Chapter Two
Economics: The Framework for Business

Review Questions

1. How did the global economic crisis unfold?

2. What steps did the Federal government and the Federal Reserve take to mitigate the crisis?

3. Compare and contrast microeconomics and macroeconomics. How do the two approaches interrelate? Use a specific example to explain.

4. What is the difference between fiscal and monetary policy? What role does politics play in shaping these policies?

5. What are the fundamental elements of the free market economic system? How can businesses thrive within this system?

6. Describe the difference between a monopolistic competition and a monopoly.

7. Why does quantity supplied tend to increase when prices go up and decrease when prices go down? Why does quantity demanded move in the opposite direction?

8. Describe the key principles of socialist and communist economic systems. Does more government control mean less economic opportunity? Why or why not?

9. Why do most countries have neither “pure” market nor “pure” planned economies? Is the trend toward the market end of the spectrum likely to continue? Why?

10. How do gross domestic product, the employment rate, and the inflation rate relate to the business cycle? Why is it difficult to predict changes in the business cycle?

Application Questions

1. Research four industries—past or present—that represent the four degrees of competition (pure competition, monopolistic competition, oligopoly, and monopoly). For each example, describe the industry, explain how it came to embody that type of competition, and describe how difficult it would be for an entrepreneur to enter the industry. Finally, provide your opinion regarding

whether certain industries are better suited to certain degrees of competition, or if all industries should strive toward one single type of competition in particular.

2. Over the last decade, a number of agricultural producers have broken free of pure competition, creating a meaningful difference—and commanding higher prices—for entire categories such as hormone-free milk and organic produce, and for individual brands such as Dole pineapples and Chiquita bananas. But many agricultural products remain undifferentiated. Examples include watermelons, carrots, and pears. Choose one example and develop a strategy to differentiate that product in the minds of consumers. Present your strategy to the class, and ask if they would be willing to pay extra for it. Why or why not?

3. How does America's economic system affect your day-to-day life? How would your life be different if you lived under socialism or communism? How would it be different if you lived under a purely free market system?

4. Major events in our country tend to have significant economic consequences. Consider the following events, and determine the likely impact of each on the five measures of economic performance discussed in the book (gross domestic product, employment, the business cycle, price levels, and productivity):
    - The Hurricane Sandy aftermath
    - The influx of illegal immigrants in the U.S.
    - The subprime mortgage crisis

5. With the current size of the U.S. federal debt, you might think that it has been around forever, but

the outsized federal debt is actually a fairly recent phenomenon. Use the Internet to research the history of the federal debt. What triggered the periods of growth and decline? How do you think the federal debt will affect you? Do you believe it will ever go down to zero? Why or why not?

Team Project

You are the governing council of a small but happy nation. Your country has a stable economy, a sustainable soybean industry, and a sizable army. You are on good terms with your four neighbors to the north, east, west, and south, but if you asked any favors of them, they would certainly want something in return.

Without warning, your neighbor to the west (and closest trading partner) collapsed under the weight of an economic crisis and fell into a state of anarchy. Its government has disappeared, its money is worthless, and its people are starving. If you can no longer trade with this neighbor, there's a chance that your country will face an economic crisis of its own. If you provide too much aid, however, your own people will starve and your neighbor will come to rely on you. If you do nothing, you face the ire of a failed state with nothing to lose. Your people don't have much to give, and they fear that economic ruin is just around the corner.

As a group, determine a creative path forward—what fiscal and/or monetary policies will you enact to sustain your own economy while dealing with your former trading partner? Create a list of action items, and write a brief narrative detailing how you expect your plan to play out. Share your decisions with the class, and discuss the similarities and differences in your action plans.

Case Connection

The Consumer Financial Protection Bureau: Too Far, or Not Far Enough?

Recall from the chapter that during the economic crisis of the late 2000s, subprime mortgages were sliced up and resold as specialized securities. As more and more households went upside-down, an estimated $2 trillion worth of these assets became toxic. The banks and investment houses that held these toxic assets could not sell them for even a fraction of their original worth, pushing those companies further into economic turmoil. As the crisis worsened and panic set in, some institutions took advantage of the lack of regulation and governmental oversight in the industry, selling these toxic assets to unsuspecting buyers as if they still held value.

Many of the participants in these schemes were eventually exposed, leading to a number of high profile, high stakes lawsuits. In October 2012, for example, federal prosecutors filed a $1 billion suit against Bank of America for knowingly committing mortgage fraud from 2007 to 2009. The discovery of rampant fraud in the financial sector also led to the creation of the Consumer Financial Protection Bureau (CFPB), a new federal agency tasked with regulating banks, payday lenders, and other financial services companies.

First proposed by Massachusetts Senator Elizabeth Warren in 2007 and signed into law in 2010, the CFPB proved a hot-button political issue from the moment it was announced. Lauded by consumer advocates eager for protection and loathed by Wall Street bankers who felt they were being unfairly punished, the CFPB captivated media attention as politicians debated the agency's organizational structure. A congressional blockade forced President Barack Obama to skip over Warren as the agency's first director, instead choosing Ohio Attorney General Richard Cordray in a controversial pro-forma recess appointment.

The CFPB's core functions include writing and enforcing federal regulatory laws, restricting practices that it deems unfair or abusive, promoting financial education, and processing consumer complaints. Much of the controversy surrounding the agency revolves around its power to regulate business practices. In the first three months of 2013, for example, the CFPB issued 10 new regulations regarding credit card fees, automated teller machine (ATM) fee disclosures, and more. While some believe the CFPB is crucial to avoiding another economic crisis, others believe that the agency oversteps its bounds and stifles innovation.

Those who believe the CFPB should be allowed to maintain—even extend—its regulatory powers make the following points:

- Weighing the positive aspects of the agency, the Economist's Schumpeter blog suggests that the financial sector has long eluded regulation thanks to weak, ineffective legislation. The CFPB is agile, powerful, and aggressive enough to contend with a deceitful industry that has operated under its own rules for too long.
- When you buy a new car, fresh produce, or ibuprofen, you can safely assume that the product has undergone rigorous testing to ensure that it is safe. When it comes to buying a mortgage or a credit card, however, you must rely solely on the word of the company trying to sell you the product. The CFPB serves as an independent advocate for the safety of individual consumers, says TIME's Michael Grunwald.
- The CFPB can restrict the practices that led to the Great Recession, and perhaps even prevent the next economic crisis. To this end, consumer advocacy group Consumer Action contends, "To

prevent another bailout, we need to extend the government's resolution authority – currently limited to FDIC-insured banks – to cover non-bank financial companies, as well."

However, those who want to abolish the CFPB (or at least substantially limit its power) make several compelling counterpoints:

- Weighing the negative aspects of the agency, the Economist's Schumpeter blog suggests that the CFPB is far too large. A financial firm might be sued by one wing of the agency for providing a financial product to a segment of the population, and sued by another wing for not providing that same product to the same segment of the population. Thus, the column argues, the CFPD is destined to devolve into a prosecutorial bureaucracy.
- According to CBS's Marlys Harris, the CFPB will threaten the health of banks that provide financing for businesses, stifling job creation and innovation. By regulating the banking sector's most profitable products and services, the CFPB will force banks to be more conservative with their money, making them less likely to grant loans to entrepreneurs and small businesses.
- The United States Congress has a constitutional right to oversee agency budgets. However, the CFPB's funding comes directly from the Federal Reserve, sidestepping congressional approval. Without a congressional check on CFPB spending, economist George Will argues that the agency is answerable to no one—and may even be unconstitutional.

You Decide:

- In your opinion, is the Consumer Financial Protection Bureau necessary? Should its powers be extended, abridged, maintained, or abolished? Explain, citing the arguments you think are the most relevant to support your position.

- In Chapter 1, you learned that business moves at breakneck speeds. On balance, do you believe that the Consumer Financial Protection Bureau will have an effect on change in the financial industry? Will it affect the U.S. economy as a whole? Explain.

- How did the economic crisis of the late 2000s affect the United States' overall economic environment? How does the Consumer Financial Protection Bureau fit into that environment? Use the chapter text to support your answer.

Sources: "U.S. Accuses Bank of America of a 'Brazen' Mortgage Fraud," by Ben Protess, New York Times website: http://dealbook.nytimes.com/2012/10/24/federal-prosecutors-sue-bank-of-america-over-mortgage-program; "Interview: Richard Cordray: Consumer Finance Protection Bureau," PBS website: http://www.pbs.org/wnet/need-to-know/economy/interview-richard-cordray-consumer-finance-protection-bureau/16774; "Treasury Unveils Plan to Buy Troubled Assets," NBC News website: http://www.nbcnews.com/id/29817617/ns/business-stocks_and_economy/t/treasury-unveils-plan-buy-troubled-assets; "About Us," Consumer Finance Protection Bureau website: http://www.consumerfinance.gov/the-bureau; "Regulations," Consumer Finance Protection Bureau website: http://www.consumerfinance.gov/regulations; "Blessing or Bureaucracy," Economist website: http://www.economist.com/blogs/schumpeter/2012/01/consumer-financial-protection-bureau; "The Case Against the Consumer Financial Protection Bureau," by Marlys Harris, CBS News website: http://www.cbsnews.com/8301-505145_162-38141193/the-case-against-the-consumer-financial-protection-bureau. "Answerable to No One," by George F. Will, Washington Post website: http://www.washingtonpost.com/opinions/george-will-a-government-agency-answerable-to-no-one/2012/11/16/27a4f604-2f53-11e2-9f50-0308e1e75445_story.html

Chapter Two
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Supply and Demand

Purpose: To demonstrate how macroeconomic concepts are integral to our daily lives

Background: Often without realizing it, many students understand and apply the concepts of supply, demand, and substitute products. This quick, discussion-based exercise is designed to demonstrate that these concepts are directly relevant to their lives, and completely consistent with their intuition and common sense.

Estimated Class Time: About 5 to 15 minutes, depending on group formations

Preparation/Materials: You may want to distribute copies of the scenario and questions

Exercise: Ask your students how many of them drink coffee. With a little probing, you could divide them into four groups based on whether they are light (up to 1 cup per day), medium (2 to 3 cups per day), heavy (4 or more cups per day), or non-coffee drinkers. (If you have less time available, this exercise also works well as a full-class discussion.) Share the scenario below, write the following questions on the board, and ask each group to try to reach a general consensus regarding their response. Direct them to appoint a spokesperson and report back to the class after about 5 to 10 minutes. Compare and contrast responses among the groups.

Scenario: The price of coffee in all of its forms (from prepared drinks at Starbucks to whole beans at the grocery store) has suddenly doubled. What will you do? How (if at all) will your coffee-drinking habits change? What factors will influence you? When you circulate among the groups, encourage them to consider the influence of the following:

- Why do they drink coffee? For the taste? To socialize? For the caffeine?
- What portion of their discretionary income do they currently spend on coffee? How would that change with the price increase?
- How would their friends/families influence them?
- Are appealing substitutes (e.g. tea, soda) easily available?
- Would timing of the price increase change their responses (e.g. final exam week versus summer vacation)?

Discussion possibilities: What did students learn about supply and demand? How does a slight change in one factor affect the other? Which is the most dominant factor? Or are they considered equally powerful in economics dynamics?

Pure Competition and Other Categories of Competition

Purpose: To help students better understand the different categories of competition and to engage in critical thinking regarding the four degrees of competition.

Background: Identifying and understanding the competitive climate for a range of different businesses will help students make better decisions as future managers and entrepreneurs. This exercise is designed to facilitate that process and to sort out potential misunderstandings, especially regarding the difference between monopolistic competition and monopolies. Clearly, pure competition—using agriculture as the example—makes for a very challenging business environment. This exercise will highlight agricultural producers who have broken free from these constraints, reaping additional profits through branding.

Estimated Class Time: About 15 minutes

Preparation/Materials: None needed

Exercise: Direct students to work with the one or two people sitting next to them to brainstorm—in five minutes—a list of industries that compete in each of the four categories: pure competition, monopolistic competition, oligopoly, and monopoly. After five minutes, reconvene as a class and ask your students to call out examples by category as you list them on the board. This will give you an opening to straighten out confusion among the categories. When the lists are complete, it will be clear that monopolistic competition and oligopoly are the dominant categories.

Next, brainstorm with your students a list of agricultural producers that have established a meaningful difference in the minds of consumers...and thus a reason for higher prices. Examples include differentiated sub-categories such as organic products, hormone-free milk, and California fruits, plus differentiated brands such as Sunkist, Dole, and Chiquita. Divide students into groups of three to five. Direct each group to choose a generic agricultural product (e.g. watermelons, or apples grown in Minnesota), and develop a strategy to differentiate that product in the minds of consumers.

Ask each group to present its strategy to the class, and ask the class to provide feedback. Bottom line: Would they pay extra for the differentiated product? Why or why not?

Discussion possibilities: Review briefly the four degrees of competition: pure competition, monopolistic competition, oligopoly, and monopoly. In the first section, did the type of competition tend to evolve? If so, how? Why? (Many industries move from monopolistic competition to oligopoly, as major players buy out competitors in the ongoing struggle to build share. Example: PCs.) The second part of the exercise focused on pure competition. What conditions make pure competition different from the other formats?

The Business Cycle

Purpose: To demonstrate the impact of the business cycle on organizations

Background: Economic contractions and expansions occur over time in every economy. This cycle is seldom predictable. This quick, discussion-based exercise demonstrates the impact of the business cycle on students' colleges and universities.

Estimated Time: 5 minutes

Preparation/Materials: None needed

Exercise: Ask your students to think about what relationship the economy has with their college or university. As they jot down a few ideas, ask them to consider how increases in unemployment might affect, if at all, enrollment and various departments within their college or university.

Discussion Possibilities: Does enrollment increase as unemployment increases? Why or why not? How might an economic downturn impact available financial aid for students? What types of changes are administrators likely to make or avoid during times of economic expansion? In times of economic contraction?

Types of Economic Systems

Purpose: To compare and contrast the advantages and disadvantages of economic systems.

Background: Distinct characteristics distinguish free-market, command, and mixed economies. This exercise is designed to make clear distinctions between types of economic systems.

Estimated Class Time: About 20 minutes

Preparation/Materials: Ask students to review the characteristics of free-market, command, and mixed economic systems.

Notes:
Resource ownership and the level of control determine the type of market system used in one's culture or country. The three basic types of market systems are free market, command market, and mixed market.

- Free market—refers to resources and industries owned completely by private individuals. This economy type is driven by the goal of profit determined by consumer demand. In a free market, the government maintains a distant role, only ensuring the market remains stable. The market system has many benefits, but also some drawbacks. These include possible shortages and surpluses due to market fluctuations, income discrepancies that can lead to a society of very rich and very poor, and distribution of public services.
- Command market—works through central planning by a government that owns all the resources. Authorities own all resources and establish all facets of the economy, including what and how much is produced, financial compensation to workers, prices of products and who can receive them. The benefits of a true command market system include a similar quality of life—though it tends to be the lowest, not the highest, standard—for all citizens, with little homelessness and no inflation due to government price controls. The command system has a number of drawbacks including limited product selection, needs determined by the government that are truly compatible with what the society requires or wants and the restriction of personal freedoms. When workers do not own the resources, and receive the same amount of compensation regardless of what they do, there is no incentive to improve existing products or make innovations.
- Mixed market—most countries in the world employ a mix of free-market and command-market systems. In an ideal mixed market, both the businesses and the government work together to meet the demand for products in the safest and most efficient manner possible. Mixed market systems are favored by a wide range of societies because they can balance diverse economic and political ideals between groups with vastly different views.

Exercise: After students have reviewed the characteristics of the types of economic systems in the notes provided, divide the class into groups of four students. Ask each group to discuss the advantages and disadvantages existing under each of the types of economic systems from the perspectives of both a business owner and a consumer.

Discussion Possibilities: How do the laws of supply and demand vary within each economic system? For a business owner, what opportunities prevail within a free-market economy? Why is the U.S. considered a mixed economy? From a consumer's perspective, how might product and brand choices vary between a command economy and a free-market economy?

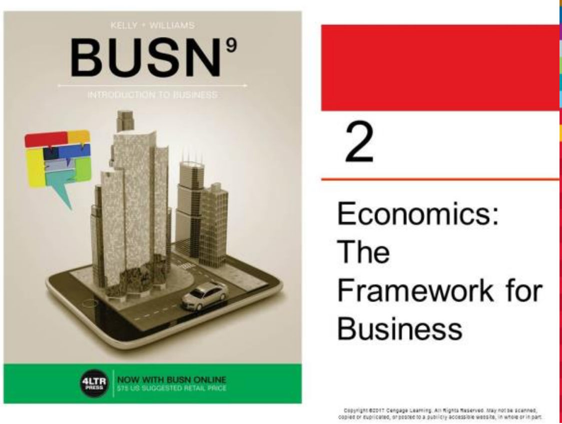
Chapter 2

Economics: The Framework for Business

Opening Activity: Ask students to share their understanding of the following words:

- Economics
- Budget
- Money
- Recession
- Inflation

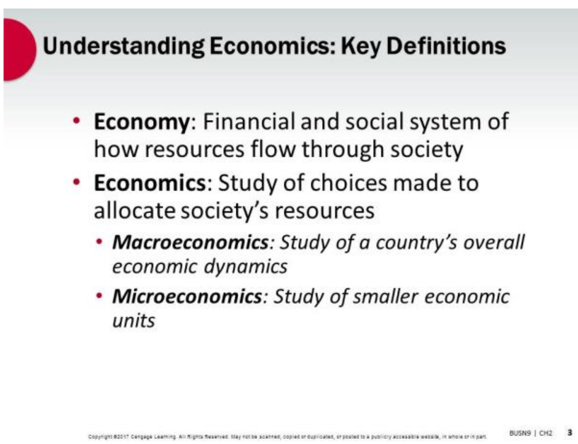
Slide 1



Slide 2

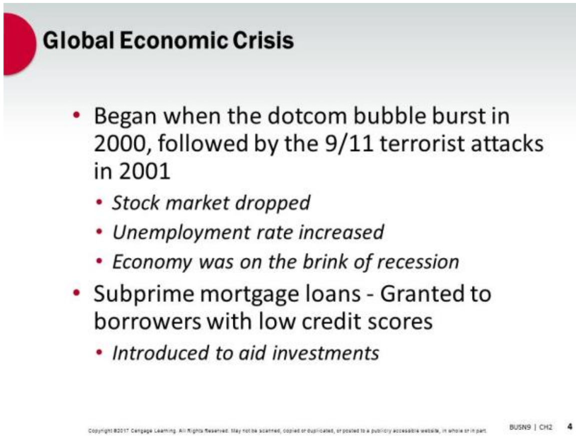
Encourage students to look for the answers to these as you move through the lecture.

Slide 3



Macroeconomics directly affects day-to-day life influencing things like what jobs will be available for people, how much salary an employee will take home after his/her taxes are deducted, etc.
Microeconomics deals with individual consumers, families, and businesses.
Macroeconomics and microeconomics played an integral role in the global economic crisis.

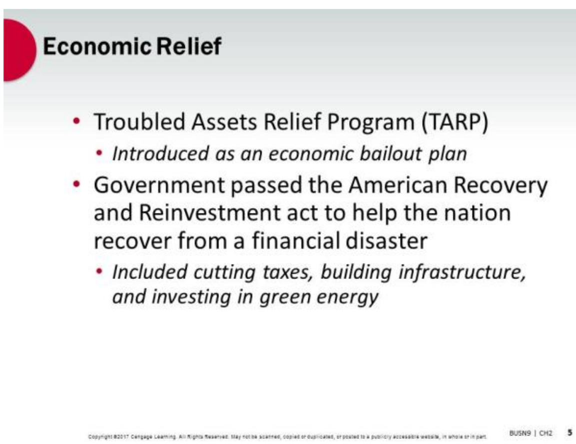
Slide 4



In an effort to avert recession by increasing the money supply and encouraging investment, the Federal Reserve decreased interest rates from 6.5% in mid-2000 to 1.25% by the end of 2002. Although the economy received a lot of money, the opportunities to invest were not that great. Subprime mortgage loans came into play attracting borrowers and lenders alike. However, as mortgage values dropped, financial institutions began to feel the pressure.

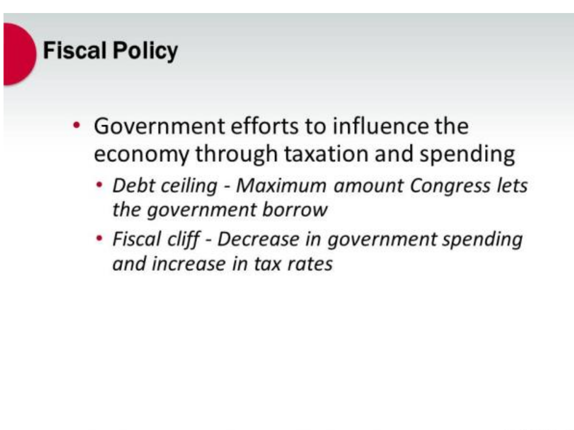
Lecture Booster: Screen the documentary, the *Inside Job* (2010) in the class.

Slide 5



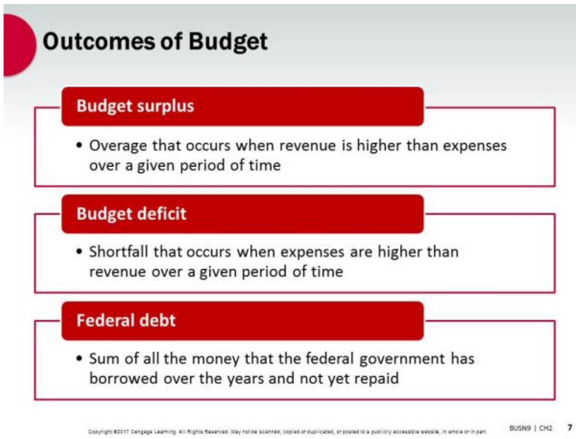
In October 2008, Congress passed the $700 billion TARP. By the end of the year, the Treasury had spent half of the money investing in banks. The Treasury also spent a portion of the money in a partial bailout of the auto industry.

Slide 6



Fiscal strategies are closely tied to political philosophy. But regardless of politics, most economists agree that lower taxes can boost the economy by leaving more money in people's pockets for them to spend or invest.
Most economists say that lowering the taxes can help in economic growth because people will have more money to spend or invest.

Slide 7

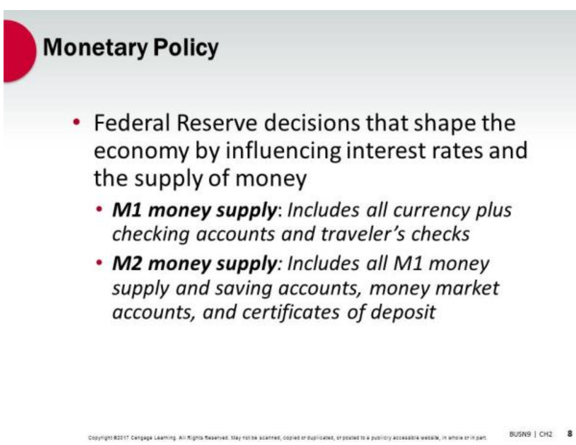


Every year, the government must create a budget, or a financial plan, that outlines expected revenue from taxes and fees, and expected spending.

The debt has grown every year since 1957, and the pace of growth will likely increase further in the wake of the economic crisis.

Lecture Booster: Allot 15 minutes to all the students and ask them to develop a budget for their own income and expenditures for the next one month and then discuss it with the rest of the class. Ask the students to discuss what they normally do when they face a budget surplus. Have the students ever enjoyed a budget surplus?

Slide 8



The core purpose of the Fed is to influence the size of the money supply, or the total amount of money within the overall economy.

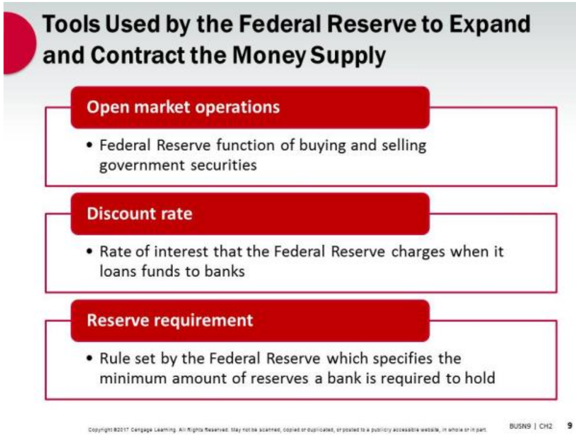
The most common definitions of money supply are M1 and M2.

In 2014, the M1 was $2.84 billion and M2 was about $11.6 billion.

If there is more money, interest rates fall. This encourages businesses to grow and consumers to spend.

If there is less money, interest rates increase. This reduces spending and checks inflation.

Slide 9



The Federal Reserve mostly uses the open market operations. Treasury bonds, notes, and bills are the IOUs the government issues to finance its deficit spending.
Open market operations are regulated by the Federal Open Market Committee.
If the Fed decreases the discount rate, it becomes easier for the banks to take out loans at a lower cost. This also reduces the rates on bank loans, thus stimulating the economy as people are more likely to borrow money and spend it too.
The reserve requirement benefits those depositors who want to borrow money without notice. Currently, the reserve requirement is 10% depending on the size and type of a bank's deposits.

Lecture Booster: Share the names of the present members of the Board of Governors. The Board of Governors of the Federal Reserve System (http://www.federalreserve.gov/default.htm; last accessed on January 27, 2015) has a lot of information that instructors could use.

Slide 10

Over time and around the globe, nations have instituted different economic systems. But a careful analysis suggests that no system is perfect, which may explain why there isn't one standard approach.
One core capitalist principle is the paramount importance of individuals, innovation, and hard work. In such a system, individuals, businesses, or nonprofit organizations privately own the vast majority of enterprises. These private-sector businesses are free to make their own choices regarding everything, and individuals are free to will buy, how much they are willing to pay, and where they will work. In this system companies must offer value to their customers.

Slide 11

The degree of competition differs between industries. A pure competition sees to it that no single producer controls the entire market's price.
In monopolistic competitions, producers have some control over the prices of their products, depending on the value that they offer their customers.
Breaking into a market characterized by oligopoly can be tough because it typically requires a huge upfront investment.
Monopolies tend to harm economies and that's why most monopolies have been made illegal under acts like the Sherman Antitrust Act (1890) and the Clayton Antitrust Act (1914).

Slide 12

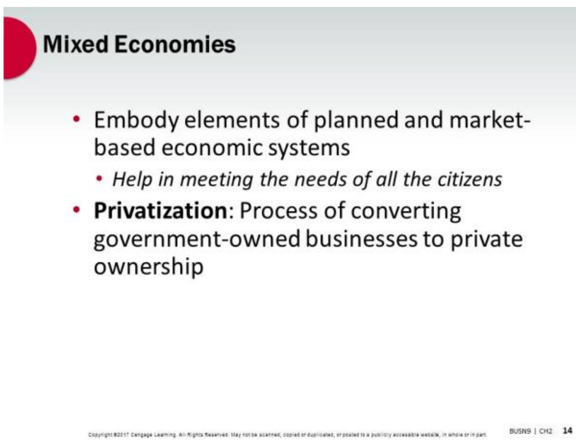
The concepts of supply and demand explain how the dynamic interaction between buyers and sellers directly affects the range of products and prices in the free market.
It's important to remember that supply and demand don't operate in a vacuum. The constant interaction between the two forces helps determine the market price in any given category. In theory, market prices adjust toward the point where the supply curve and the demand curve intersect.

Lecture Booster: Explain about Giffen goods to the students. Giffen goods are products or services whose demand increases when their price increases.

Slide 13

In planned economies, the government controls the economy. Socialism and communism are the two different types of planned economies. In a socialist economy although the official government goal is to run the key enterprises that directly affect public welfare enterprises in the best interest of the overall public, inefficiencies and corruption often interfere with effectiveness. Karl Marx introduced communism in his book *Communist Manifesto*. Countries that adopted communism—Soviet Union, North Korea, and Vietnam—have failed.

Slide 14



Pure economies—market or planned—will not be able to fulfill all the needs of the citizens. This is one of the reasons why most countries are opting for mixed economies.

Even the United States does not have a pure market economy. The various departments of the government own a number of enterprises like the postal services schools, etc.

In the last 30 years, the majority of economies have gone in for privatization.

The price of economic restructuring is very high and proves to be a hurdle for nations undergoing market reforms.

Lecture Booster: The instructor can share the growth of the mixed economy in a country of his or her choice.

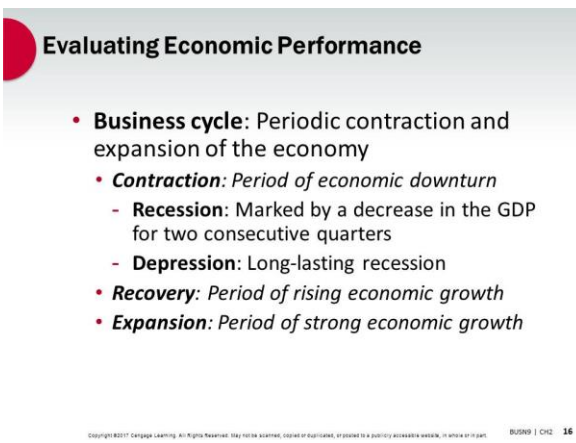
Slide 15

All domestic production is included in the GDP, even when the producer is foreign-owned. While calculating GDP, illegal activities and legal goods that are not reported to avoid taxation are not taken into consideration.

The level of employment contributes to a country's economic health. When people have jobs, they have money to spend and invest. This in turn will contribute to the company's economic growth.

Frictional unemployment tends to be ultimately positive, whereas the same is not true of structural unemployment, which happens when the economy has no need for skills that someone has to offer.

Slide 16



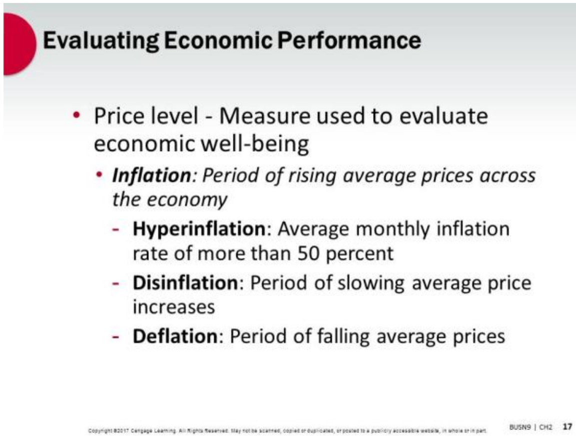
The cycle does not have a predictable pattern, the phases of the cycle are different each time they happen and no one can accurately predict the changes.

In the contraction phase businesses cut back on production, and consumers shift their buying patterns to more basic products and fewer luxuries.

In the recovery phase businesses begin to expand, consumers start to regain confidence, and spending begins to rise.

The expansion phase observes businesses expanding to capitalize on emerging opportunities. Consumers are optimistic and confident, which fuels purchasing, which fuels production, which fuels further hiring.

Slide 17



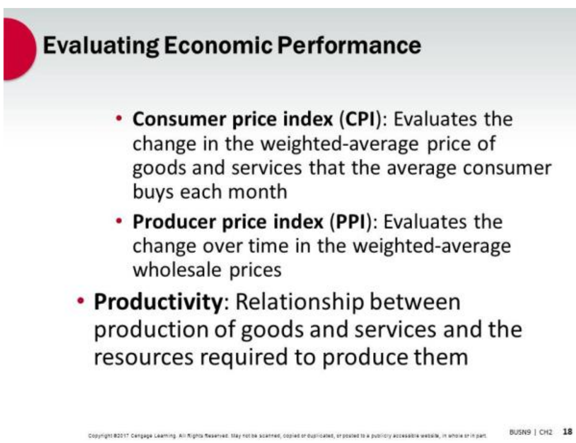
The rate of price changes is also a factor that is used to measure the economic well-being of a country.

A low level of inflation is a sign of a healthy economy. If inflation rises beyond control, it becomes hyperinflation.

The United States was going through a phase of disinflation in the mid-1990s and in the second half of 2008.

Deflation is a sign of economic trouble and is usually accompanied by rising unemployment.

Slide 18



Sometimes, the changes in the PPI predict that changes in the CPI because producers tend to pass on price increases and decreases to consumers within a month or two of the changes.

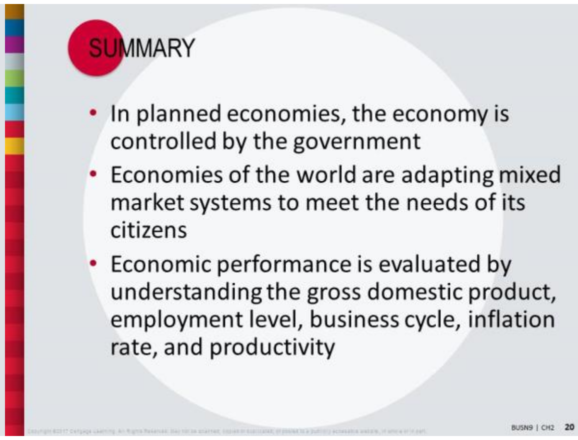
Most firms aim at producing more goods and services by using fewer hours and other inputs. If the productivity is high then GDP grows.

The advent of new technologies has helped the United States achieve good productivity.

Students' should remember that higher productivity doesn't indicate good quality.

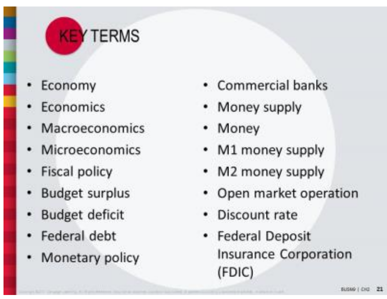
Slide 19

Slide 20



Now that the chapter is covered, revisit these points with the students.

Slide 21



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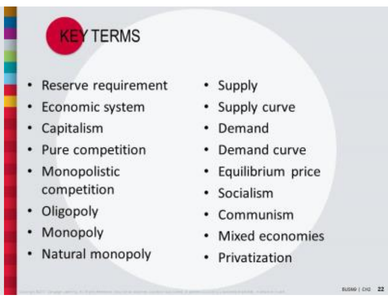

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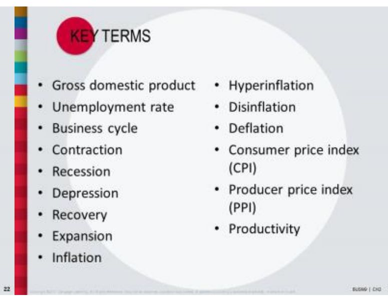

These slides list the important terms covered in this chapter.

Closing Activity: Ask students to individually research one product for which demand is likely to increase even when prices go up (a Giffen good).

The Assignment: Ask students to write a one-page report on the product that they researched and include reasons for its increasing demand.

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Economics: The Framework for Business

LEARNING OUTCOMES

1 Define economics and discuss the evolving global economic crisis

2 Analyze the impact of fiscal and monetary policy on the economy

3 Explain and evaluate the free market system and supply and demand

4 Explain and evaluate planned market systems

5 Describe the trend toward mixed market systems

6 Discuss key terms and tools to evaluate economic performance

Understanding Economics: Key Definitions

- **Economy**: Financial and social system of how resources flow through society
- **Economics**: Study of choices made to allocate society's resources
  - ***Macroeconomics***: *Study of a country's overall economic dynamics*
  - ***Microeconomics***: *Study of smaller economic units*

Global Economic Crisis

- Began when the dotcom bubble burst in 2000, followed by the 9/11 terrorist attacks in 2001
  - *Stock market dropped*
  - *Unemployment rate increased*
  - *Economy was on the brink of recession*
- Subprime mortgage loans - Granted to borrowers with low credit scores
  - *Introduced to aid investments*

Economic Relief

- Troubled Assets Relief Program (TARP)
  - *Introduced as an economic bailout plan*
- Government passed the American Recovery and Reinvestment act to help the nation recover from a financial disaster
  - *Included cutting taxes, building infrastructure, and investing in green energy*

Fiscal Policy

- Government efforts to influence the economy through taxation and spending
  - *Debt ceiling - Maximum amount Congress lets the government borrow*
  - *Fiscal cliff - Decrease in government spending and increase in tax rates*

Outcomes of Budget

Budget surplus

- Overage that occurs when revenue is higher than expenses over a given period of time

Budget deficit

- Shortfall that occurs when expenses are higher than revenue over a given period of time

Federal debt

- Sum of all the money that the federal government has borrowed over the years and not yet repaid

Monetary Policy

- Federal Reserve decisions that shape the economy by influencing interest rates and the supply of money
  - ***M1 money supply***: *Includes all currency plus checking accounts and traveler's checks*
  - ***M2 money supply****: Includes all M1 money supply and saving accounts, money market accounts, and certificates of deposit*

Tools Used by the Federal Reserve to Expand and Contract the Money Supply

Open market operations

- Federal Reserve function of buying and selling government securities

Discount rate

- Rate of interest that the Federal Reserve charges when it loans funds to banks

Reserve requirement

- Rule set by the Federal Reserve which specifies the minimum amount of reserves a bank is required to hold

Capitalism (Free Market System)

- Economic system based on:
  - *Private ownership - Right to own business and keep after-tax profits and to private property*
  - *Economic freedom - Right to free choice*
  - *Fair competition*

Degrees of Competition

- **Pure**: Many competitors selling identical products
- **Monopolistic**: Many competitors selling differentiated products
- **Oligopoly**: Handful of competitors selling products that can be similar or different
- **Monopoly**: One producer dominating the industry, leaving no room for competitors

Fundamental Principles of a Free Market System

- **Supply**: Quantity of products that producers are willing to offer for sale at different market prices
  - ***Supply curve***
- **Demand**: Quantity of products that consumers are willing to buy at different market prices
  - ***Demand curve***
- **Equilibrium price**: Quantity demanded of a product equals the quantity supplied

Planned Economies: Socialism and Communism

- **Socialism**: Government should own and operate key enterprises that directly affect public welfare
- **Communism**: Public ownership of all enterprises
  - *Under the direction of strong central government*

Mixed Economies

- Embody elements of planned and market-based economic systems
  - *Help in meeting the needs of all the citizens*
- **Privatization**: Process of converting government-owned businesses to private ownership

Evaluating Economic Performance

- **Gross domestic products (GDP)**
  - *Total value of all final goods and services produced within a nation's physical boundaries over a given period of time*
- Employment level
  - ***Unemployment rate****: Percentage of people in the labor force over age 16 who do not have jobs and are seeking employment*
    - Frictional and structural
    - Cyclical and seasonal

Evaluating Economic Performance

- **Business cycle**: Periodic contraction and expansion of the economy
  - ***Contraction****: Period of economic downturn*
    - **Recession**: Marked by a decrease in the GDP for two consecutive quarters
    - **Depression**: Long-lasting recession
  - ***Recovery****: Period of rising economic growth*
  - ***Expansion****: Period of strong economic growth*

Evaluating Economic Performance

- Price level - Measure used to evaluate economic well-being
  - ***Inflation**: Period of rising average prices across the economy*
    - **Hyperinflation**: Average monthly inflation rate of more than 50 percent
    - **Disinflation**: Period of slowing average price increases
    - **Deflation**: Period of falling average prices

Evaluating Economic Performance

- **Consumer price index** (**CPI**): Evaluates the change in the weighted-average price of goods and services that the average consumer buys each month
- **Producer price index** (**PPI**): Evaluates the change over time in the weighted-average wholesale prices

- **Productivity**: Relationship between production of goods and services and the resources required to produce them

SUMMARY

- Economics is the study of choices made to allocate society's resources
- Fiscal and monetary policies are used to improve economic performance
- Free market system is based on private ownership, economic freedom, and fair competition
  - *Supply and demand explain how the interaction between buyers and sellers directly affects the range of products and prices*

SUMMARY

- In planned economies, the economy is controlled by the government
- Economies of the world are adapting mixed market systems to meet the needs of its citizens
- Economic performance is evaluated by understanding the gross domestic product, employment level, business cycle, inflation rate, and productivity

KEY TERMS

- Economy
- Economics
- Macroeconomics
- Microeconomics
- Fiscal policy
- Budget surplus
- Budget deficit
- Federal debt
- Monetary policy
- Commercial banks
- Money supply
- Money
- M1 money supply
- M2 money supply
- Open market operation
- Discount rate
- Federal Deposit Insurance Corporation (FDIC)

KEY TERMS

- Reserve requirement
- Economic system
- Capitalism
- Pure competition
- Monopolistic competition
- Oligopoly
- Monopoly
- Natural monopoly
- Supply
- Supply curve
- Demand
- Demand curve
- Equilibrium price
- Socialism
- Communism
- Mixed economies
- Privatization

KEY TERMS

- Gross domestic product
- Unemployment rate
- Business cycle
- Contraction
- Recession
- Depression
- Recovery
- Expansion
- Inflation
- Hyperinflation
- Disinflation
- Deflation
- Consumer price index (CPI)
- Producer price index (PPI)
- Productivity

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