolistic competition do consider their competitors, the emphasis is more on differentiation and less on direct price competition or strategic interdependence as seen in oligopolies. The decisions of one firm in a monopolistically competitive market have a less direct impact on the strategies of other firms compared to an oligopoly, making the consideration of other firms' strategies less critical.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1b: Describe characteristics of perfect competition, monopolistic competition, oligopoly, and pure monopoly.

Q.1441 The main differentiating characteristic between perfect competition and monopolistic competition is the:

- A. taxation.
- B. pricing power.
- C. number of firms.

The correct answer is **B**.

The main differentiating characteristic between perfect competition and monopolistic competition is the degree of pricing power that firms possess. In a perfectly competitive market, firms are price takers, meaning they have no control over the price of their products. This is because the products offered are homogeneous, and there are many sellers and buyers in the market, making the competition intense. On the other hand, in monopolistic competition, firms have some degree of pricing power. This is attributed to the fact that they can differentiate their products from those of competitors through branding, quality, features, or marketing strategies. This differentiation makes consumers perceive their products as unique in some way, allowing firms to influence the price of their products to a certain extent.

A is incorrect. Taxation is not a primary differentiating factor between perfect competition and monopolistic competition. Both market structures can be subject to various forms of taxation, but this does not fundamentally alter the nature of competition within these markets. Taxation affects firms across different market structures and is not a characteristic that distinguishes perfect competition from monopolistic competition.

C is incorrect. While the number of firms is a relevant characteristic in understanding market structures, it is not the main differentiating factor between perfect competition and monopolistic competition. Both market structures are characterized by a relatively large number of firms. However, the key distinction lies in the ability of firms to set prices. In perfect competition, the presence of many firms selling homogeneous products means that no single firm can influence market prices. In contrast, in monopolistic competition, even though there are many firms, each firm has some ability to differentiate its product and thus exert some control over its pricing. While the number of firms is fairly large in both forms, there is no pricing power for the firms in perfect competition whereas, in monopolistic competition, firms have some pricing power. In order to actually raise their prices, the firms must be able to differentiate their products using strategies such as branding or marketing.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1b: describe characteristics of perfect competition, monopolistic competition, oligopoly, and pure monopoly.

Q.1444 In which of the following conditions can a firm in a perfectly competitive market maximize its profit?

- A. Demand = Price = Marginal cost.
- B. Demand = Price > Marginal revenue.
- C. Demand = Price = Marginal revenue < Marginal cost.

The correct answer is **A**.

In a perfectly competitive market, a firm can maximize its profit when the condition of Demand = Price = Marginal Cost is met. This scenario represents the equilibrium point where the firm's marginal cost of producing an additional unit equals the market price, which is also the price consumers are willing to pay. At this point, the firm is producing at an efficient scale, where the cost of producing one more unit is exactly equal to the revenue gained from selling that unit. This ensures that the firm is not missing out on potential profits by producing too little, nor is it incurring losses by producing too much where the cost of production would exceed the revenue.

B is incorrect. This option incorrectly suggests that a firm can maximize its profit when Demand = Price > Marginal Revenue. In a perfectly competitive market, price is equal to marginal revenue, as the price at which a firm can sell its product is determined by the market and is the same for every unit sold. Therefore, suggesting that price is greater than marginal revenue contradicts the fundamental principle of perfect competition, where firms are price takers and cannot influence the market price.

C is incorrect. The statement that Demand = Price = Marginal Revenue < Marginal Cost describes a situation where the firm is producing at a point where the cost of producing an additional unit is higher than the revenue that unit would bring in. This condition would lead to losses on each additional unit produced, as the firm would be selling at a price lower than the cost of production. In a perfectly competitive market, firms seek to produce at a level where marginal cost equals marginal revenue and price, ensuring that they are neither losing money on additional units nor missing out on potential profits by producing too few units. Producing at a point where marginal cost exceeds marginal revenue and price would not allow a firm to maximize its profit, but rather lead to inefficiencies and potential losses.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1a: Determine and interpret breakeven and shutdown points of production, as well as how economies and diseconomies of scale affect costs under perfect and imperfect competition.

Q.1445 Soybeans Corp. operates in a perfectly competitive market. What is the *most likely* impact on the equilibrium price and quantity if the market demand decreases?

- A. The equilibrium price and quantity will decrease.
- B. The equilibrium price and quantity will increase.
- C. The equilibrium price will decrease while the equilibrium quantity will increase.

The correct answer is **A**.

In a perfectly competitive market, firms are price takers, meaning they accept the market price as given and adjust their output levels accordingly. The market equilibrium, where supply equals demand, determines both the price and quantity of goods sold. When there is a decrease in market demand, it leads to a shift in the demand curve to the left. This shift results in a new equilibrium point where the equilibrium price and the equilibrium quantity are both lower than before. The decrease in demand means that consumers are willing to buy less of the product at any given price, leading to a surplus at the original equilibrium price. To eliminate this surplus, the price must fall, encouraging more purchases and discouraging some production until a new equilibrium is reached where the lower quantity of goods is sold at a lower price.

B is incorrect. Suggesting that the equilibrium price and quantity will increase contradicts the basic principles of supply and demand. A decrease in demand, without a change in supply, leads to a surplus of goods at the original price. To clear this surplus, the price must decrease, which also results in a decrease in the quantity supplied, as producers adjust to the lower price level. Therefore, both the equilibrium price and quantity decrease, not increase.

C is incorrect. This option incorrectly states that while the equilibrium price will decrease, the equilibrium quantity will increase. In the context of a decrease in market demand, both the equilibrium price and quantity decrease. The rationale behind this is straightforward: a decrease in demand leads to a surplus at the original price, necessitating a price reduction to stimulate purchases. This price reduction, in turn, leads to a decrease in the quantity supplied as producers adjust to the new market conditions. Thus, it is not possible for the equilibrium quantity to increase when the demand decreases in a perfectly competitive market.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1a: Determine and interpret breakeven and shutdown points of production, as well as how economies and diseconomies of scale affect costs under perfect and imperfect competition.

Q.1451 Which of the following is *least likely* to be used as a pricing strategy in a monopoly?

- A. Single price strategy.
- B. Interdependent pricing.
- C. Discriminating pricing strategy.

The correct answer is **B**.

Interdependent pricing is least likely to be used as a pricing strategy in a monopoly. In a monopoly market structure, a single firm dominates the market without any close substitutes, giving it significant control over pricing and production decisions. The concept of interdependent pricing primarily applies to oligopolistic markets, where a few firms dominate, and each firm's pricing strategy is heavily influenced by the pricing decisions of its competitors. This is due to the kinked demand curve theory, which suggests that firms in an oligopoly are hesitant to change prices because they are uncertain about how their competitors will react. If one firm lowers prices, others may follow, leading to a price war. Conversely, if a firm raises prices, competitors may not follow, leading to a loss of market share. Therefore, prices tend to be sticky in oligopolies, with firms closely watching each other's pricing moves.

A is incorrect. A single-price strategy is indeed a common approach in a monopoly. This strategy involves setting one price for all consumers of the product or service, regardless of the quantity purchased. Since the monopolist is the sole provider of the product or service in the market, it can set the price without concern for competition. This strategy simplifies pricing and sales processes but does not allow the monopolist to capture consumer surplus effectively.

C is incorrect. Discriminating pricing strategy, also known as price discrimination, is another tactic that can be effectively employed by monopolies. This strategy involves charging different prices to different groups of consumers for the same product or service, based on their willingness to pay. The goal is to capture more consumer surplus by extracting higher prices from consumers who are willing to pay more, while still selling to those who are more price-sensitive at lower prices. Examples include offering discounts to students or seniors, charging different prices in different markets, or varying prices based on the time of purchase. This strategy allows monopolies to maximize their profits by catering to diverse consumer segments with varying price sensitivities.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1c: Explain supply and demand relationships under monopolistic competition, including the optimal price and output for firms as well as pricing strategy.

Q.1455 Earth, Sun, Moon, and Star firms have market shares of 28%, 22%, 15%, and 10% respectively. The 4-firm Herfindahl-Hirschman Index is *closest* to:

A. 1609.

B. 1593.

C. 1871.

The correct answer is **B**.

The HHI Index was developed by two economists (OC Herfindahl and A.O. Hirschman). It first squares the market shares of the top N companies then sums them up. The HHI index is 1 for a firm operating as a monopoly.

$$\text{4-firm HHI} = 28^2 + 22^2 + 15^2 + 10^2 = 1593$$

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1e: Identify the type of market structure within which a firm operates and describe the use and limitations of concentration measures.

Q.1457 In which of the following forms of market structures does a firm make output and pricing decisions based on the anticipated actions of its competitors?

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

The correct answer is **A**.

In an oligopoly, firms make output and pricing decisions with a keen awareness of their competitors' potential actions. This market structure is characterized by a small number of firms that dominate the market, leading to a high degree of interdependence among them. Each firm understands that its decisions regarding prices and output levels can significantly influence the market environment, prompting reactions from competitors. This strategic interaction is a defining feature of oligopolies, where firms often engage in behaviors such as price matching, product differentiation, and non-price competition to gain a competitive edge. The anticipation of competitors' responses plays a crucial role in decision-making processes, as firms must consider not only their own strategies but also predict how their rivals will react to changes in prices or output levels. This dynamic creates a complex environment where strategic planning and foresight are essential for success.

B is incorrect. In a monopoly, a single firm dominates the market with no direct competitors. This market structure allows the monopolist to make pricing and output decisions without needing to consider competitors' actions, as it has significant control over the market. The lack of competition in a monopoly means that the firm does not have to anticipate competitors' responses when setting prices or output levels, unlike in an oligopoly.

C is incorrect. Perfect competition is a market structure characterized by a large number of small firms, each of which has no control over the market price. Firms in a perfectly competitive market are price takers, meaning they accept the market price as given and adjust their output levels accordingly. There is no room for strategic interaction among firms regarding pricing or output decisions, as no single firm has enough market power to influence market conditions. The decisions of one firm have no significant impact on the overall market or on the actions of competitors, making the anticipation of competitors' actions irrelevant in this context.

CFA Level 1, Volume 1, Topic 2 - Economics, Learning Module 1 - Firms and Market Structures, LOS 1b:Describe characteristics of perfect competition, monopolistic competition, oligopoly, and pure monopoly.
