# *Business in Action 8th edition Bovee Solutions Manual*

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# Chapter 2
# UNDERSTANDING BASIC ECONOMICS

## Chapter Overview

This chapter introduces important micro- and macroeconomic concepts such as demand versus supply, competition, monetary and fiscal policies, inflation, and economic indicators. It distinguishes among major economic systems and discusses ways of measuring economic activity. It also covers the debate over deregulation and identifies key roles that government plays in the economy.

## Chapter Outline

I. What Is This Thing Called the Economy?
   A. The **economy** is the sum total of all the economic activity within a given region
   B. **Economics** is the study of how a society uses its scarce resources to produce and distribute goods and services
      1. **Microeconomics** is the study of economic behavior among consumers, businesses, and industries that collectively determine the quantity of goods and services demanded and supplied at different prices
      2. **Macroeconomics** is the study of a country's larger economic issues, such as competition, government policies, and how an economy maintains and allocates its scarce resources
   C. Each society must decide how to use its economic resources or factors of production
      1. **Natural resources** – things that are useful in their natural state (land, forests, minerals, and water)
      2. **Human resources** – people and their individual talents and capacities
      3. **Capital** – money, computers, machines, tools, and buildings
      4. **Entrepreneurship** – the spirit of innovation, the initiative and the willingness to take on risks involved in creating/operating a business
      5. **Knowledge** – the collective intelligence of an organization
   C. The supply of these factors of production is limited
      1. **Scarcity** creates competition for resources
      2. Scarcity forces consumers, companies, and governments to make trade-offs
         a. **Opportunity cost** is the value of the most attractive option not selected when making a trade-off

II. Economic Systems
   A. An **economic system** is the basic set of rules for allocating a society's resources to satisfy its citizens' needs
      1. **Free-market system** – individuals and companies decide what products to produce, how to produce them, to whom to sell them, and at what price

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a. Referred to as **capitalism** – private parties own/operate the majority of businesses and competition, supply, and demand determine goods/services produced
b. No economy is without limited intervention by government, creating a mixed economy or mixed capitalism

2. **Planned system** – governments largely control allocation of resources
   a. Communism is the economic system that allows individuals the least degree of economic freedom
   b. **Socialism** has a high degree of government planning and some government ownership of capital resources, but private ownership is permitted in some industries
3. Governments change structure of economy in two ways:
   a. **Nationalizing** – assuming ownership of selected companies or industries
   b. **Privatizing** – allowing private businesses to perform services once performed by the government

III. The Forces of Demand and Supply

A. **Demand** – buyers' willingness and ability to purchase products at various price points
   1. The **demand curve** shows the relationship between price and demand – as price decreases, demand increases (i.e., more people are willing to buy)

B. **Supply** – the quantities of a good/service that producers will provide on a particular date at various prices
   1. The **supply curve** shows the relationship between supply and demand – as price increases, the quantity that sellers are willing to supply increases

C. Demand and supply curves intersect at **equilibrium point** – the point at which quantity supplied equals quantity demanded

IV. The Macro View: Understanding How an Economy Operates

A. **Competition** is rivalry among businesses for the same customers.

B. There are different degrees of competition
   1. **Pure competition –** the market situation in which there are so many buyers and sellers that no single buyer or seller can individually influence market price
   2. **Monopoly –** the market situation in which one company dominates the market and can control prices
   3. **Monopolistic competition –** the market situation in which there are many sellers who differentiate their products from those of competitors in at least some small way
   4. **Oligopoly** – the market situation in which a very small number of suppliers, sometimes only two, provide a particular good or service

C. Economic activity changes in response to factors such as investment patterns, shifts in consumer attitudes, world events and basic economic forces – called economic fluctuation or **business cycles**
   1. Economic expansion – when the economy is growing and consumers are spending more money
   2. Economic contraction – when spending declines, employment drops and the economy slows down

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a. A **recession** is two consecutive quarters of decline in gross domestic product
b. A deep and prolonged recession can be considered a depression, a catastrophic collapse of financial markets

D. **Unemployment rate** – the percentage of labor force currently without employment
1. Four types of unemployment – frictional, structural, cyclical, and seasonal

E. **Inflation** – the steady rise in the average prices of goods and services throughout the economy
1. **Deflation** is the sustained fall in average prices

V. Government's Role in a Free-Market System

A. There is considerable debate over the key roles that governments play in the economy
1. **Regulation** involves relying more on laws and policies than on market forces to govern economic activity
2. **Deregulation** involves removing laws and regulations to allow the market to prevent excesses and correct itself over time

B. The government plays a role in the economy in four major areas:
1. Protecting stakeholders through numerous regulatory agencies
2. Fostering competition through prevention of monopolies
a. Antitrust legislation
b. Merger and acquisition approval
3. Encouraging innovation and economic development
4. Stabilizing and stimulating the economy through use of monetary policy and fiscal policy
a. **Monetary policy** involves adjusting the nation's money supply by increasing or decreasing interest rates. It is administered by the Federal Reserve Board
b. **Fiscal policy** involves changes in the government's revenues (taxation) and expenditures

VI. Economic Measures and Monitors

A. **Economic indicators** are statistics such as interest rates, unemployment rates, housing data and industrial productivity
1. Leading indicators (such as housing starts and durable-goods orders) suggest changes that may happen to the economy in the future
2. Lagging indicators (such as the unemployment rate) provide confirmation that something has happened in the past

B. Price indexes offer a way to monitor inflation or deflation
1. The **consumer price index (CPI)** measures rate of inflation by comparing change in prices of a representative "basket" of consumer goods and services
2. The **producer price index (PPI)** is a statistical measure of price trends at the producer and wholesaler levels

C. The **gross domestic product (GDP)** is the value of all the final goods and services produced by businesses located within a nation's borders.

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## Classroom Activities

***Break-out Group Discussion*: *Capitalism vs. Socialism***
Goal: Ask students to discuss the pros and cons of both capitalism and socialism and to come away with the understanding that each system has its own benefits and shortcomings.

Time Limit: 15 minutes.

Details:

1. Break students into groups of five. (2 minutes)
2. Ask each group to come up with the top pros and cons of capitalism or socialism. Sample list items include capitalism's efficient self-adjusting market mechanism via "demand vs. supply", encouragement of hard work and entrepreneurship, lower taxes, higher income disparity, and generally poorer records in the public sector such as education, healthcare and social welfare, and socialism's generally better records in education, healthcare and social welfare, lower income disparity, higher taxes and less incentive for hard work and entrepreneurship. Use examples of countries and regions to illustrate such differences, e.g. U.S. and Hong Kong for capitalism, and France and Canada for socialism (10 minutes)
3. Ask representatives/speakers from each group to present their results to the whole class, either verbally or written (on the blackboard). (3 minutes)

Summary: Instructor summarizes the top pros and cons for both capitalism and socialism, and concludes that the best system tends to be a mixed system that incorporates the beneficial elements of both systems.

***In-Class Activity*: *GDP vs. GNP***
Goal: Help students differentiate between Gross Domestic Product (GDP) and Gross National Product (GNP).

Time Limit: 10 minutes.

Details:

1. Draw a table with three columns and four rows on the blackboard with the following column headings respectively: "Scenarios", "Which Country's GDP" and "Which Country's GNP."
2. Lists the following three scenarios under the column heading "Scenarios."
    a. An American banker working in London
    b. A Chinese factory worker in a Coca Cola bottling plant in Shanghai

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c. An Australian volunteer in South Africa

3. Ask students to pair up and recreate the content of the blackboard in their notebooks. They then need to populate the rest of the table by listing the names of countries under the two column headings corresponding to GDP and GNP.
4. Make it clear to students that the main difference between GDP and GNP is that GDP considers *where* the production occurs and GNP considers *who* is responsible for the production. For instance, in Scenario A, the goods and services produced by an American banker in London should be classified as the GDP of United Kingdom (UK) and the GNP of United States (US).

   *Hint: GNP excludes the value of production from foreign-owned businesses within a nation's boundaries (Scenario B). Volunteering is not a component of GDP or GNP (Scenario C).*

## End-of-Chapter

### Behind The Scenes
***The Push for Grid Parity at Suntech Power***

*Critical Thinking Questions*

**2-1. If consumers are willing to wait weeks or months for the latest iPhone, why does Apple need to worry about producing enough phones to meet immediate demand?**
If consumers are made to wait weeks or months, some may become impatient and switch to Samsung or another brand of phone. Producing the phones is no simple task, as it involves the coordination of many component parts to be designed, manufactured, and shipped, as well as the structuring of wireless service contracts. (LO: 3, AACSB: Analytical Thinking)

**2-2. If Apply temporarily can't meet demand for a product, should it raise the price to bring supply and demand into balance? Why or why not?**
A demand curve shows that as price increases, demand decreases. So raising the price temporarily could help balance out supply and demand. However, doing so might turn off consumers who expected to pay the prescribed price. Consumers expect this kind of fluctuation of prices in airline tickets, but it is not conventional with consumer goods. (LO: 3, AACSB: Analytical thinking)

**2.3 Apple is famously secretive about the details of upcoming product launches, leaving consumers and industry insiders to speculate on the features and functions of new models. What effect might this have on demand?**
Shrouding the new model is mystery could help to increase the mystique of the product, and therefore its demand. However, withholding news of special features could also lose out on attracting buyers who would desire these features. (LO: 3, AACSB: Analytical thinking)

*Learn More Online*

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Students' responses will depend, in large part, on the material currently posted on the website. (LO: 3, AACSB: Analytical thinking).

## Test Your Knowledge

*Questions for Review*

**2-4. Why is the economic concept of scarcity a crucial concept for businesspeople to understand?**

The economic concept of scarcity is a crucial concept for businesspeople to understand because scarcity creates competition for resources and forces trade-offs on the part of every participant in the economy. First, businesses and industries compete with each other for the resources they need, including materials, employees and customers. Second, given this universal scarcity of resources, businesses are constantly forced to make trade-offs, such as deciding how much money to spend on advertising a new product versus how much to spend on the materials used to make it, or deciding how many employees to have in sales versus customer support. (LO: 1)

**2-5. How does macroeconomics differ from microeconomics?**

Macroeconomics looks at the study of an economy as a whole. It is the "bigger picture" view. It examines factors such as changes in unemployment, national income, rate of the economy's growth, the nation's gross domestic product, and inflation and price levels. Microeconomics looks at the smaller picture. It focuses more on consumers, businesses, and industries. Microeconomics examines factors such as supply and demand and the determination of price and output in markets. (LO: 1)

**2-6. Does the United States have a purely free-market economy or a mixed economy?**

The U.S. has a mixed economy. (LO: 2)

**2-7. What is the difference between monetary policy and fiscal policy?**

Monetary policy is government policy and actions taken by the Federal Reserve Board to regulate the nation's money supply. Fiscal policy is the use of government revenue collection and spending to influence the business cycle. (LO: 5)

**2-8. Why might a government agency seek to block a merger or acquisition?**

To preserve competition, a government agency may stipulate requirements companies must meet to gain approval of a proposed merger or acquisition. If the governmental agency thinks a proposed merger or acquisition might restrain competition, it may deny approval altogether. (LO: 5, AACSB: Ethical understanding and reasoning)

*Questions for Analysis*

**2-9. Why do governments intervene in the free-market system?**

Governments intervene in free-market systems to influence prices and wages or to change the way resources are allocated. This practice of limited intervention is called mixed capitalism, which is the economic system of the United States.

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Under mixed capitalism, the pursuit of private gain is regarded as a worthwhile goal that ultimately benefits society as a whole. (LO: 2)

**2-10. How do countries know if their economic systems are working?**

Economic indicators are statistics such as interest rates, unemployment rates, and housing data, GNP, GDP, CPI, etc. A country's professional economists sort and interpret these data to monitor and measure the country's economic performance and predict its future performance. (LO: 6)

**2-11. Are the fluctuations in the business cycle predictable?**

No, such fluctuations are rarely predictable. (LO: 4)

**2-12. Is it beneficial for the country as a whole for individual U.S. states to compete with one another to attract companies? (Offering tax breaks in exchange for building new facilities is a common tactic states use to attract commercial investment, for example.)**

It may not be wise for such competition to get out of control because each competing state will hurt from low tax revenues. (LO: 5, AACSB: Analytical thinking)

**2-13. Ethical Considerations. The risk of failure is an inherent part of free enterprise. Does society have an obligation to come to the aid of entrepreneurs who try but fail? Why or why not?**

Students' answers will vary, but may reflect some of the following concerns:

- Entrepreneurs willing to face risks of failure are a vital force in capitalist economies
- Such entrepreneurs will be rewarded handsomely when they become successful
- Many such entrepreneurs are involved in multiple ventures and may use earnings from successful ventures to fund, develop or improve ventures that are less successful (LO: 5, AACSB: Ethical understanding and reasoning)

*Questions For Application*

**2-14. How might government and education leaders work with business to minimize structural unemployment?**

Government and education leaders might work with businesses to provide educational opportunities and training programs that would best match workers' skills with the current needs of employers in an effort to minimize structural unemployment. (LO: 6, AACSB: Analytical thinking)

**2-15. How would a decrease in Social Security benefits to retired persons affect the economy?**

First it would lower government spending and perhaps reduce the national debt. While many might see this as an economic boost, all things being equal, a decrease in government spending would also reduce the amount of money in the economy. For example, because of the circular flow, the elderly would have less money to spend so businesses that cater to the needs of the elderly might be hurt and the employees of those businesses might lose their jobs and so on. In order for the economy to stay balanced, the decrease in money spent by the government on Social Security would have to be substituted by an infusion of

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money into the economy from another source. Plus the multiplier effect of that change would have to be analyzed. (LO: 6, AACSB: Analytical thinking)

**2-16. If you wanted to increase demand for your restaurant but are unable to lower prices or increase advertising, what steps might you take?**

Applying the law of demand vs. supply, you may want to relocate your restaurant to a neighborhood/area where there are not as many other restaurants, i.e. where there is less supply. There will be less competition and you may even be able to raise your price slightly without driving customers away. (LO: 3, AACSB: Analytical thinking)

**2-17. Concept Integration. What effect might the technological environment, discussed in Chapter 1, have on the equilibrium point in a given market?**

Student answers may vary; however, the following provides a possible scenario:

- Technological advances may help reduce the cost of producing goods and services and therefore increasing the supply for a given market at every price, thus moving the equilibrium point as well. (LO: 3, AACSB: Information technology)

## Expand Your Knowledge

*Discovering Career Opportunities*

Thinking about a career in economics? Find out what economists do by reviewing the *Occupational Outlook Handbook* in your library or online at **www.bls.gov/oco**. This is an authoritative resource for information about all kinds of occupations. Search for "economists" then answer these questions:

**2-18. Briefly describe what economists do and their typical working conditions.**

Economists study the production and distribution of resources, goods, and services by collecting and analyzing data, researching trends, and evaluating economic issues. Economists typically research and analyze economic issues, conduct surveys and collect data, analyze data using mathematical models and statistical techniques, and prepare reports, tables, and charts that present research results. They also interpret and forecast market trends, advise businesses, governments, and individuals on economic topics, design policies or make recommendations for solving economic problems, and write articles for publication in academic journals and other media sources.

Economists apply economic analysis to issues within a variety of fields, such as education, health, development, and the environment. Some economists study the cost of products, healthcare, or energy. Others examine employment levels, business cycles, or exchange rates. Still, others analyze the effect of taxes, inflation, or interest rates.

Economists held about 16,900 jobs in 2012, of which 45 percent were in government. Another 19 percent worked in management, scientific, and professional consulting services. Economists typically work independently in an office. However, many economists collaborate with other economists and statisticians, sometimes working on teams. Some economists work from home,

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and others may be required to travel as part of their job or to attend conferences. (LO: 5)

**2-19. What is the job outlook for economists? What is the average salary for starting economists?**

Employment of economists is projected to grow 14 percent from 2012 to 2022, about as fast as the average for all occupations.

Businesses and organizations across many industries are increasingly relying on economic analysis and quantitative methods to analyze and forecast business, sales, and other economic trends. Demand for economists should grow as a result of the increasing complexity of the global economy, additional financial regulations, and a more competitive business environment. As a result, demand for economists should be best in private industry, especially in management, scientific, and professional consulting services.

However, employment in the federal government—the largest employer of economists—is projected to decline. As a result, the need for economists in the federal government is likely to be limited.

The median annual wage for economists was $91,860 in May 2012. The median wage is the wage at which half the workers in an occupation earned more than the amount and half earned less. (LO: 5, AACSB: Ethical understanding and reasoning)

**2-20. What training and qualifications are required for a career as an economist? Are the qualifications different for jobs in the private sector as opposed to those in the government?**

A master's degree or Ph.D. is required for most economist jobs. Positions in business, research, or international organizations often require a combination of graduate education and work experience.

Students can pursue an advanced degree in economics with a bachelor's degree in a number of fields, but a strong background in math is essential. A Ph.D. in economics requires several years of study after earning a bachelor's degree, including completion of detailed research in a specialty field.

Candidates with a bachelor's degree qualify for some entry-level economist positions, including jobs with the federal government. An advanced degree is sometimes required for advancement to higher level positions.

Most who complete a bachelor's degree in economics find jobs outside the economics profession as research assistants, financial analysts, market research analysts, and similar positions in business, finance, and consulting. (LO: 5)

*Improving Your Tech Insights: Data Mining*

To find a few ounces of precious gold, you dig through a mountain of earth. To find a few ounces of precious information, you dig through mountains of data, using *data mining*, a combination of technologies and techniques to extract important customer

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insights buried within thousands or millions of transaction records. (Data mining has many other uses as well, such as identifying which employees are most valuable to a firm. And a related technology, *text mining*, applies similar analysis tools to documents.)

Data mining is an essential part of *business intelligence* because it helps extract trends and insights from millions of pieces of individual data (including demographics, purchase histories, customer service records, and research results). Data mining helps marketers identify who their most profitable customers are, which goods and services are in highest demand in specific markets, how to structure promotional campaigns, where to target upcoming sales efforts, and which customers are likely to be high credit risks, among many other benefits. You may hear the term *business analytics* and *predictive analytics* used in this context as well, to describe efforts to extract insights from databases.

Research one of the commercially available data-mining or business analytics systems. The list of member companies of the Data Mining Group (**www.dmg.org**) is a good place to start**. In a brief email message to your instructor, describe how the system you've chosen can help companies market their goods and services more effectively.**
Student answers will vary depending on the magazines or companies they pick. (LO: 6, Information technology)

## Practice Your Skills

*Sharpening Your Communication Skills*
**The subprime mortgage crisis that helped throw the global economy into the Great Recession bewildered a lot of people. In a brief paragraph (no more than 100 words), explain what a subprime mortgage is and why these loans helped trigger the recession.**

Student answers will vary but they should define subprime mortgages, which are home loans for borrowers with low credit scores. They should also address the high risk and high default nature of such loans. Students need to mention that half of subprime mortgages are Adjustable Rate Mortgages, which are especially vulnerable to payment shock when low initial rates expired. (LO: 4, AACSB: Reflective thinking)

*Building Your Team Skills*
Economic indicators help businesses and governments determine where the economy is headed. As part of a team assigned by your instructor, analyze the following newspaper headlines for clues to the direction of the U.S. economy:

- "Housing Starts Lowest in Months"
- "Fed Lowers Discount Rate and Interest Rates Tumble"
- "Retail Sales Up 4 Percent Over Last Month"
- "Business Debt Down from Last Year"

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- More Manufacturers Showing Interest in Upgrading Production Equipment"
- "Local Economy Sinks as Area Unemployment Rate Climbs to 9.2 Percent"
- "Computer Networking Firm Reports 30-Day Backlog in Installing Business Systems"

**Is each item good news or bad news for the economy? Why? What does each news item mean for large and small businesses? Report your team's findings to the class. Did all the teams come to the same conclusions about each headline? Why or why not? With your team, discuss how these different perspectives might influence the way you interpret economic news in the future.** (LO: 6, AACSB: Analytic thinking)

- **Housing Starts Lowest In Months**
  This indicates that consumers are not very confident about the future, so they are "staying put" rather than building new houses.

- **Fed Lowers Discount Rate And Interest Rates Tumble**
  This headline indicates that aggregate demand is slow. In order to boost the economy and encourage firms to invest more, the Fed lowers the discount rate and other interest rates follow.

- **Retail Sales Up 4 Percent Over Last Month**
  Increase in sales indicates a healthy economy with employment rates rising and rising consumer confidence as a result. Some inflationary pressure may result.

- **Business Debt Down From Last Year**
  This indicates that business owners are less confident and less willing to take on debt.

- **More Manufacturers Showing Interest in Upgrading Production Equipment**
  This headline indicates that businesses are replacing labor with machines.

- **Local Economy Sinks as Area Unemployment Rate Climbs to 9.2 Percent**
  This indicates that high unemployment rate often contributes to lower consumer spending, resulting in a shrinking local economy.

- **Computer Networking Firm Reports 30-Day Backlog in Installing Business Systems**
  This indicates growth in the economy, as businesses are growing.

*Developing Your Research Skills*

Some career paths have higher unemployment risks during the ups and downs of economic fluctuations. **Research three business careers that should be relatively "recession proof" in the coming years, meaning that employment is unlikely to**

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**drop dramatically (or may even increase) during a recession. Summarize your findings in a one-page report.**
Student answers may vary but three likely such careers are healthcare, education, and green technology. (LO: 4)

### Assisted-graded Questions

**2.21 Why is competition an important element of the free-market system?**

The need to compete for customers keeps prices down, encourages cost-cutting techniques, and promotes a diversity of goods to cater to diverse and changing consumer preferences. Because competition responds to customer demands, products that are low quality or dangerous will be removed from the market, while products or services that are quality, fairly priced, and meet consumers needs will stay on the market. Because companies will not receive money for goods that the consumer does not find worthwhile, the system is considered to be "self-regulating." (LO: 4, AACSB: Analytical thinking)

**2.22 How might the word "free" affect public and political discussions of free-market systems?**

There is much debate about how "free" the free market should be. In a broader view, this argument springs from profound philosophical differences over the role government should play in society as a whole. More narrowly, even professional economists don't always agree on what role the government should play in the economy. Much of the debate is framed as the argument between regulation versus deregulation. (LO: 5, AACSB: Ethical understanding and reasoning)

## CHECKPOINTS

**LEARNING OBJECTIVE 1: Define *economics,* and explain why scarcity is central to economic decision making.**

**Critical thinking:**
(1) Why is entrepreneurship considered a factor of production?
Entrepreneurship is considered a factor of production because it is finite, just like the other four factors of production, in that not everyone has the spirit of innovation, the initiative, and the willingness to take the risks involved in creating and operating businesses. Like the other four factors, entrepreneurship can also be used to satisfy society's needs.

(2) If you had an unlimited amount of money, would you ever need to make trade-offs again? Why or why not?
Students' responses will vary depending on personal opinions but points to consider include the fact that economics is defined in terms of scarcity, and scarcity makes trade-off a necessity.

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(1) Did you consider opportunity cost when you chose the college or university you are currently attending?
Students' responses will vary depending on personal experiences.

(2) What trade-offs did you make in order to read this chapter at this exact moment in your life? (Think about the decisions you made to get to a point in your life where you're taking a business course.)
Students' responses will vary depending on personal experiences.

**LEARNING OBJECTIVE 2: Differentiate among the major types of economic systems.**

**Critical thinking:**
(1) Why are no economies truly free, in the sense of having no controls or restrictions?
Because in all economies, local, state, national, and even international governments intervene in the economy to various degrees, to accomplish goals that leaders deem socially or economically desirable. These interventions include taxation and price controls.

(2) What are some possible risks of privatizing basic services such as the transportation infrastructure?
Some possible risks include that the private entities that are in control of transportation infrastructure could sacrifice infrastructure quality and safety to minimize costs and maximize profits. They may also be entities controlled by foreign governments that may not be friendly towards the U.S. or even become hostile both politically and militarily.

**It's your business:**
(1) What is your emotional reaction to the terms *capitalism* and *socialism*? Explain why you feel the way you do.
Students' responses will vary depending on personal opinions.

(2) Would you rather pay lower taxes and accept the fact that you need to pay for many services such as health care and education, or pay higher taxes with the assurance that the government will provide many basic services for you? Why?
Students' responses will vary depending on personal opinions.

**LEARNING OBJECTIVE 3: Explain the interaction between demand and supply.**

**Critical thinking:**
(1) How does the interaction of demand and supply keep a market in balance, at least approximately and temporarily?
The interaction of demand and supply keep a market in balance through the equilibrium point.

(2) If the prices of complementary products for a given product go up, what effect is this increase likely to have on demand for that product?

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This increase will likely reduce the demand for that product.

**It's your business:**
(1) Are there any products or brands you are so loyal to that you will purchase them at almost any price? Will you accept less-expensive substitutes?
Students' responses will vary depending on personal opinions.

(2) Have you ever purchased something simply because it was on sale? Why or why not?
Students' responses will vary depending on personal experiences.

**LEARNING OBJECTIVE 4: Identify four macroeconomic issues that are essential to understanding the behavior of the economy.**

**Critical thinking:**
(1) Are colleges and universities an example of pure competition or monopolistic competition? Why?
They are monopolistic competition since they offer products that can be distinguished from competing products in at least some small way, such as strengths in certain majors or facilities.

(2) Are monopolies always harmful to consumers? Why or why not?
Not necessarily. There are some government sanctioned monopolies such as utilities and the U.S. Postal Service, which are not really harmful to consumers.

**It's your business:**
(1) What state of the business cycle is the economy currently in? Is this influencing your career plans?
Students' responses will vary depending on personal experiences and opinions.

(2) Have you ever been unemployed (at a time when you were actively looking for work)? Which of the four categories of unemployment would you have fallen under?
Students' responses will vary depending on personal experiences and opinions.

**LEARNING OBJECTIVE 5: Outline the debate over deregulation, and identify four key roles that governments play in the economy.**

**Critical thinking:**
(1) Would it be wise for the government to put price controls on college tuition? Why or why not?
Students' responses will vary depending on personal opinions as well as how much of a role they think government should play in the economy.

(2) Under what conditions, if any, should the federal government step in to rescue failing companies?
Students' responses will vary depending on how much of a role they think government should play in private industries.

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(1) How do you benefit from competition among the companies that supply you with the goods and services you need?
Students' responses will vary depending on personal opinions

(2) Does this competition have any negative impact on your life?
Students' responses will vary depending on personal opinions

**LEARNING OBJECTIVE 6: Identify the major ways of measuring economic activity.**

**Critical thinking:**
(1) Why would anyone bother to monitor lagging indicators?
Lagging indicators are important since they provide confirmation that something (such as a recession) has occurred in the past.

(2) Why is GDP considered a more accurate measure of a country's economic health than GNP?
GDP is considered a more accurate measure since it includes goods and services produced within a country's borders, and enables a nation to evaluate its economic policies and to compare its current performance with prior periods or with the performance of other nations.

**It's your business:**
(1) In your multiple economic roles as a consumer, employee, and investor, is inflation a good thing, a bad thing, or both? Explain your answer.
Students' responses will vary depending on personal opinions.

(2) How have increases in college costs affected your educational plans?
Students' responses will vary depending on personal experiences.

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# Chapter 2
# Understanding Basic Economics

**Business in Action 8e**
**Bovée/Thill**

# Introduction

- This chapter offers
  - A brief introduction to economics from a business professional's perspective
  - A high-level look at the study of economics, types of economic systems, and the interaction of supply and demand
- Understanding basic economic principles is essential to successful business management

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# Learning Objectives

1. Define *economics*, and explain why scarcity is central to economic decision making.
2. Differentiate among the major types of economic systems.
3. Explain the interaction between demand and supply.

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# Learning Objectives (cont.)

4. Identify four macroeconomic issues that are essential to understanding the behavior of the economy.
5. Outline the debate over deregulation, and identify four key roles that governments play in the economy.
6. Identify the major ways of measuring economic activity.

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# What Is This Thing Called The Economy?

- **Economy**
  - The sum total of all the economic activity within a given region
- **Economics**
  - The study of how a society uses its scarce resources to produce and distribute goods and services

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# What Is This Thing Called The Economy? (cont.)

- **Microeconomics**
  - The study of how consumers, businesses, and industries collectively determine the quantity of goods and services demanded and supplied at different prices
- **Macroeconomics**
  - The study of "big picture" issues in an economy, including competitive behavior among firms, the effect of government policies, and overall resource allocation issues

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# Factors of Production

- **Natural resources**
  - ↳ Land, forests, minerals, water, and other tangible assets usable in their natural state
- **Human resources**
  - ↳ All the people who work in an organization or on its behalf

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# Factors of Production (cont.)

- **Capital**
  - The funds that finance the operations of a business as well as the physical, human-made elements used to produce goods and services, such as factories and computers
- **Entrepreneurship**
  - The combination of innovation, initiative, and willingness to take the risks required to create and operate new businesses

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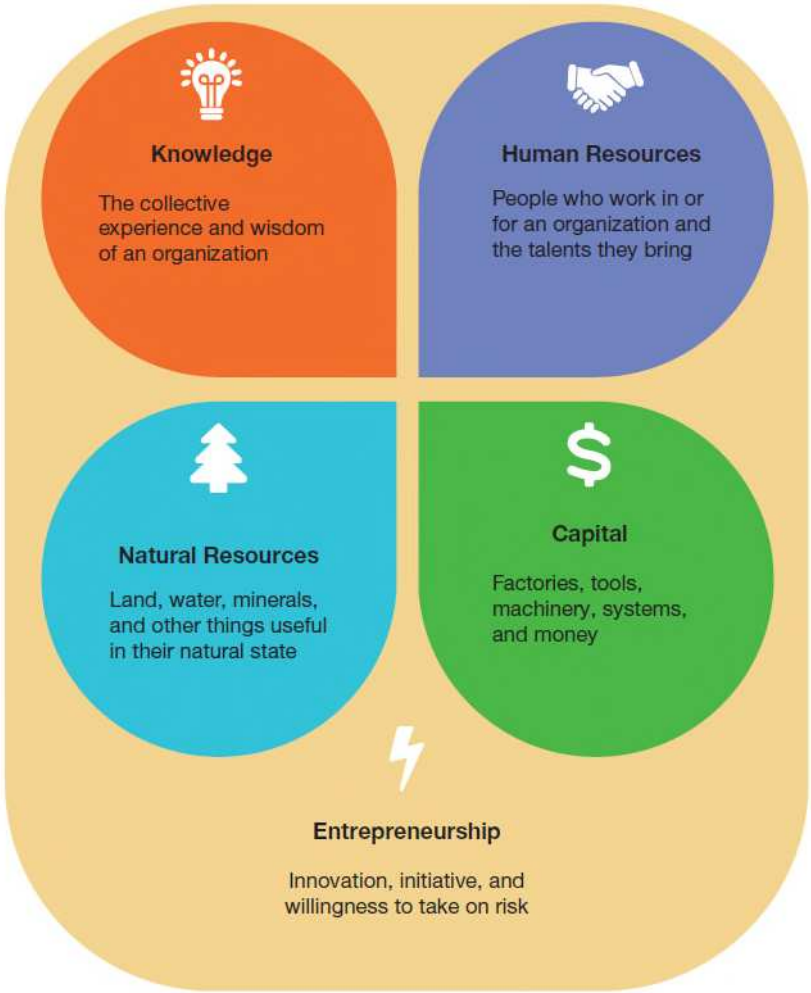
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# Factors of Production (cont.)

- **Knowledge**
  - ↳ Expertise gained through experience or association

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# Exhibit 2.1 Factors of Production




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# The Economic Impact of Scarcity

- **Scarcity**
  - ↳ A condition of any productive resource that has finite supply
- **Opportunity cost**
  - ↳ The value of the most appealing alternative not chosen

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# Economic Systems

- **Economic system**
  - The policies that define a society's particular economic structure; the rules by which a society allocates economic resources
  - Free-market, planned

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# Free Market Systems

- **Free-market system**
  - ↳ An economic system in which decisions about what to produce and in what quantities are decided by the market's buyers and sellers
- **Capitalism**
  - ↳ Economic system based on economic freedom and competition

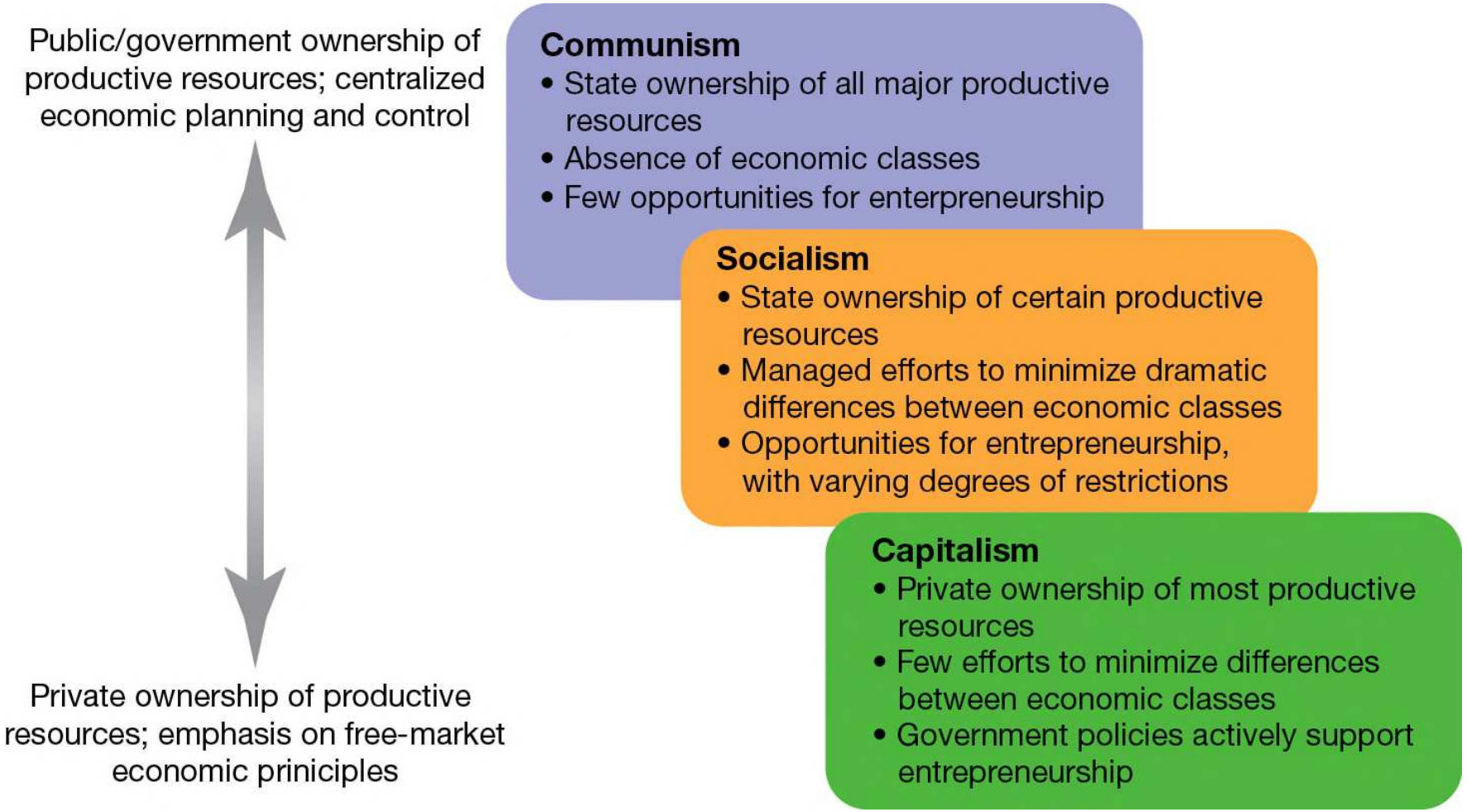
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# Planned Systems

- **Planned system**
  - ↳ Economic system in which the government controls most of the factors of production and regulates their allocation
- **Socialism**
  - ↳ Economic system characterized by public ownership and operation of key industries combined with private ownership and operation of less-vital industries

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# Exhibit 2.2 Economic Systems




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# Nationalization and Privatization

- **Nationalization**
  - A government's takeover of selected companies or industries
- **Privatization**
  - Turning over services once performed by the government and allowing private businesses to perform them instead

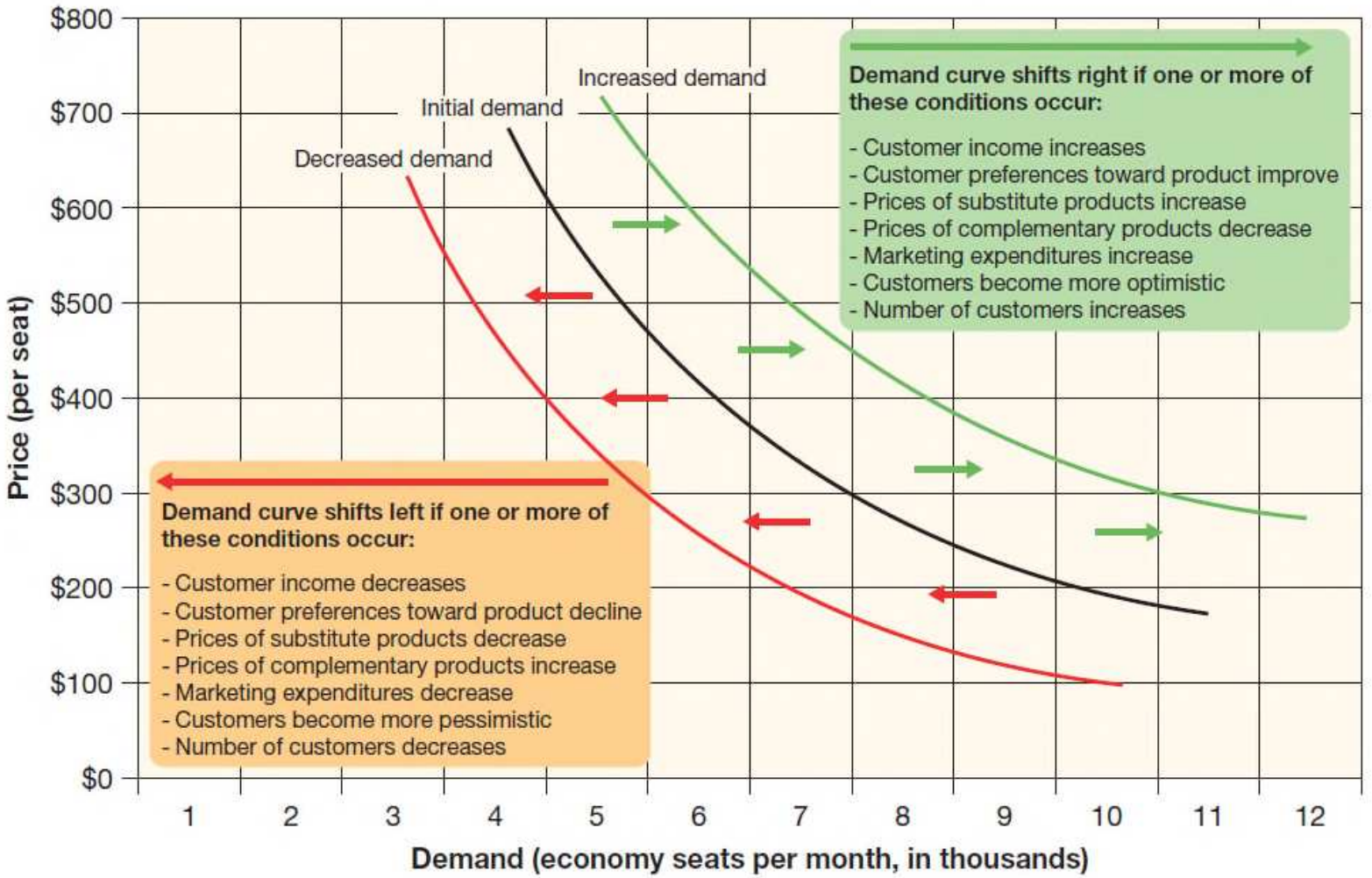
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# The Forces of Demand and Supply

- **Demand**
  - ↳ Buyers' willingness and ability to purchase products at various price points
- **Supply**
  - ↳ A specific quantity of a product that the seller is able and willing to provide at various prices
- **Demand curve**
  - ↳ A graph of the quantities of a product that buyers will purchase at various prices

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# Exhibit 2.3 Demand Curve



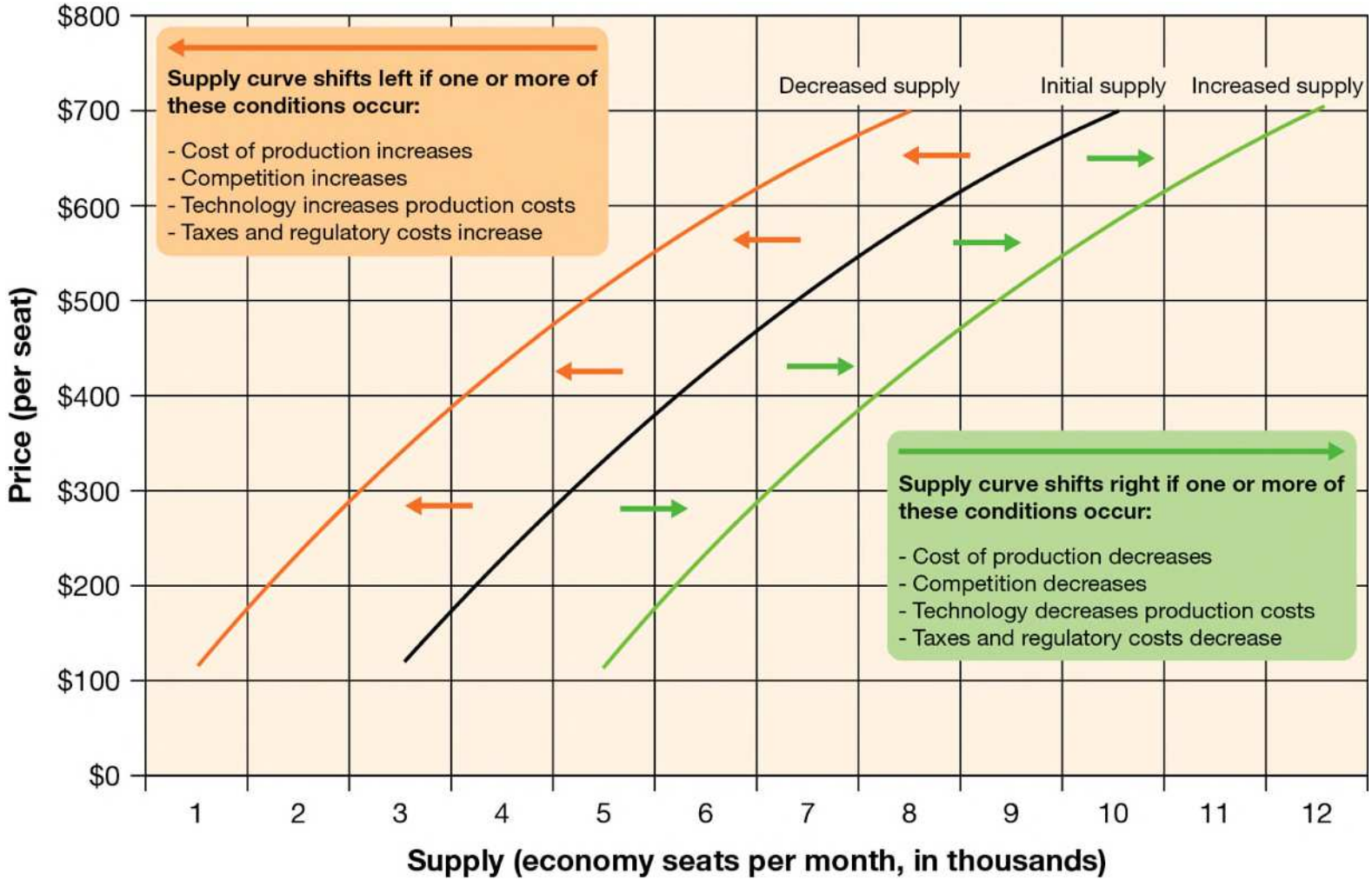

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# Understanding Supply

- **Supply curve**
  - A graph of the quantities of a product that sellers will offer for sale, regardless of demand, at various prices

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# Exhibit 2.4 Supply Curve



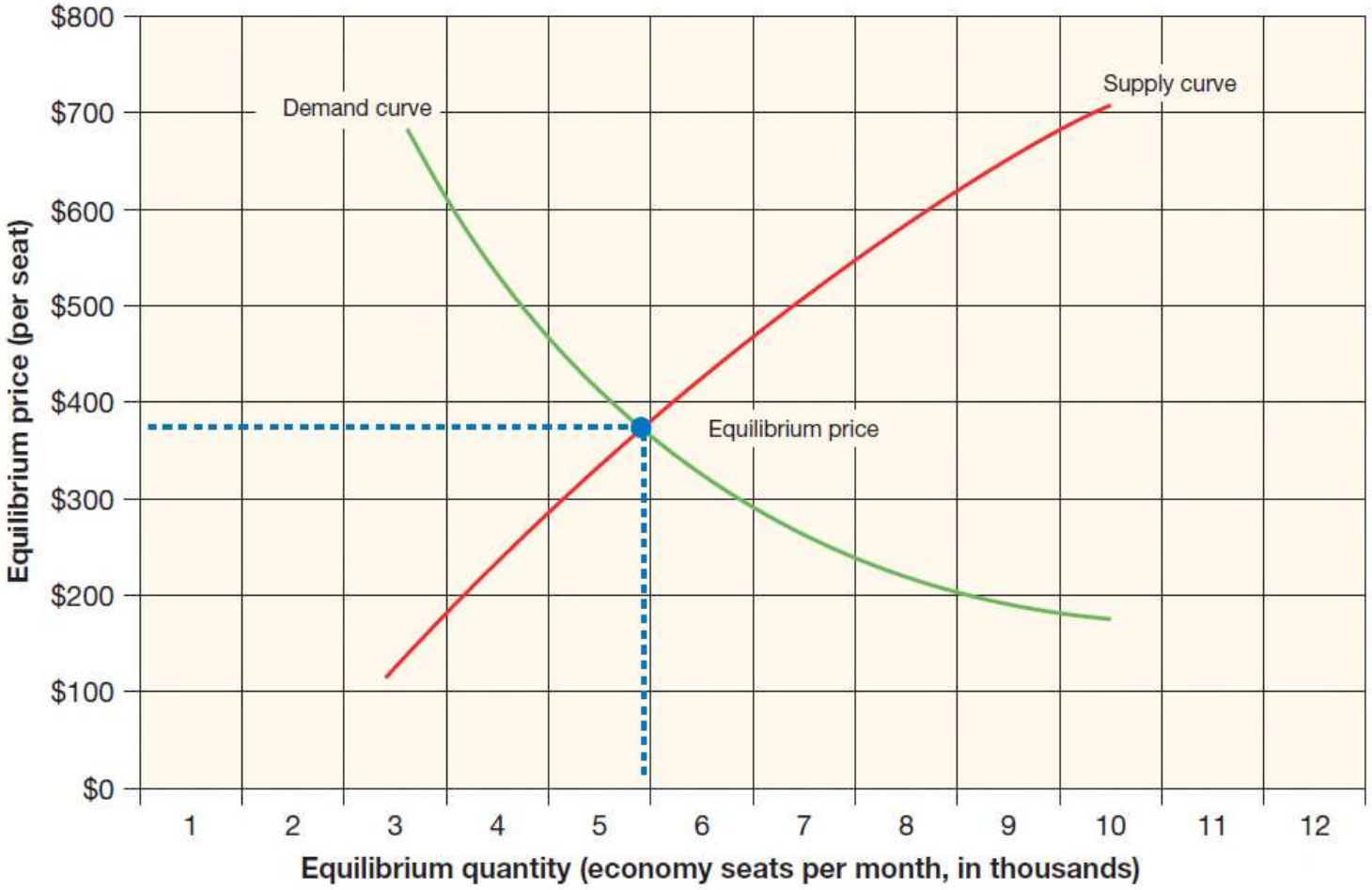

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# Understanding How Demand and Supply Interact

- **Equilibrium point**
  - ↳ The point at which quantity supplied equals quantity demanded
- Because the supply and demand curves are dynamic, so is the equilibrium point
- As variables affecting supply and demand change, so will the equilibrium price

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# Exhibit 2.5 The Relationship Between Supply and Demand




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# Competition in a Free-Market System

- **Competition**
  - ↳ Rivalry among businesses for the same customers
- **Pure competition**
  - ↳ A situation in which so many buyers and sellers exist that no single buyer or seller can individually influence market prices

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# Competition in a Free-Market System (cont.)

- **Monopoly**
  - A situation in which one company dominates a market to the degree that it can control prices
- **Monopolistic competition**
  - A situation in which many sellers differentiate their products from those of competitors in at least some small way

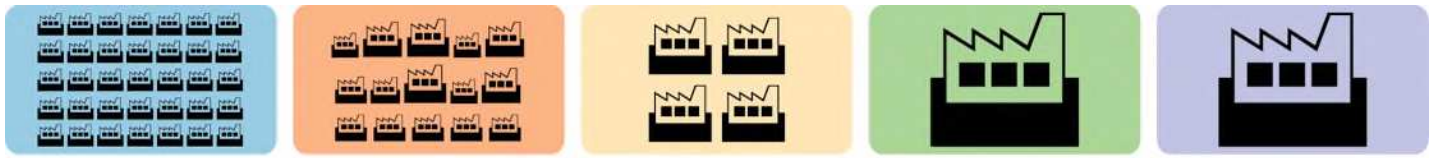
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# Competition in a Free-Market System (cont.)

- **Oligopoly**
  - A market situation in which a very small number of suppliers, sometimes only two, provide a particular good or service

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# Exhibit 2.6 Categories of Competition



| Pure Competition | Monopolistic Competition | Oligopoly | Pure Monopoly | Regulated Monopoly |
|---|---|---|---|---|
| **Characteristics:**<br>• Many small suppliers<br>• Virtually identical products<br>• Low barriers to entry | **Characteristics:**<br>• Can have few or many suppliers, of varying size<br>• Products can be distinguished but are similar enough to be replacements<br>• Variable barriers to entry but market open to all | **Characteristics:**<br>• Small number of suppliers, even as few as just two (a *duopoly*)<br>• Products can be distinguished in important ways, but replacements are still available<br>• Barriers to entry tend to be high, making entering the market difficult | **Characteristics:**<br>• Only one supplier in a given market<br>• Monopoly achieved without government intervention, by innovation, specialization, exclusive contracts, or a simple lack of competitors<br>• Products are unique, with no direct replacements available<br>• Barriers to entry are extremely high, making entering the market difficult or impossible | **Characteristics:**<br>• Only one supplier in a given market<br>• Monopoly granted by government mandate, such as a license to provide cable TV and Internet service<br>• No product competition is allowed<br>• Barriers to entry are infinitely high; new competitors are not allowed |
| **Price competition:**<br>• No single firm can grow large enough to influence prices across the market | **Price competition:**<br>• Firms that excel in one or more aspects can gain some control over pricing | **Price competition:**<br>• Individual firms can have considerable control over pricing | **Price competition:**<br>• Suppliers can charge as much as they want, at least until people stop buying | **Price competition:**<br>• Prices are set by government mandate |
| **Buyers' choices:**<br>• Extensive | **Buyers' choices:**<br>• Extensive | **Buyers' choices:**<br>• Limited | **Buyers' choices:**<br>• None | **Buyers' choices:**<br>• None |

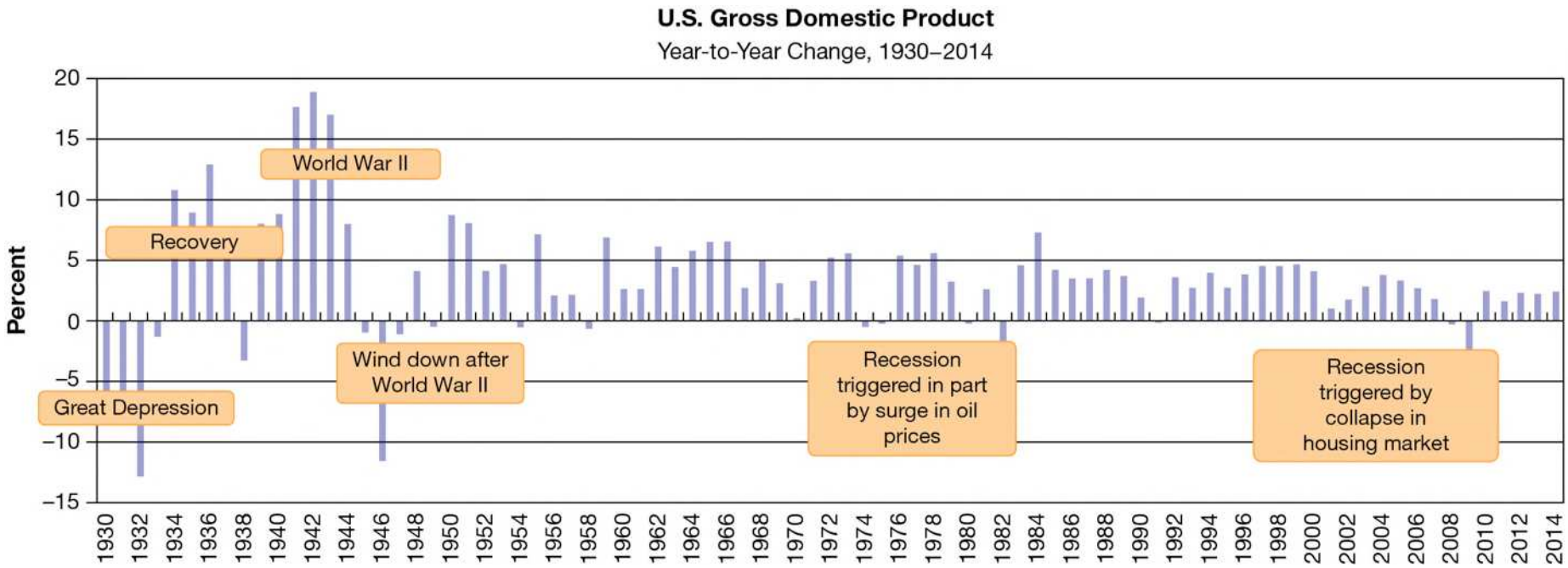
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# Business Cycles

- **Recession**
  - A period during which national income, employment, and production all fall; defined as at least six months of decline in the GDP
- **Business cycles**
  - Fluctuations in the rate of growth that an economy experiences over a period of several years

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# Exhibit 2.7 Fluctuations in the U.S. Economy



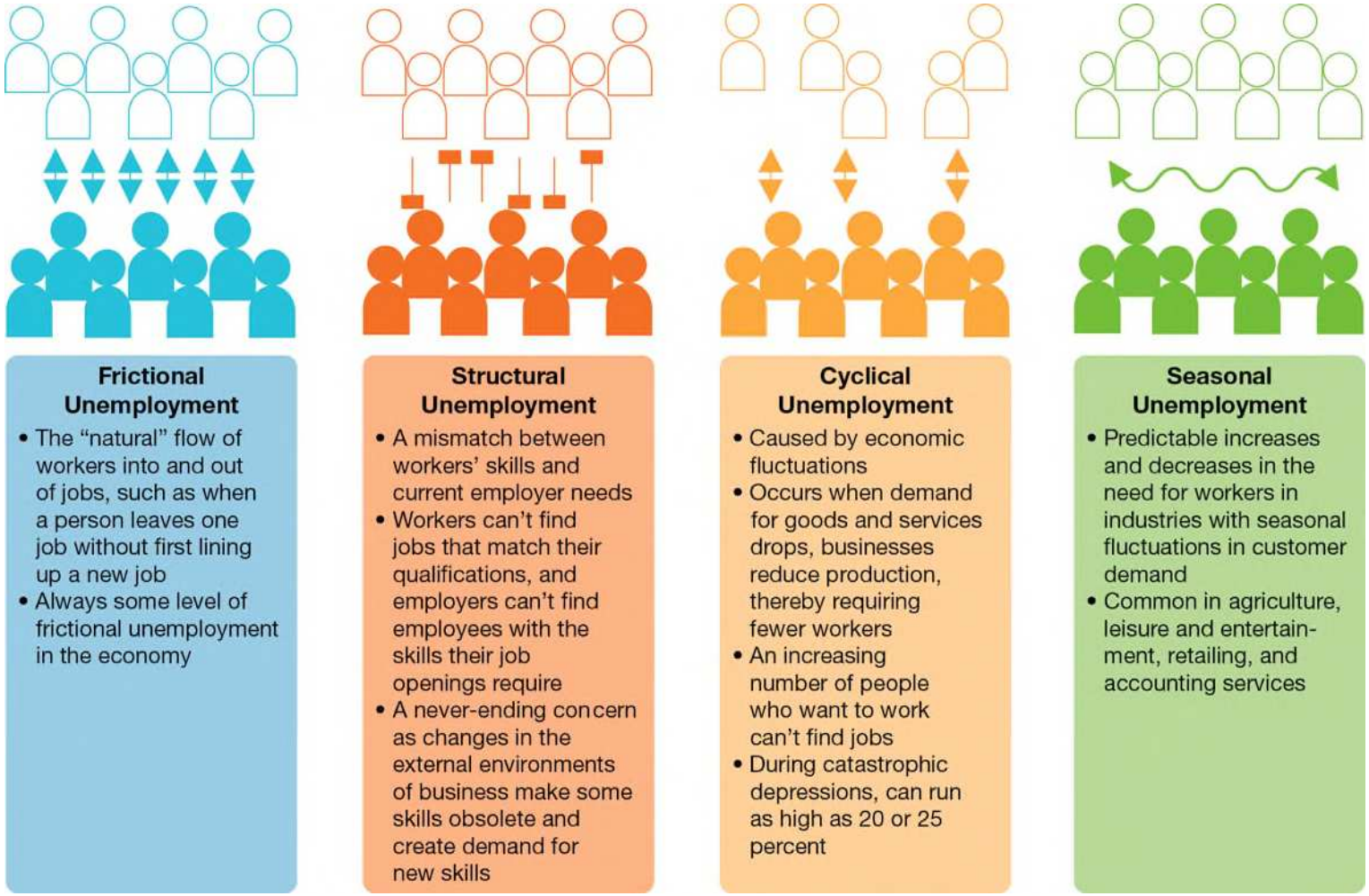

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# Unemployment

- **Unemployment rate**
  - The portion of the labor force (everyone over 16 who has or is looking for a job) currently without a job

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# Exhibit 2.8 Types of Unemployment




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# Inflation and Deflation

- **Inflation**
  - An economic condition in which prices rise steadily throughout the economy
- **Deflation**
  - An economic condition in which prices fall steadily throughout the economy

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# Government's Role in a Free-Market System

- Protecting stakeholders
- Fostering competition
- Encouraging innovation and economic development
- Stabilizing and stimulating the economy

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# Government's Role in a Free-Market System (cont.)

- **Regulation**
  - ↳ Relying more on laws and policies than on market forces to govern economic activity
- **Deregulation**
  - ↳ Removing regulations to allow the market to prevent excesses and correct itself over time

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# Stabilizing and Stimulating the Economy

- **Monetary policy**
  - ↳ Government policy and actions taken by the Federal Reserve Board to regulate the nation's money supply
- **Fiscal policy**
  - ↳ Strategy for the use of government revenue collection and spending to influence the business cycle

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# Exhibit 2.9 Major Government Agencies and What They Do

| Government Agency or Commission | Major Areas of Responsibility |
|---|---|
| Consumer Financial Protection Bureau (CFPB) | Educates consumers about and supervises providers of consumer financial services |
| Consumer Product Safety Commission (CPSC) | Regulates and protects public from unreasonable risks of injury from consumer products |
| Environmental Protection Agency (EPA) | Develops and enforces standards to protect the environment |
| Equal Employment Opportunity Commission (EEOC) | Protects and resolves discriminatory employment practices |
| Federal Aviation Administration (FAA) | Sets rules for the commercial airline industry |
| Federal Communications Commission (FCC) | Oversees communication by telephone, telegraph, radio, and television |
| Federal Energy Regulatory Commission (FERC) | Regulates rates and sales of electric power and natural gas |
| Federal Highway Administration (FHA) | Regulates vehicle safety requirements |
| Federal Trade Commission (FTC) | Enforces laws and guidelines regarding unfair business practices and acts to stop false and deceptive advertising and labeling |
| Food and Drug Administration (FDA) | Enforces laws and regulations to prevent distribution of harmful foods, drugs, medical devices, and cosmetics |
| Interstate Commerce Commission (ICC) | Regulates and oversees carriers engaged in transportation between states: railroads, bus lines, trucking companies, oil pipelines, and waterways |
| Occupational Safety and Health Administration (OSHA) | Promotes worker safety and health |
| Securities and Exchange Commission (SEC) | Protects investors and maintains the integrity of the securities markets |
| Transportation Security Administration (TSA) | Protects the national transportation infrastructure |

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# Exhibit 2.10 Major Types of Taxes

| Type of Tax | Levied On |
|---|---|
| Income taxes | Income earned by individuals and businesses. Income taxes are the government's largest single source of revenue. |
| Real property taxes | Assessed value of the land and structures owned by businesses and individuals. |
| Sales taxes | Retail purchases made by customers. Sales taxes are collected by retail businesses at the time of the sale and then forwarded to state governments. Disputes continue over taxes e-commerce sales made across state lines. |
| Excise taxes | Selected items such as gasoline, tobacco, and liquor. Often referred to as "sin" taxes, excise taxes are implemented in part to help control potentially harmful practices. |
| Payroll taxes | Earnings of individuals to help fund Social Security, Medicare, and unemployment compensation. Corporations match employee contributions. |

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# Economic Measures and Monitors

- **Economic indicators**
  - Statistics that measure the performance of the economy
  - Leading, lagging

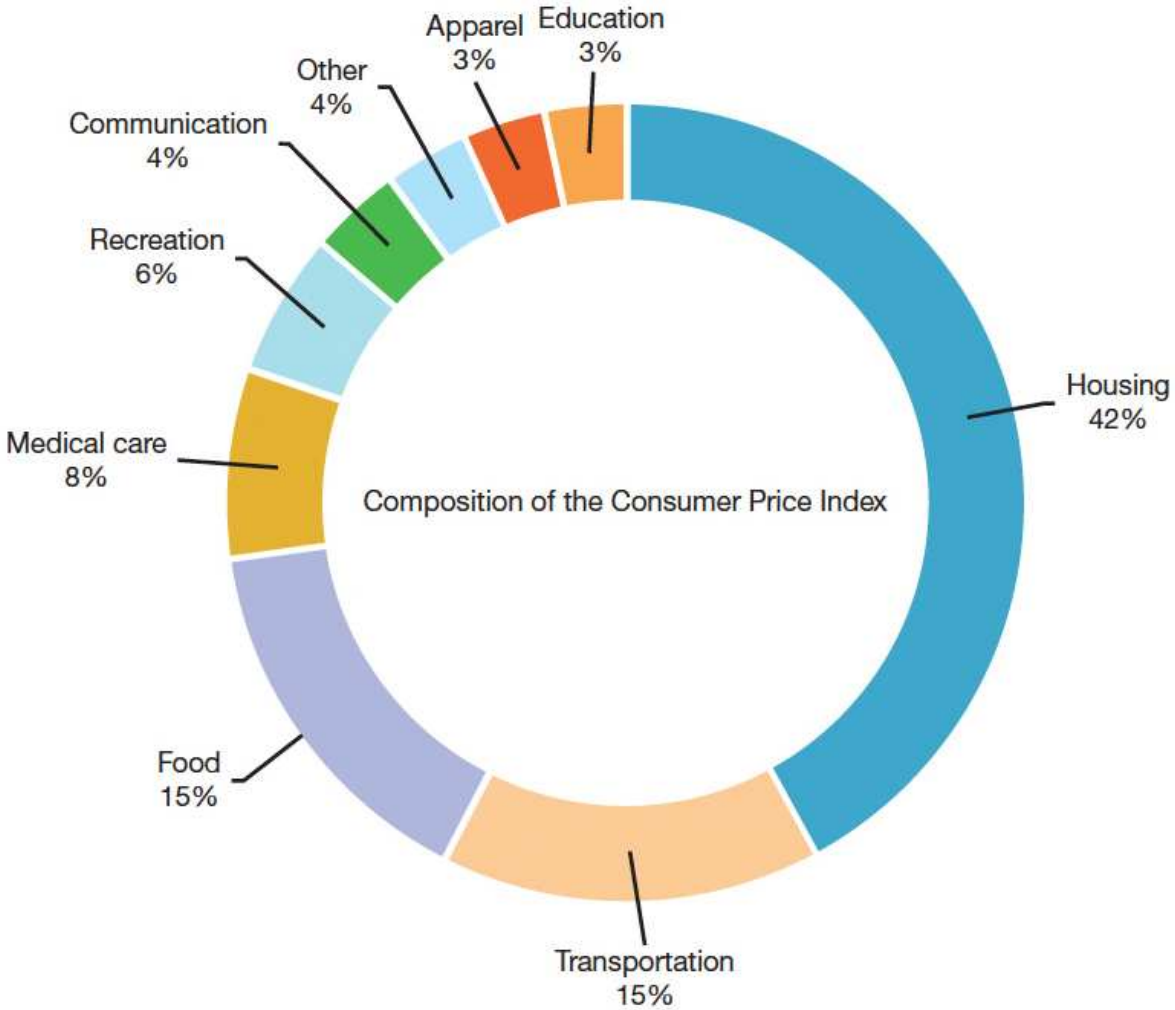
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# Price Indexes

- **Consumer price index (CPI)**
  - ↳ A monthly statistic that measures changes in the prices of a representative collection of consumer goods and services
- **Producer price index (PPI)**
  - ↳ A statistical measure of price trends at the producer and wholesaler levels

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# Exhibit 2.11 Composition of the Consumer Price Index




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# National Economic Output

- **Gross domestic product (GDP)**
  - The value of all the final goods and services produced by businesses located within a nation's borders; excludes outputs from overseas operations of domestic companies

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# Applying What You've Learned

1. Define *economics*, and explain why scarcity is central to economic decision making.
2. Differentiate among the major types of economic systems.
3. Explain the interaction between demand and supply.

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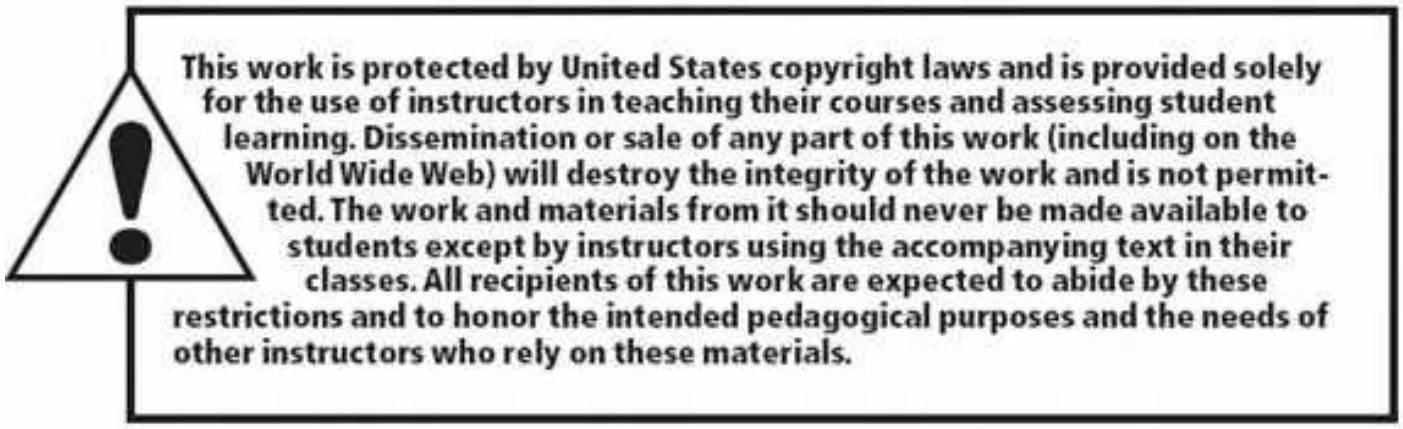
# Applying What You've Learned (cont.)

4. Identify four macroeconomic issues that are essential to understanding the behavior of the economy.
5. Outline the debate over deregulation, and identify four key roles that governments play in the economy.
6. Identify the major ways of measuring economic activity.

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