chapter 2

Understanding Economics and How It Affects Business

what's new in this edition

additions to the 11th edition:

- Getting to Know Matt Flannery of Kiva
- Name That Company: Florida Public Service Commission
- New key term: Core Inflation
- Spotlight on Small Business: Bugs Bug Orange Farmers and Drive Prices Up
- Reaching Beyond Our Borders: Economic Expansion in Africa

revisions to the 11th edition:

- Statistical data and examples throughout the chapter were updated to reflect current information.
- Making Ethical Decisions: How Corruption Harms the Economy

deletions from the 10th edition:

- Getting to John Maynard Keynes
- Name That Company: FINCA
- Reaching Beyond Our Borders
- Thinking Green
- Spotlight on Small Business
- Figure 2.7: How the Consumer Price Index is Put Together

brief chapter outline and learning objectives

CHAPTER 2

UNDERSTANDING ECONOMICS AND HOW IT AFFECTS BUSINESS

* Getting to Know MATT FLANNERY

* **learning objective 1**
  Explain basic economics.

I. HOW ECONOMIC CONDITIONS AFFECT BUSINESSES

- **A. What Is Economics?**
- **B. The Secret to Creating a Wealthy Economy**
- **C. Adam Smith and the Creation of Wealth**
- **D. How Businesses Benefit the Community**

* **learning objective 2**
  Explain what capitalism is and how free markets work.

II. UNDERSTANDING FREE-MARKET CAPITALISM

- **A. The Foundations of Capitalism**
- **B. How Free Markets Work**
- **C. How Prices Are Determined**
- **D. The Economic Concept of Supply**
- **E. The Economic Concept of Demand**
- **F. The Equilibrium Point, or Market Price**
- **G. Competition within Free Markets**
- **H. Benefits and Limitations of Free Markets**

* **learning objective 3**
  Compare socialism and communism.

III. UNDERSTANDING SOCIALISM

- **A. The Benefits of Socialism**
- **B. The Negative Consequences of Socialism**

IV. UNDERSTANDING COMMUNISM

* **learning objective** 4

Analyze the trend toward mixed economies.

V. THE TREND TOWARD MIXED ECONOMIES

* **learning objective** 5

Discuss the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

VI. UNDERSTANDING THE U.S. ECONOMIC SYSTEM

A. Key Economic Indicators

1. Gross Domestic Product
2. The Unemployment Rate
3. Inflation and Price Indexes

B. Productivity in the United States

C. Productivity in the Service Sector

D. The Business Cycle

* **learning objective** 6

Contrast *fiscal policy* and *monetary policy*, and explain how each affects the economy.

E. Stabilizing the Economy through Fiscal Policy

F. Fiscal Policy in Action during an Economic Crisis

G. Using Monetary Policy to Keep the Economy Growing

VII. SUMMARY

name that **company**

This organization has administrative control over the Florida Power and Light Company because the United States wants to control potential monopolies. What is the name of this organization?

Students should read the chapter before guessing the company's name: Florida Public Service Commission

Getting to Know MATT FLANNERY

Before he co-founded the microfunding company, Kiva.org, Matt Flannery tried to start ent other companies, but his heart wasn't in them. Flannery found his "dream job" in Kiva.

learning objective 1

Explain basic economics.

I. HOW ECONOMIC CONDITIONS AFFECT BUSINESSES

A. An economic system either promotes or hinders business activity.

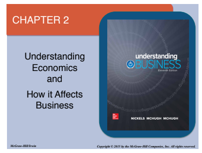
B. Much of America's business success is due to an economic and social climate that allows businesses to operate freely.

1. Any change in the U.S. economic system has a major influence on the business system.
2. Also, **GLOBAL ECONOMICS** and **WORLD POLITICS** have a major influence on U.S. business.

C. **WHAT IS ECONOMICS?**

1. ***ECONOMICS*** is the study of how society chooses to employ resources to produce goods and services and distribute them for consumption among various competing groups and individuals.

PPT 2-1
Chapter Title

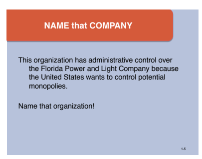


PPT 2-2
Learning Objectives

PPT 2-3
Learning Objectives

PPT 2-4
Matt Flannery

PPT 2-5
Name That Company



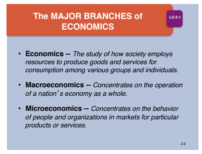
(See the complete PPT slide notes on page 2.43 of this manual.)

2. ***MACROECONOMICS*** is the part of economic study that looks at the operation of a nation's economy as a whole.
3. ***MICROECONOMICS*** is the part of economic study that looks at the behavior of people and organizations in particular markets.
4. *Economics* is sometimes defined as the allocation of scarce resources.
5. ***RESOURCE DEVELOPMENT*** is the study of how to increase resources and to create the conditions that will make better use of those resources.
6. Businesses help economic systems by inventing products and services that expand available resources *(example: mariculture, raising fish in ocean pens).*

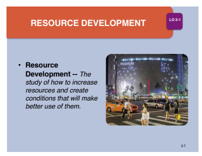
D. **THE SECRET TO CREATING A WEALTHY ECONOMY**

1. The English economist Thomas Malthus believed that population growth would outstrip resources.
   a. In response, Thomas Carlyle called economics **"THE DISMAL SCIENCE."**
   b. Many still believe, like Malthus, that the solution to poverty is birth control.
   c. **WORLD POPULATION** is currently growing more slowly than expected.
   d. But population in the **DEVELOPING WORLD** will continue to climb quickly.
2. Others believe that a large population can be a valuable resource, especially if people are educated.

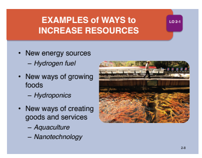
PPT 2-6
The Major Branches of Economics



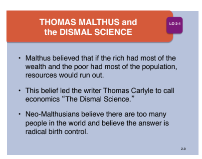
PPT 2-7
Resource Development



PPT 2-8
Examples of Ways to Increase Resources



PPT 2-9
Thomas Malthus and the Dismal Science



critical thinking exercise 2-1

KNOW YOUR HISTORY OF ECONOMICS

This Internet exercise is designed to help students gather information about economics from a historic perspective. (See the complete exercise on page 2.70 of this manual.)

lecture enhancer 2-1

INDIA'S UPCOMING ERA OF GROWTH

India is a burgeoning economic powerhouse with one of the fastest growing working-age populations. However, it must overcome some bumps in the road. (See the complete lecture enhancer on page 2.63 of this manual.)

3. The **SECRET TO ECONOMIC DEVELOPMENT** can be summed up in the saying *"Give a man a fish and you feed him for a day, but teach a man to fish and you feed him for a lifetime."*
4. Business owners provide **JOBS AND ECONOMIC GROWTH** for their employees as well as for themselves.
5. Economists and governments examine what makes some countries relatively rich and other countries relatively poor, then develop policies that lead to **INCREASED PROSPERITY** for everyone.

E. **ADAM SMITH AND THE CREATION OF WEALTH**

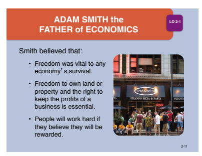
1. **ADAM SMITH** believed wealth could be created through entrepreneurship.
   a. Rather than dividing *fixed* resources, Smith envisioned creating *more* resources so that everyone could be wealthier.
   b. In 1776, Smith wrote ***THE WEALTH OF NATIONS,*** in which he outlined steps for creating prosperity.
2. Smith believed that **FREEDOM** was vital to the survival of any economy.
3. Also, he believed that people will work hard if they have **INCENTIVES** for doing so.
4. Smith is considered to be the **FATHER OF MODERN ECONOMICS.**

F**. HOW BUSINESSES BENEFIT THE COMMUNITY**

1. The ***INVISIBLE HAND*** is a phrase coined by Ad-

PPT 2-10
Population as a Resource

PPT 2-11
Adam Smith the Father of Econom-ics



critical thinking exercise 2-2

APPLYING ECONOMIC PRINCIPLES TO EDUCATION

Principles such as competition and productivity apply to nonprofit organizations, such as schools, as well as businesses. (See the complete exercise on page 2.71 of this manual.)

am Smith to describe the process that turns self-directed gain into social and economic benefits for all.

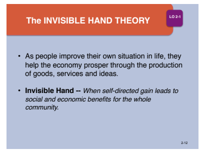
2. Basically, this meant that a person working hard to make money for his or her own **PERSONAL INTEREST** would *(like an invisible hand)* also **BENEFIT OTHERS.**
   a. *For example, a farmer trying to make money would grow as many crops as possible.*
   b. This would provide jobs and needed food for others.
   c. If everyone worked hard in his or her own self interest, Smith said, society as a whole would prosper.
3. Smith assumed that as people become wealthier, they would reach out to help the less fortunate, but that hasn't always happened.
   a. Many U.S. businesspeople are becoming concerned about social issues and their obligation to return to society some of what they've earned.
   b. It is important for businesses to be ethical as well as generous.

* **learning objective 2**

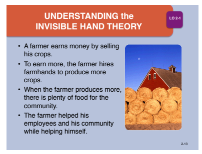
Explain what capitalism is and how free markets work.

II. UNDERSTANDING FREE-MARKET CAPITALISM

PPT 2-12
The Invisible Hand Theory



PPT 2-13
Understanding the Invisible Hand Theory



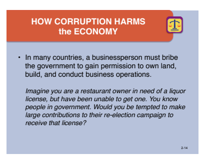
lecture enhancer 2-2

A NEW CROP OF CONSUMERS IN AFRICA

Africa has a growing middle class that rivals both China and India. Despite the persisting wealth disparities, more Africans have disposable incomes in which they can buy goods from others. (See the complete lecture enhancer on page 2.63 of this manual.)

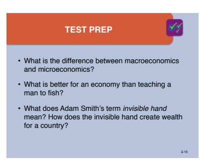
MAKING ethical decisions

PPT 2-14
How Corruption Harms the Economy



test prep

PPT 2-15
Test Prep



A. Following the ideas of Adam Smith, businesspeople created more wealth than ever before.
   1. But **GREAT DISPARITIES** in wealth remained or even increased.
   2. Although it is not easy, opportunities to start one's own business have always been there, especially in a free market.
   3. ***CAPITALISM*** is an economic system in which all or most of the factors of production and distribution are privately owned and operated for profit.
      a. In capitalist countries, businesspeople decide how to use their resources and how much to charge.
      b. No country is purely capitalist, but the foundation of the U.S. is capitalism.
      c. Capitalism is also the foundation for the economics of England, Canada, Australia, and most developed nations.
      d. Some countries are practicing **STATE CAPITALISM** where the state runs some businesses instead of private owners (e.g., China).

B. **THE FOUNDATIONS OF CAPITALISM**
   1. People under free-market capitalism have **FOUR BASIC RIGHTS:**
      a. The right to **PRIVATE PROPERTY**
      b. The right to **OWN A BUSINESS** and to keep all of that business's profits after taxes

bonus case 2-1

FOUNDATIONS OF THE CAPITALIST SYSTEM

What are the moral, ethical, and spiritual foundations of capitalism? (See the complete case, discussion questions, and suggested answers beginning on page 2.75 of this manual.)

PPT 2-16
Capitalism

lecture enhancer 2-3

TRACKING THE UNDERGROUND ECONOMY

Not all incomes are reported to the IRS. Is the U.S. government losing out? (See the complete lecture enhancer on page 2.64 of this manual.)

lecture enhancer 2-4

EU NATIONS ADD UNDERGROUND ECONOMIES TO GDP

EU countries like U.K., Italy, and Ireland are adding illicit activities like drug sales, prostitution, and even smuggling to their lists of official goods and services to boost their GDP. (See the complete lecture enhancer on page 2.65 of this manual.)

PPT 2-17
State Capitalism

c. The right to **FREEDOM OF COMPETITION**
d. The right to **FREEDOM OF CHOICE**

2. One benefit of such rights is that people are willing to take more **RISKS** than they would otherwise.
3. President Franklin Roosevelt believed **FOUR ADDITIONAL FREEDOMS** were essential:
   a. Freedom of **SPEECH AND EXPRESSION**
   b. Freedom to **WORSHIP IN YOUR OWN WAY**
   c. Freedom from **WANT**
   d. Freedom from **FEAR**

C. **HOW FREE MARKETS WORK**

1. In a free-market system, decisions about what to produce and in what quantities are made by **THE MARKET.**
2. **CONSUMERS** send signals to **PRODUCERS** about what to make, how many, and so on through the mechanism of **PRICE***. (Text example: T-shirts supporting favorite baseball teams.)*
3. In a free market the **PRICE** tells producers how much to produce, reducing the chances of a long-term shortage of goods.

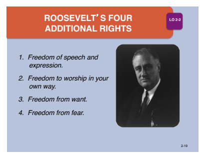
D. **HOW PRICES ARE DETERMINED**

1. Prices in a free market are not determined by sellers; rather, buyers and sellers negotiating in the marketplace determine them.
2. Price is determined through the economic concepts of supply and demand.

E. **THE ECONOMIC CONCEPT OF SUPPLY**

PPT 2-18
Capitalism's Four Basic Rights

PPT 2-19
Roosevelt's Four Additional Rights

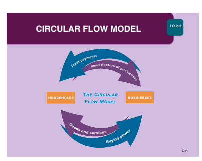


PPT 2-20
Free Markets

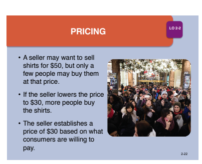
lecture enhancer 2-5
THE CIRCULAR FLOW MODEL

The Circular Flow Model is used to explain how businesses and individuals interact in a free-market economy. (See the complete lecture enhancer on page 2.65 of this manual.)

PPT 2-21
Circular Flow Model



PPT 2-22
Pricing



1. ***SUPPLY*** refers to the quantity of products that manufacturers or owners are willing to sell at different prices at a specific time.
2. The amount supplied will **INCREASE** as the price **INCREASES** (**DIRECT** relationship).
3. The quantity producers are willing to **SUPPLY** at certain prices is illustrated on a **SUPPLY CURVE.**

F. **THE ECONOMIC CONCEPT OF DEMAND**

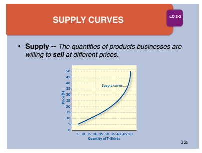
1. ***DEMAND*** refers to the quantity of products that people are willing to buy at different prices at a specific time.
2. The quantity demanded will **DECREASE** as the price **INCREASES** (**INVERSE** relationship).
3. The quantities consumers are willing to buy at certain prices are illustrated on a **DEMAND CURVE.**

G**. THE EQUILIBRIUM PRICE, OR MARKET PRICE**

1. The key factor in determining the quantity supplied and the quantity demanded is **PRICE.**
   a. At the **EQUILIBRIUM POINT**, the supply and demand curves cross**,** and the quantity demanded equals the quantity supplied.
   b. ***MARKET PRICE*** is the price determined by supply and demand.
2. In free-market economies it is the **INTERACTION** between **SUPPLY** and **DEMAND** that determines the market price in the long run.
   a. If **SURPLUSES** (too many products) develop, a signal is sent to sellers to **LOWER** the price.

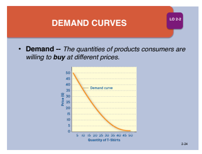
PPT 2-23
Supply Curves

TEXT FIGURE 2.1
The Supply Curve at Various Prices



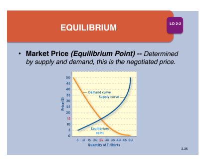
PPT 2-24
Demand Curves

TEXT FIGURE 2.2
Demand Curves



PPT 2-25
Equilibrium

TEXT FIGURE 2.3
The Equilibrium Point



critical thinking exercise 2-3

FINDING THE EQUILIBRIUM POINT

How does the equilibrium price of a product change when forces in the economy change? (See the complete exercise on page 2.72 of this manual.)

b. If **SHORTAGES** (not enough products) develop, a signal is sent to sellers to **INCREASE** the price.

c. Eventually, supply will again equal demand.

3. In countries without a free-market system, there is no such mechanism, so there are often **SHORTAGES OR SURPLUSES.**

4. When government interferes in free markets, surpluses and shortages may develop.

H. **COMPETITION WITHIN FREE MARKETS**

1. Competition exists in different degrees, ranging from perfect to nonexistent.

2. ***PERFECT COMPETITION*** is the degree of competition in which there are many sellers in a market and none is large enough to dictate the price of a product.

   a. Sellers produce products that appear to be **IDENTICAL**.

   b. *There are no true examples of perfect competition, but agricultural products are often used as an example.*

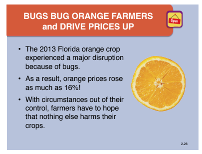
3. ***MONOPOLISTIC COMPETITION*** is the degree of competition in which a large number of sellers produce very similar products that buyers nevertheless perceive as different.

   a. **PRODUCT DIFFERENTIATION**, making buyers think similar products are different, is a key to success.

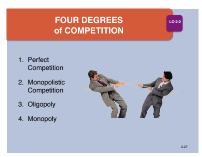
   b. *The fast-food industry is an example.*

SPOTLIGHT ON
small business

PPT 2-26
Bugs Bug Orange Farmers and Drive Prices Up



PPT 2-27
Four Degrees of Competition



4. An ***OLIGOPOLY*** is a degree of competition in which just a few sellers dominate a market.
    a. The **INITIAL INVESTMENT** required to enter the market is usually high.
    b. Prices among competing firms tend to be close to the same.
    c. *Examples include breakfast cereal and soft drinks.*
5. A ***MONOPOLY*** is a degree of competition in which only one seller controls the total supply of a product or service, and sets the price.
    a. U.S. laws prohibit the creation of monopolies, but do permit **APPROVED MONOPOLIES** in markets for public utilities.
    b. New laws have ended the monopoly status of utilities in some areas, creating intense competition among utility companies.
    c. **DEREGULATION** is meant to increase competition and lower prices for consumers.

I. **BENEFITS AND LIMITATIONS OF FREE MARKETS**

1. The free market allows open competition among companies.
2. Free-market capitalism provides opportunities for poor people to work their way out of poverty.
3. Capitalism also creates **INEQUITIES** between those who have gained wealth and those who are not able to.
4. Not all businesspeople agree on how to deal with this **INEQUITY**.

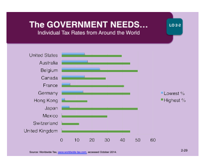
critical thinking exercise 2-4

STANDARD OF LIVING COMPARISON

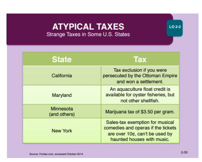
This exercise asks students to research key economic indicators for a capitalist country, a socialist country, and a communist country. (See the complete exercise on page 2.74 of this manual.)

PPT 2-28
Free Market Benefits and Limitations

PPT 2-29
The Government Needs . . .



PPT 2-30
Atypical Taxes



5. Greed has led some businesspeople to engage in **UNETHICAL PRACTICES** and deceive the public.
6. Some government **REGULATIONS ARE NECESSARY** to protect stockholders and vulnerable citizens.

* **learning objective** 3
  Compare socialism and communism.

III. UNDERSTANDING SOCIALISM

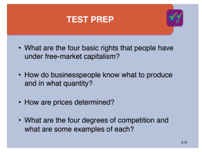
A. ***SOCIALISM*** is an economic system based on the premise that some, if not most, basic businesses should be owned by the government so that profits can be distributed among the people.
   1. Entrepreneurs can own small businesses, but their profits are **STEEPLY TAXED** to pay for social programs.
   2. Advocates of socialism acknowledge the major benefits of capitalism, but believe that **WEALTH SHOULD BE MORE EVENLY DISTRIBUTED.**

B. The **MAJOR BENEFIT** of socialism is **SOCIAL EQUALITY**.
   1. Income is taken from the wealthier people and redistributed to the poorer members of the population.
   2. Workers in socialist countries are given free education, free health care, free child care, and more employee benefits.

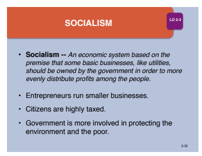
C. **THE NEGATIVE CONSEQUENCES OF SOCIALISM**
   1. Socialism may create **EQUALITY**, but it **TAKES AWAY SOME WORK INCENTIVES**.

test
prep

PPT 2-31
Test Prep



PPT 2-32
Socialism



PPT 2-33
Benefits of Socialism

2. Tax rates in some nations once reached 83%.
3. Because wealthy professionals have very high tax rates, many of them leave socialist countries for countries with lower taxes.
4. The loss of the best and brightest people to other countries is called ***BRAIN DRAIN.***
5. Socialist systems can result in **FEWER INVENTIONS AND LESS INNOVATION.**

IV. UNDERSTANDING COMMUNISM

A. ***COMMUNISM*** is an economic and political system in which the government makes almost all economic decisions and owns almost all the major factors of production.

B. **PROBLEMS WITH COMMUNISM**

1. The government has no way of knowing what to produce because prices don't reflect **SUPPLY** and **DEMAND**.
2. **SHORTAGES** of many items may develop.
3. Communism doesn't inspire businesspeople to work hard, and is slowly disappearing as an alternative economic form.

C. Most communist countries today are **SUFFERING SEVERE ECONOMIC DEPRESSION**, including North Korea and Cuba.

1. Some countries, such as Venezuela, are moving toward communism.
2. The former Soviet Union is moving toward free markets.

PPT 2-34
Negatives of Socialism

PPT 2-35
Communism

3. Russia now has a flat tax of 13%, a much lower tax rate than the U.S. has.
4. The trend toward free markets is growing.

* **learning objective** 4

  Analyze the trend toward mixed economies.

V. THE TREND TOWARD MIXED ECONOMIES

A. There are two dominant economic systems:

1. **FREE-MARKET ECONOMIES**
   a. ***FREE-MARKET ECONOMIES*** are economic systems in which the market largely determines what goods and services get produced, who gets them, and how the economy grows.
   b. This system is commonly known as **CAPITALISM.**
2. **COMMAND ECONOMIES**
   a. ***COMMAND ECONOMIES*** are economic systems in which the government largely decides what goods and services will be produced, who will get them, and how the economy will grow.
   b. These economies are known as **SOCIALISM** and **COMMUNISM**.

B. No one economic system is perfect by itself.

1. Free-market mechanisms haven't been responsive enough to a nation's social and economic needs and haven't adequately protected the environment.
2. Socialism and communism haven't always created enough jobs or wealth to keep economies growing

PPT 2-36
Two Major Economic Systems

fast enough.

3. Socialist and communist countries have moved toward **CAPITALISM**.
4. So-called capitalist countries tend to move toward **SOCIALISM**.
5. No country is purely socialist or purely capitalist, rather some **MIX OF THE TWO SYSTEMS**.
6. The result has been a **BLEND** of capitalism and communism.

C. ***MIXED ECONOMIES*** are economic systems in which some allocation of resources is made by the market and some by government.

D. **THE U.S. HAS A MIXED ECONOMY.**

1. The role of government in many parts of the economy is a matter of some debate.
2. For instance, the government has become the largest employer in the U.S.

* **learning objective 5**

Discuss the economic system of the United States, including the significance of key economic indicators (especially GDP), productivity, and the business cycle.

VI. UNDERSTANDING THE U.S. ECONOMIC SYSTEM

A. **KEY ECONOMIC INDICATORS**

1. **GROSS DOMESTIC PRODUCT (GDP)**

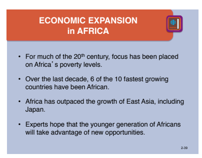
a. ***GROSS DOMESTIC PRODUCT (GDP)*** is the total value of final goods and services produced in a country in a given year.

b. Both domestic and foreign-owned companies can produce goods and services included in GDP.

PPT 2-37
Mixed Economies

PPT 2-38
Trending toward Mixed Economies

REACHING BEYOND
our borders

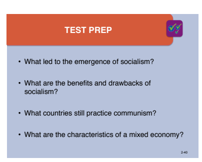


PPT 2-39
Economic Expansion in Africa

TEXT FIGURE 2.4
Comparisons of Key Economic Systems

This text figure compares capitalism, socialism, communism, and mixed economies on five key elements.

test prep



PPT 2-40
Test Prep

c. A major influence on the growth of GDP is how productive the workforce is.

d. ***GROSS OUTPUT (GO)*** is a measure of total sales volume at all stages of production.

e. GO is considered a better indicator of the business cycle.

2. **THE UNEMPLOYMENT RATE**

a. The ***UNEMPLOYMENT RATE*** is the number of civilians at least 16 years old who are unemployed and tried to find a job within the prior four weeks.

b. There are four types of unemployment: frictional, structural, cyclical, and seasonal (as seen in **Text Figure 2.5.)**

c. The U.S. tries to protect those who are unemployed because of recessions, industry shifts, and other cyclical factors.

3. **INFLATION AND PRICE INDEXES**

a. **THE PRICE INDEXES** help measure the health of the economy.

b. ***INFLATION*** is a general rise in the prices of goods and services over time.

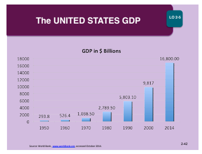
c. ***DISINFLATION*** is a situation in which price increases are slowing *(the inflation rate is declining).*

d. ***DEFLATION*** is a situation in which prices are declining, occurring when countries produce so many goods that people cannot afford to buy them all.

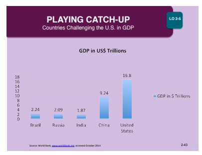
e. ***STAGFLATION*** is a situation when the

PPT 2-41
Gross Domestic Product

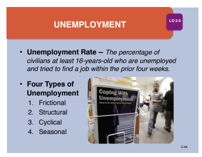
PPT 2-42
The United States GDP



PPT 2-43
Playing Catch Up



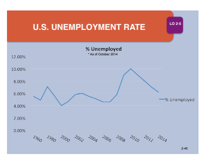
PPT 2-44
Unemployment



TEXT FIGURE 2.5
U.S. Unemployment Rate 1989–2014

This text figure shows the unemployment rate for the years from 1989 to 2014.

PPT 2-45
U.S. Unemployment Rate

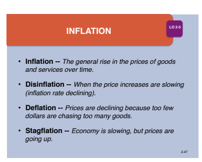


TEXT FIGURE 2.6
Four Types of Unemployment

This figure describes the four types of unemployment: frictional, structural, cyclical, and seasonal.

PPT 2-46
Best and Worst Cities for a Job Search

PPT 2-47
Inflation



economy is slowing, but prices keep going up anyhow.

f. **CONSUMER PRICE INDEX (CPI)**

i. The ***CONSUMER PRICE INDEX (CPI)*** consists of monthly statistics that measure the pace of inflation or deflation.

ii. Some wages, rents, government benefits, and interest rates are based on the CPI.

iii. **CORE INFLATION** is the CPI minus food and energy costs.

g. The ***PRODUCER PRICE INDEX (PPI)*** is an index that measures prices at the wholesale level.

B. **PRODUCTIVITY IN THE UNITED STATES**

1. U.S. productivity has gone up in recent years because computers have made production faster.
2. The **HIGHER PRODUCTIVITY** is, the **LOWER COSTS** are in producing goods and services, and the lower prices can be.
3. The U.S. economy is a **SERVICE ECONOMY**—very labor-intensive—creating productivity issues.

C. **PRODUCTIVITY IN THE SERVICE SECTOR**

1. Technologies may add to the quality of the services but not to the **OUTPUT PER WORKER** which is the definition of productivity.
2. New measures of productivity for the service economy are needed to measure **QUALITY** as well as **QUANTITY** of output.

D. **THE BUSINESS CYCLE**

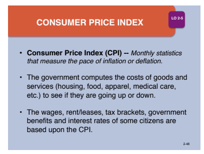
lecture enhancer 2-6
OTHER ECONOMIC INDICATORS

In addition to the GDP, CPI, and unemployment indicators, there are other economic indicators that can forecast changes in the economy. (See the complete lecture enhancer on page 2.66 of this manual.)

lecture enhancer 2-7
HOW ACCURATE IS GDP?

Many components go in to creating the GDP. However, some argue it's not entirely accurate. (See the complete lecture enhancer on page 2.67 of this manual.)

PPT 2-48
Consumer Price Index



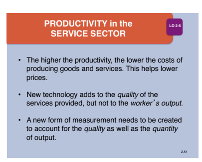
PPT 2-49
Producer Price Index

PPT 2-50
Productivity

lecture enhancer 2-8
HONDA BECOMES AN AMERICAN EXPORTER

After years of producing vehicles in the U.S., Honda has capitalized on the enhanced productivity here and has began shipping out its cars. (See the complete lecture enhancer on page 2.67 of this manual.)

PPT 2-51
Productivity in the Service Sector



1. ***BUSINESS CYCLES*** are the periodic rises and falls that occur in economies over time.
2. Joseph Schumpeter identified **FOUR PHASES OF BUSINESS CYCLES:**
   a. In an **ECONOMIC BOOM,** there is strong business activity.
   b. A ***RECESSION*** is two or more consecutive quarters of decline in the GDP.
   c. A ***DEPRESSION*** is a severe recession, usually accompanied by deflation.
   d. A **RECOVERY** occurs when the economy stabilizes.
3. The goal of economists is to predict these fluctuations, which can be very difficult.
4. Fluctuations in the economy are **INEVITABLE**.
5. The government uses **FISCAL** and **MONETARY** policy to minimize these disruptions.

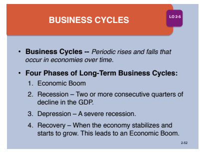
✱ **learning objective 6**

Contrast fiscal policy and monetary policy, and explain how each affects the economy.

E. **STABILIZING THE ECONOMY THROUGH FISCAL POLICY**

1. ***FISCAL POLICY*** is the federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending.
2. The first half of fiscal policy involves **TAXATION.**
   a. **HIGH TAX RATES** may discourage small-business ownership.
   b. **LOW TAX RATES** would tend to give the

PPT 2-52
Business Cycles



lecture enhancer 2-9
WHAT IS A DEPRESSION?

There is a well-established definition for a recession. A depression is, well, not so easy to define. (See the complete lecture enhancer on page 2.68 of this manual.)

PPT 2-53
Fiscal Policy

economy a boost.

3. The second half of fiscal policy involves **GOVERNMENT SPENDING.**
   a. The **NATIONAL DEFICIT** is the amount of money that the federal government spends over and above the amount it gathers in taxes.
   b. The ***NATIONAL DEBT*** is the sum of government deficits over time.
   c. The national debt of the U.S. is over **$17 TRILLION**.
4. One way to lessen the annual deficits is to **CUT GOVERNMENT SPENDING**, but there is a continuing need for social programs and for military spending.

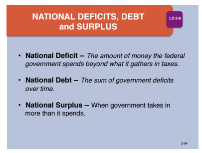
F. **FISCAL POLICY IN ACTION DURING AN ECONOMIC CRISIS**

1. President George W. Bush followed the basic economic principles of free markets.
   a. However, the economy plummeted and President Bush approved spending almost $1 trillion to revive the failing economy.
   b. President Barack Obama promised to spend additional funds.
2. ***KEYNESIAN ECONOMIC THEORY*** is the theory that a government policy of increasing spending and cutting taxes could stimulate the economy in a recession.

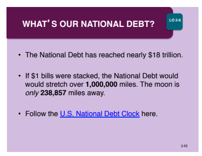
TEXT FIGURE 2.8
The National Debt

This text figure shows the national debt—the sum of government deficits over time—for years 1980 to 2014.

PPT 2-54
National Deficits, Debt, and Surplus



PPT 2-55
What’s Our National Debt?



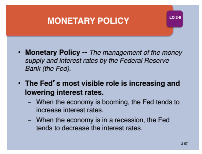
PPT 2-56
What Can a _____ Dollars Buy?

G. **USING MONETARY POLICY TO KEEP THE ECONOMY GROWING**

1. The **FEDERAL RESERVE SYSTEM (THE FED)** is a semiprivate organization that decides how much money to put into circulation.
2. ***MONETARY POLICY*** is the management of the monetary supply and interest rates; it is controlled by the Fed.
    a. When the economy is booming, the Fed tends to **RAISE INTEREST RATES.**
    b. **LOWERING INTEREST RATES** encourages more business borrowing.
    c. Raising and lowering interest rates helps control the rapid ups and downs of the economy.
    d. In 2010–2014, the Fed kept interest rates near zero, but the economy remained sluggish.
3. The Federal Reserve also controls the **MONEY SUPPLY**.
    a. The **MORE MONEY** the Fed makes available to businesspeople, the **FASTER THE ECONOMY GROWS.**
    b. To **SLOW THE ECONOMY**, the Fed **LOWERS** the money supply.
4. The economic goal is to keep the economy growing.

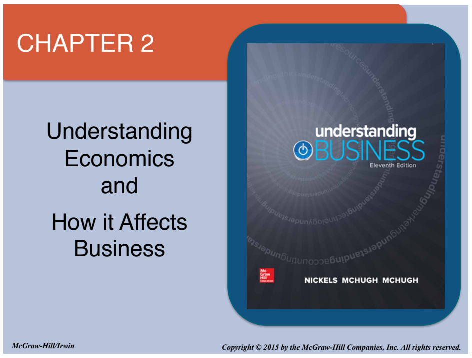
VII. SUMMARY

PPT 2-57
Monetary Policy



PowerPoint slide notes

PPT 2-1
Chapter Title



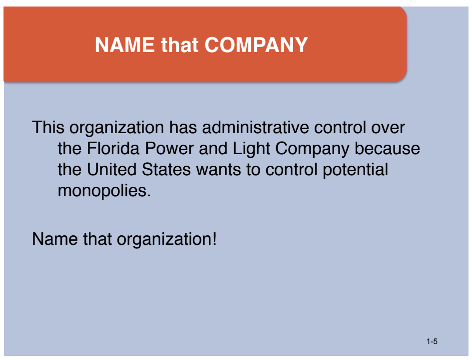
PPT 2-2
Learning Objectives

PPT 2-3
Learning Objectives

PPT 2-4
Matt Flannery

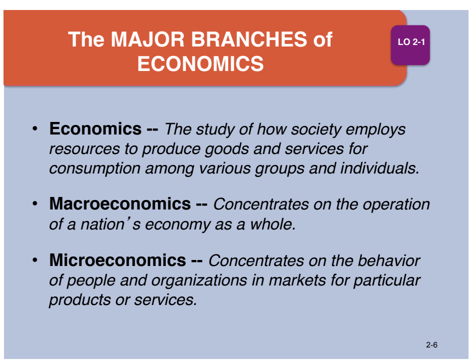
PPT 2-5
Name That Company

Organization: Florida Public Service Commission



PPT 2-6
The Major Branches of Economics

This slide gives students insight into the definition of economics. When going over this definition it often helps to further define the term resources. The term resources ties back into Chapter 1 and includes the factors of production: land, labor, capital, knowledge and entrepreneurship.



PPT 2-7
Resource Development

RESOURCE DEVELOPMENT

LO 2-1

- **Resource Development --** *The study of how to increase resources and create conditions that will make better use of them.*

2-7

Businesses can contribute to an economic system by inventing new products that increase the availability and development of an economy's resources.

PPT 2-8
Examples of Ways to Increase Resources

EXAMPLES of WAYS to INCREASE RESOURCES

LO 2-1

- New energy sources
  - *Hydrogen fuel*
- New ways of growing foods
  - *Hydroponics*
- New ways of creating goods and services
  - *Aquaculture*
  - *Nanotechnology*

2-8

PPT 2-9
Thomas Malthus and the Dismal Science

THOMAS MALTHUS and the DISMAL SCIENCE

LO 2-1

- Malthus believed that if the rich had most of the wealth and the poor had most of the population, resources would run out.
- This belief led the writer Thomas Carlyle to call economics "The Dismal Science."
- Neo-Malthusians believe there are too many people in the world and believe the answer is radical birth control.

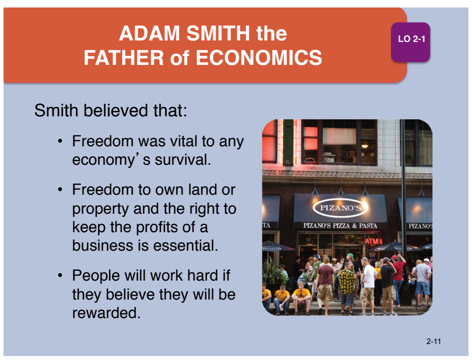
2-9

Thomas Malthus believed that if people were left to their own devices there would be chaos; therefore the government needed to be heavily involved in controlling the economy. Malthus' ideas are still with us. Neo-Malthusian ideas of overpopulation are prevalent in books such as Paul Ehrlich's *The Population Bomb* which contains ideas similar to those presented by Thomas Malthus 200 years ago

PPT 2-10
Population as a Resource

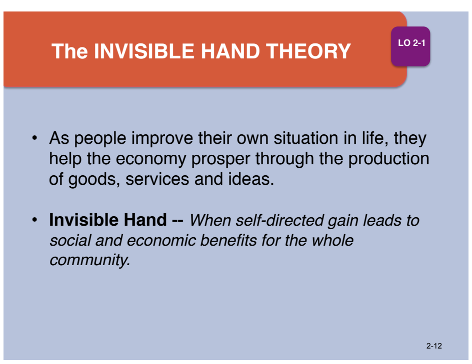
Malthus viewed a large population as a negative. However, many economists today see a highly educated population as a valuable, scarce resource. Countries like Japan and Germany are examples of nations that have become economically successful due to large well-educated populations producing sophisticated high-value products.

PPT 2-11
Adam Smith the Father of Economics



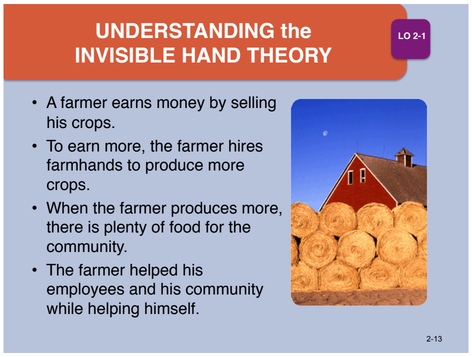
Adam Smith's ideas were laid out in his seminal book, *An Inquiry into the Nature and Causes of the Wealth of Nations*. Smith believed strongly in more "natural liberty" and less government intervention into the economy (an idea that was an anathema to Malthus). Smith argued that allowing people the freedom to own land and the right to keep profit would not create chaos as Malthus had argued, but rather would create greater resources for all.

PPT 2-12
The Invisible Hand Theory



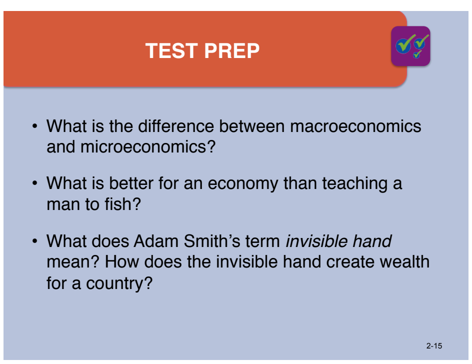
The invisible hand was at the heart of Adam Smith's theory describing the process of turning self-directed gain into social and economic benefits for all.

PPT 2-13
Understanding the Invisible Hand Theory



PPT 2-14
How Corruption Harms the Economy

PPT 2-15
Test Prep



1. Macroeconomics looks at the operations of a nation's economy as a whole. Microeconomics looks at the behavior of people and organizations in markets for particular products or services.
2. To create wealth in an economy, it is better to teach a man to start a fish farm, whereby he will be able to feed a village for a lifetime.
3. The invisible hand is the term used by Adam Smith to describe the processes that turn self-directed gains into social and economic benefits for all. To become wealthy, people working in their own self-interest producing goods and services expand by hiring others to provide employment and increases the well-being of others. They also tend to reach out to help the less fortunate over time.

PPT 2-16
Capitalism

PPT 2-17
State Capitalism

PPT 2-18
Capitalism's Four Basic Rights

The four basic rights under a capitalist system are straightforward, but which of the four basic rights has been weakened in the United States over the past 30 years? When asked this question, rarely do students touch on the concept of eminent domain and the weakening of the right to own private property due to the Kelo vs. New London Supreme Court case of 2005. If time permits, students can explore this case and the potential impact the case may have on American capitalism.

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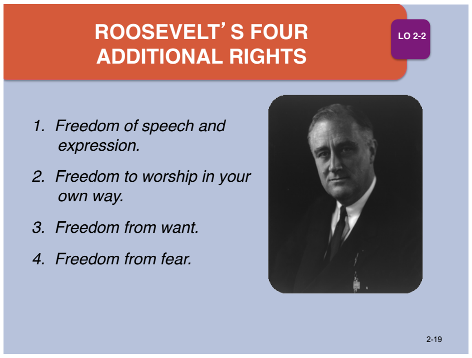
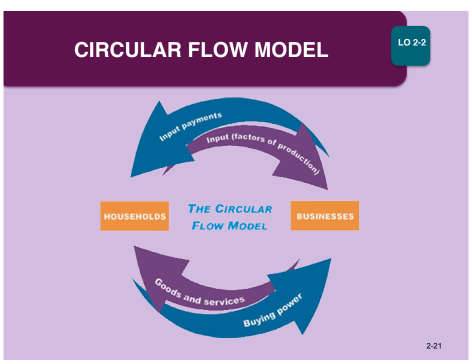
PPT 2-19
Roosevelt's Four Additional Rights



PPT 2-20
Free Markets

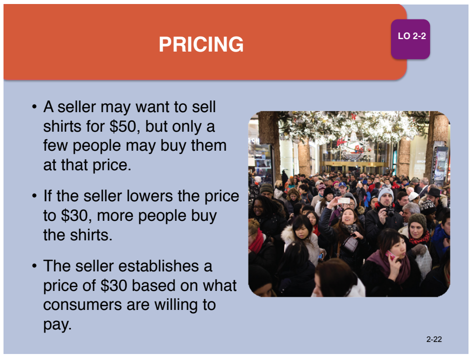
PPT 2-21
Circular Flow Model



In a free-market economy, business activity involves two major players: individuals (**households**) who own the resources that are the inputs into the productive process, and **businesses** that use these inputs (factors of production) to create goods and services.

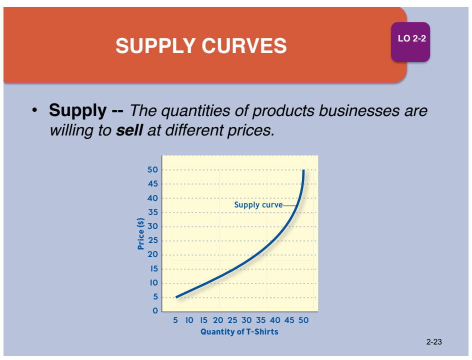
1. In the **Resource Market** (top part of the model)
   a. Businesses demand resources.
   b. Households own the resource.
   c. Income from providing these resources flows back to the households.
   d. The price of these resources is set by laws of supply and demand.
2. In the **Product Market** (lower part of the model)
   a. Businesses use these resources to create goods and services.
   b. Households (individuals) demand these goods and services.
   c. Individuals use their income to purchase goods and services.

PPT 2-22
Pricing

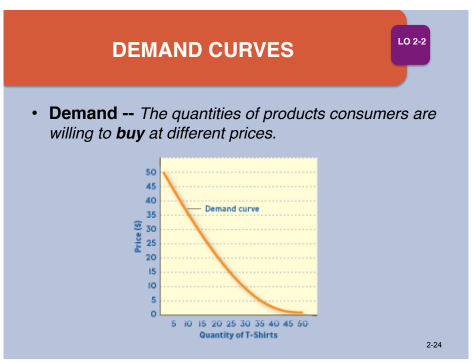


Prices are determined by consumers negotiating with the sellers.

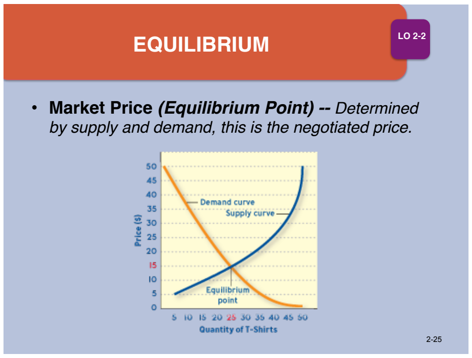
PPT 2-23
Supply Curves



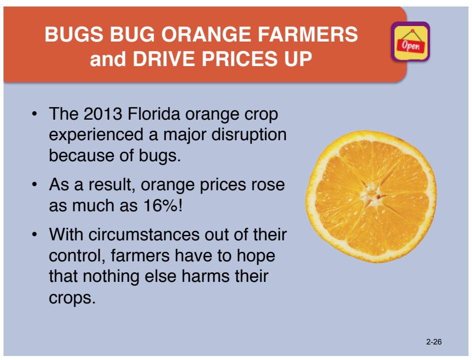
PPT 2-24
Demand Curves



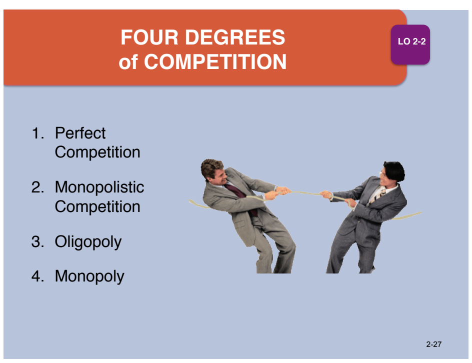
PPT 2-25
Equilibrium



PPT 2-26
Bugs Bug Orange Farmers and Drive Prices Up

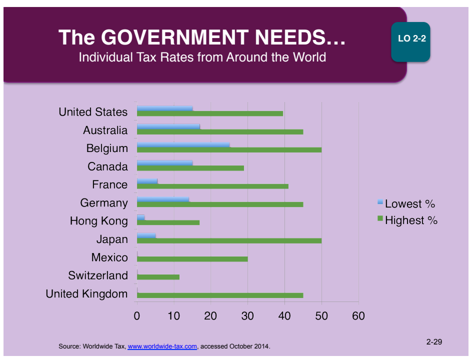


PPT 2-27
Four Degrees of Competition



PPT 2-28
Free-Market Benefits and Limitations

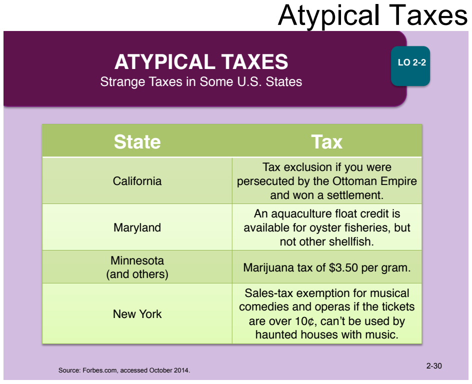
PPT 2-29
The Government Needs…



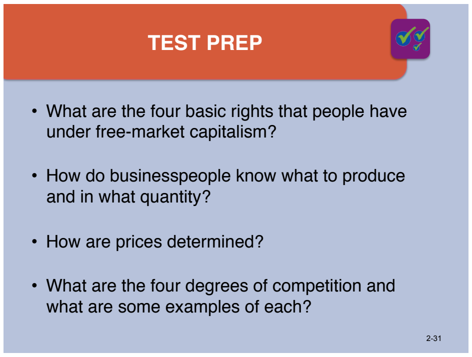
1. Students may be surprised at the difference between the rates in the United States and many other countries. For example the U.S. rate seems low compared to Belgium's rate which is 50%.
2. To help explain the difference between the U.S. rate and Belgium's higher rate, you can discuss some of the differences between capitalism and socialism. (*Socialism believes that the government should provide increased services for people by redistributing income from the richer people to the poor. Explain to the students that in socialist countries citizens are given free education, free health care, and more employee benefits (like longer vacations and family leave). Therefore they must pay higher taxes to support these benefits.*
3. Point out the major disadvantages of socialism:
   - Reduced incentives to work harder result in less innovation.
   - Marginal tax rates are higher and can sometimes approach 85% after a person reaches a certain amount of income (in other words, eight-five cents of each dollar earned is paid in taxes.
   - Brain drain.

PPT 2-30
Atypical Taxes

A little bit about the lighter side of taxes.

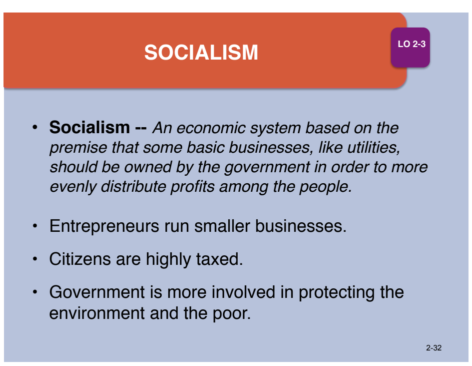


PPT 2-31
Test Prep



1. The four basic rights are: the right to own private property, the right to own a business and keep all that business's profits, the right to freedom of choice, and the right to freedom of competition.
2. Decisions about what to produce and in what quantity are decided by the market, consumers sending signals about what to make, how many, in what color and so on.
3. Prices are determined by the economic concepts of supply and demand.
4. The four degrees of competition are:
    - Perfect competition—such as a farmer's market where good are indistinguishable. Today, however, there are no good examples of perfect competition.
    - Monopolistic competition—such as fast-food restaurants where products are similar but consumers perceive the products to be different. Product differentiation is a key here.
    - Oligopoly—a situation where just a few major producers dominate a market such as tobacco, gasoline, automobiles, and so on. A few sellers dominate because the initial investment to enter such a market is significant.
    - Monopoly—a situation where only one producer exists in a market. U.S. law prohibits the creation of monopolies.

PPT 2-32
Socialism



PPT 2-33
Benefits of Socialism

Such education benefits helped Finland become the world leader in student achievement.

BENEFITS of SOCIALISM

LO 2-3

- Social equality
- Free education
- Free healthcare
- Free childcare
- Longer vacations
- Shorter work weeks
- Generous sick leave

2-33

PPT 2-34
The Negatives of Socialism

NEGATIVES of SOCIALISM

LO 2-3

- Few incentives for businesspeople to take risks.
- **Brain Drain**: *Some of a country's best and brightest workers (i.e. doctors, lawyers and business owners) move to capitalistic countries.*
- Fewer inventions and innovations because the reward is not as great as in capitalistic countries.

2-34

PPT 2-35
Communism

COMMUNISM

LO 2-3

- **Communism --** *An economic and political system in which the government makes* ***almost all*** *economic decisions and owns almost all the major factors of production.*
- Prices don't reflect demand which may lead to shortages of items, including food and clothing.
- Most communist countries today suffer severe economic depression and citizens fear the government.

2-35

PPT 2-36
Two Major Economic Systems

TWO MAJOR ECONOMIC SYSTEMS

LO 2-4

- **Free-Market Economies --** *The* ***market*** *largely determines what goods and services are produced, who gets them, and how the economy grows.*
- **Command Economies --** *The* ***government*** *largely determines what goods and services are produced, who gets them, and how the economy will grow.*

2-36

PPT 2-37
Mixed Economies

MIXED ECONOMIES

LO 2-4

- **Mixed Economies --** *Some allocation of resources is made by the market and some by the government.*
- Neither free-market nor command economies have created sound economic conditions so countries use a mix of the two economic systems.

2-37

PPT 2-38
Trending toward Mixed Economies

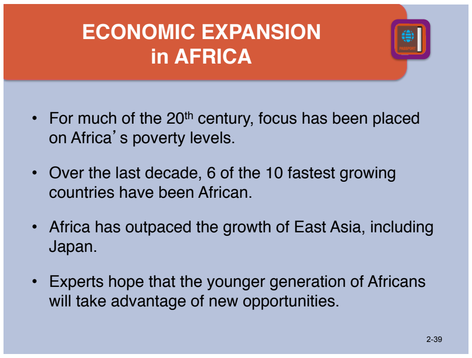
TRENDING TOWARD MIXED ECONOMIES

LO 2-4

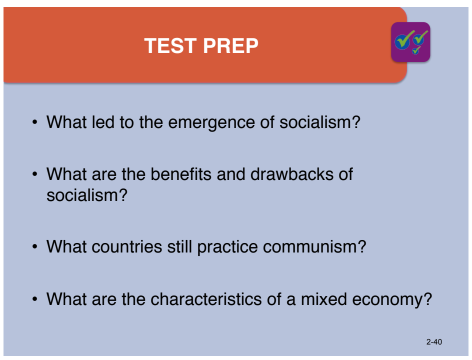
- Communist governments are disappearing.
- Socialist governments are cutting back on social programs, lowering taxes and moving toward capitalism.
- Capitalist countries are increasing social programs and moving more toward socialism.

2-38

PPT 2-39
Economic Expansion in Africa

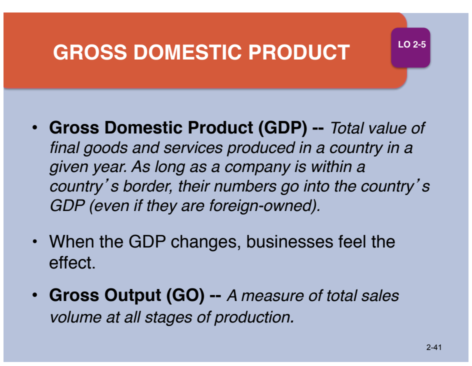


PPT 2-40
Test Prep

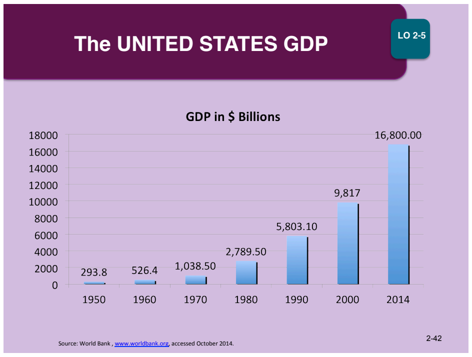


1. Socialists believe that wealth should be more evenly distributed than in free-market capitalism. Government should be empowered to carry out the distribution of wealth.
2. Free education through college, free health care, and free child-care are some of the benefits of socialism. The key drawback of socialism is high taxes often causing a "brain drain" in the economy. Socialism also tends to inspire less innovation.
3. Most nations have drifted away from communism but North Korea and Cuba still espouse communism. Russia, Vietnam, and China still have some communist practices in place.
4. Mixed economies have systems where the allocation of resources is made by the market and some by the government. Like most nations of the world, the United States is a mixed economy.

PPT 2-41
Gross Domestic Product

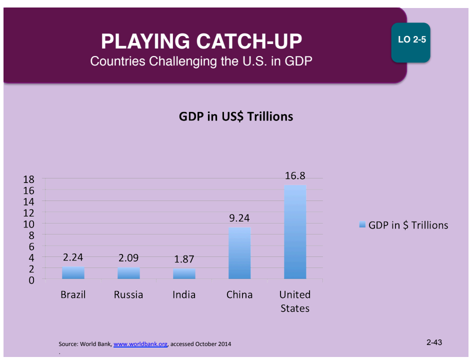


PPT 2-42
The United States GDP



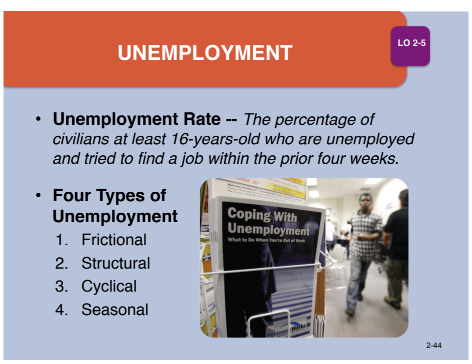
1. In 2014, the U.S. gross domestic product was nearly $17 trillion.
2. This compares to the GDP of $ 5.8 trillion in 1990 and $ 2.8 trillion in 1980. As can be seen on the slide, the U.S. GDP has grown over 400% since 1980.

PPT 2-43
Playing Catch Up



1. America is often referred to as "*the engine that runs the world's economy." It is easy to see the truth in this statement* with U.S. gross domestic product far exceeding the four other countries listed on the slide.
2. While China has grown dramatically since 1975, their economy is still dwarfed by that of the United States.
3. Much is made of the economic growth of China, India, Russia and Brazil, but students must understand the sum of these four countries' gross domestic products is approximately half that of the United States.

PPT 2-44
Unemployment



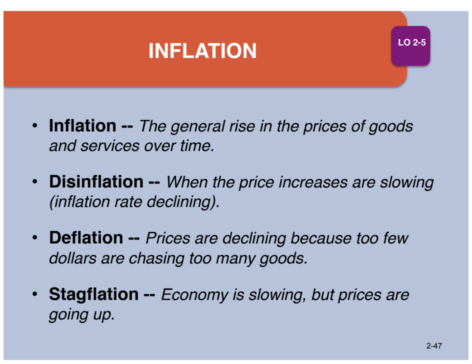
While the term unemployment seems simple enough, the Bureau of Labor Statistics (BLS) has a very specific definition. According to the BLS unemployment is the percentage of civilians at least 16-years-old who are unemployed and tried to find a job within the prior four weeks. The BLS figure does not include workers who had to take part-time jobs because they couldn't find full-time work, those who are underemployed (working at jobs far below their qualifications), or those workers who gave up looking for jobs altogether. If that was not confusing enough there are four types of unemployment which students are often surprised to discover.

PPT 2-45
U.S. Unemployment Rate

The unemployment rate in the United States over the past 50-plus years has been as low as 3.9 percent, but more recently has climbed past 10 percent. Although the unemployment rate is climbing in the United States, it still has a long way to go to reach the unemployment rate in Zimbabwe (80 percent).

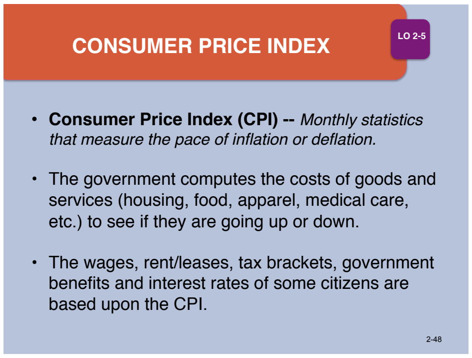
PPT 2-46
Best and Worst Cities for a Job Search

PPT 2-47
Inflation



When discussing inflation, disinflation, deflation and stagflation, introducing the term hyperinflation is particularly interesting to students. Historical examples of countries suffering from hyperinflation post-World War I and currently Zimbabwe bring this topic to life.

PPT 2-48
Consumer Price Index

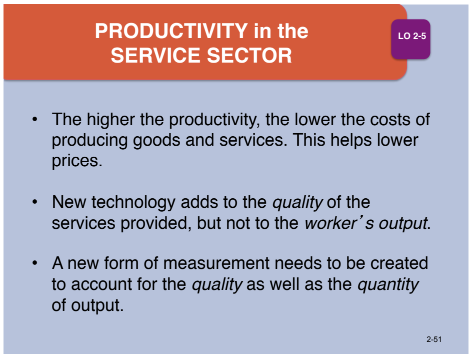


After discussing hyperinflation in the previous slide, students can appreciate the importance of monitoring a nation's inflation rate to prevent it from spiraling out of control. As inflation is increasing, it acts as a hidden tax increase eroding the purchasing power of the population.

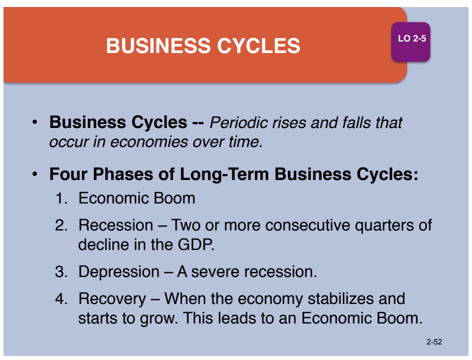
PPT 2-49
Price Index

PPT 2-50
Productivity

PPT 2-51
Productivity in the Service Sector



PPT 2-52
Business Cycles

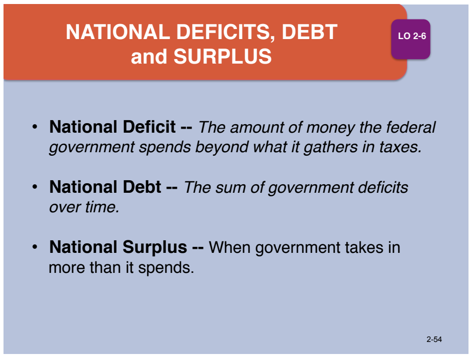


Yes, it is true that a recession is two or more consecutive quarters of contracting gross domestic product, but students will be interested to know that for a recession to be officially labeled a recession it must be declared by the National Bureau of Economic Research. Their website, www.nber.org, provides numerous resources to further explain this part of the business cycle.

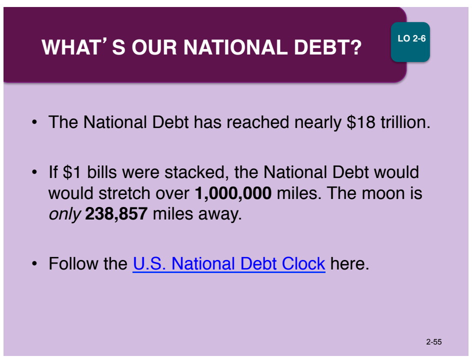
PPT 2-53
Fiscal Policy

In the U.S., the percentage of the GDP the government takes through taxes at all levels is about 28%. However, when you count all fees, taxes on the highest-earning citizens could exceed 50%.

PPT 2-54
National Deficits, Debt, and Surplus

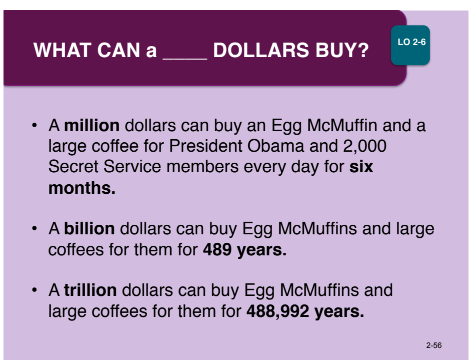


PPT 2-55
What's Our National Debt?



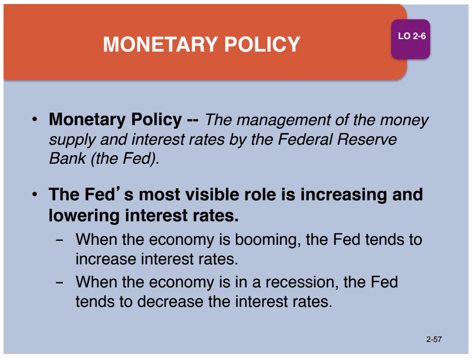
1. Discuss with the class the size of the national debt and what impact this has on the economy. (*Increased borrowing by the government takes money out of the consumer and business markets, impacting the cost of borrowing.)*
2. The national debt has continued to increase roughly $2 billion per day since September 30, 2012.
3. On a per person basis, each citizen's share of this debt is over $56,000.
4. A family of four shares the debt burden of about $224,000.

PPT 2-56
What Can a ___ Dollars Buy?

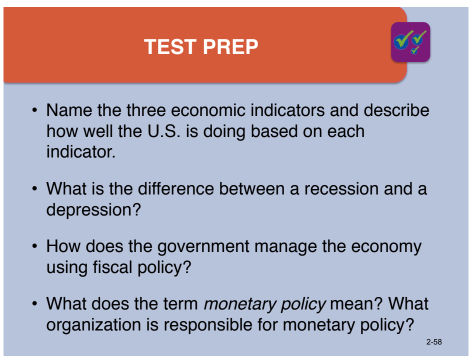


1. Before showing the slide, ask students, "If you were a rich, generous person who wanted to treat President Obama and his 2,000 Secret Service members to an Egg McMuffin every morning, how many days could you treat them if you decided to spend a million dollars? A billion dollars? A trillion dollars?"
2. Students are usually surprised to see how much a million, billion, or trillion dollars can buy.

PPT 2-57
Monetary Policy



PPT 2-58
Test Prep



1. The three key economic indicators are the Gross Domestic Product (GDP), the unemployment rate, and the price indexes. Our high GDP allows citizens to enjoy a high standard of living. In 2000, the U.S. reached it lowest unemployment rate in over 30 years. However, the recent recession could lead unemployment to at least 10 percent. The consumer price index (CPI) has not risen to high levels keeping inflation in check. However the recession has caused fears of deflation.
2. A recession is two or more consecutive quarters of decline in the GDP. A depression is a severe recession, usually accompanied by deflation.
3. Fiscal policy refers to the government's efforts to keep the economy stable by increasing or decreasing taxes or government spending.
4. Monetary policy is the management of the nation's money supply and interest rates. The Federal Reserve controls the money supply in the United States.

lecture enhancers

"It's a recession when your neighbor loses his job; it's a depression when you lose your own."
Harry S. Truman

"Three groups spend other people's money: children, thieves, politicians. All three need parental supervision."
Dick Army, politician

lecture enhancer 2-1

INDIA'S UPCOMING ERA OF GROWTH

By all accounts, India is destined for massive growth over the next decade. Yet India is always measured in the shadow of its neighbor and fellow burgeoning economic superpower, China. After all, by 2030 the two nations are estimated to account for 34% of the globe's total economic output. Experts assert that China will be on top, however, and is on target to overtake the United States with 24% of world GDP by the same year.

But China's massive growth could ultimately be hindered by its one-child policy. With population escalation stunted, the pool of Chinese citizens eligible for work will shrink just as the nation surges toward GDP dominance. India, on the other hand, will experience one of the fastest growths of working-age populations in the world between 2010 and 2050. India's upcoming spike of work-eligible citizens could provide it with a much-needed advantage over not only China, but also the fully developed economies of the United States and Europe. Small countries with low birthrates like Sweden, Austria, and Denmark could eventually drop off the list of the 30 biggest economies in the world. Instead, high population and expanding nations like India could take up the economic mantle in the next decade and beyond.

First, however, India must suitably develop its crumbling infrastructure. Cracked roads and bridges present the biggest impediment towards India's growth. While the country nearly matched China in total economic expansion in 2009 at 9.7%, its dire infrastructure is ranked 91st out of 139 nations, behind Ethiopia and Indonesia. Even worse, despite its vast population India lacks the skilled labor to repair and rebuild. Though laborers abound, many Indians look down on the profession since those jobs were previously performed by lower classes. Therefore parents want their kids to upgrade to life as an engineer rather than a mason or a carpenter. In an effort to combat their skilled worker shortage, Indian companies are forming their own training schools that will hopefully convert standard laborers into capable contractors and foremen.[i]

lecture enhancer 2-2

A NEW CROP OF CONSUMERS IN AFRICA

While a great deal of focus has been given to burgeoning economic superpowers like India and China, Africa has a growing middle class that rivals both those countries. Thanks to open markets and greater political stability, economists estimate that Africa's middle class (those who spend $2–20 a day) makes up 34% of the continent's population. A new study shows that this 313-million-strong middle class, which has grown 60% over the last decade, is upwardly mobile and in the market for foreign goods.

However, this isn't to say that Africa is prosperous. Sixty-one percent of Africa's 1 billion people continue to live on less than $2 a day. Vast wealth disparities persist as well. The net worth of 100,000 of the continent's richest citizens accounts for 60% of its gross domestic product. A further 180 million people can afford to spend only $2 to $4 a day, making them vulnerable to economic shifts that could knock them out of the middle class. Even those firmly entrenched in the new consumer class are far from rich, with daily spending budgets between $4 and $20.

To many, the fact that a significant portion of Africa's population has disposable income at all is cause for celebration. In fact, some analysts credit this new breed of consumer for buffering Africa against much of the global financial crisis. Also with jobs on the rise, rural Africans are flocking to cities. The U.S. ambassador to South Africa even claims that Africa is now nearly as urbanized as China. Again, all this newfound growth must be viewed alongside current stories of tragedies against citizens in Uganda and Nigeria as well as the violent repressions in Libya. Still, one can only hope that much of the violence and chaos that has defined Africa for decades is now in the past, leaving the future open for more political freedom and economic growth.[ii]

lecture enhancer 2-3

TRACKING THE UNDERGROUND ECONOMY

A peculiar statistic has been puzzling economists ever since the economy began its recovery. Retail sales have climbed steadily over the last four years despite the fact that gains in reported income have stalled. So if people still aren't getting paid more, where is this disposable cash flow coming from? According to some, one need not look further than the underground economy.

Then again, the sum total of unreported U.S. income isn't a thing you can easily track on a graph. All untaxed cash transactions are considered part of the underground economy, including everything from drug deals to yard sales. Although a definite amount is impossible to determine, most economists value America's shadow economy at $2 trillion annually. That accounts for as much as 19 percent of total income, resulting in a yearly tax gap that tops out at $500 billion. Experts fear that disparity will only grow larger as more and more people become dependent on under-the-table transactions to supplement their earnings.

Kevin Kalmes, for instance, was out of work for two years when she received a foreclosure notice on her home. She began to sell items from her basement to raise cash and eventually made enough money to save the house. Rather than shutter her ad-hoc second-hand shop, though, Kalmes kept her rummage sale going full-time without permits. Kalmes' story represents just one among thousands in which people had to devise their own ways to make money legally in this still shaky economy. Over the long term experts hope that the current stimulus driven by untaxed cash and enjoyed by retailers will lead to job creation. Ideally, that would mean fewer people would have to toil in the shadow economy in order to make their living. Still, there's a chance that companies could remain reluctant to hire, driving even more people to seek out cash through tax-free means. If this turns out to be the case, then the U.S. government may stand to lose an increasing share of vital tax revenue.[iii]

lecture enhancer 2-4
EU NATIONS ADD UNDERGROUND ECONOMIES TO GDP

Even though the U.S. has a gross domestic product (GDP) valued at nearly $17 trillion, that huge figure still doesn't come close to providing a complete picture of the American economy. Each year billions upon billions of transactions go undocumented, untaxed, and ultimately unrecorded by official GDP statisticians. Whether it's earning a few bucks by mowing a neighbor's lawn or by selling drugs, these concealed deals all form what's known as the underground economy.

Many economists have said that it's impossible to determine the true value of the underground economy, but that's not getting in the way of some European nations looking for an easy GDP boost. According to recently implemented EU regulations, the total debt held by a member nation may not exceed 3 percent of its GDP. As a result, the U.K., Italy, and Ireland are adding illicit activities like drug sales, prostitution, and even smuggling to their lists of official goods and services. With inflated GDPs, these countries will be able to take on more debt without facing sanctions from the European community.

Although the EU hasn't officially commented on this practice, a number of experts have questioned its merit. After all, criminals usually do their best to hide their earnings. Not only does this make it difficult to determine their total income, but it also means that their cash is not being taxed. Such misleading information could potentially make a nation's GDP less accurate. On the other hand, completely ignoring illegal vices distorts the look of an economy by leaving out a big chunk of its output. Nevertheless, tallying up drug sales isn't the only way some nations are looking to expand the definition of GDP. The U.K., for instance, is also revamping the way it measures nonprofit groups. This policy is expected to boost GDP more than drug sales and prostitution.[iv]

lecture enhancer 2-5
THE CIRCULAR FLOW MODEL

(**PPT 2-21** presents this simplified Circular Flow Model.)

Economists often use *models* to explain economic principles. A model is like a map of a concept. A *road map* shows you the major highways and waterways, not every tree. An *economic model* presents an economic concept as a bare-bones "map," containing only the major elements. Thus a model does not contain all the detail and complexity of the concept, just the simplified major elements.

One such economic model is the Circular Flow Model, a simplified presentation of the basic transactions in a free-market economy. The two major elements are **consumers** (presented in the model as *households*) and the **businesses** that create goods and services.

Each of the factors of production mentioned in the text has a price. To use *land*, a business must make rent or mortgage payments (simplified as *rent*). *Labor* must be paid salary or *wages*. The buildings, equipment, production lines, and so on (*capital*) are financed by paying *interest*. Finally, the entrepreneur expects to earn a *profit* from using his or her *entrepreneurship*. However, this resource payment is not guaranteed. If costs exceed income, the business may suffer a *loss*. (Some newer versions of this model include *knowledge* as a factor of production; older versions usually don't.)

Businesses demand resources in order to produce products and services. In a capitalist economy, the households own the factors of production and must be compensated. This income flows back into the households. The prices of resources are set by the interaction of supply and demand.

The goods and services that households demand are created by business. The consumers in these households use the income from their factors of production to purchase goods and services.

Thus, business activity flows in a circle, which is illustrated by the Circular Flow Model. The market for resources (top arrows) is known as the *resource market*. The bottom flow is referred to as the *product market.*

This is a simplified model of pure capitalism, and it ignores a major player—government. Purchases of goods and services by all levels of government amount to about 20% of the nation's gross domestic product. More sophisticated models include the government's role in diverting resource payments as taxes and spending on government programs, which creates a more realistic representation of a mixed economy.

lecture enhancer 2-6

OTHER ECONOMIC INDICATORS

In addition to the key economic indicators mentioned in the text—CPI, GDP, unemployment rate—other indicators measure different segments of the economy. Below are some of the more important ones.

KEY ECONOMIC INDICATORS

Producer Price Index	Monthly index that measures changes in wholesale prices
Prime Interest Rate	Lowest interest rate that banks charge preferred borrowers on short-term loans
Housing Starts	Tracks how many new single-family homes or buildings were constructed during the month and can detect trends in the economy looking forward
Durable-Goods Orders	New orders for goods that last more than three years
Balance of Trade	Total value of a country's exports minus the total value of its imports, over a specific period of time
Inflation Rate	Percentage increase in prices of goods or services over a period of time
Consumer Confidence Index	Measures the degree of consumer confidence in the economy, and can indicate an upcoming increase or decrease in economic activity

THE "BEIGE BOOK"

Many economists use the Federal Reserve Board "Beige Book" to detect trends in the economy. The correct name for the report is "Summary of Commentary on Current Economic Conditions by Federal Reserve District." Each Federal Reserve Bank gathers information on current economic conditions in its district. The Beige Book summarizes this information by district and sector and is a gauge on the strength of the economy.

TIMING OF THE INDICATORS

Economic indicators can further be classified by the timing of the indicator.

Some indicators are **lagging**, meaning that they don't change direction until a few quarters *after* the economy does. An example is the unemployment rate. Unemployment tends to increase for two or three quarters after the economy starts to improve.

Coincident indicators move *at the same time* as the economy does. The gross domestic product measures the economy's output as it occurs.

Leading economic indicators are indicators that change *before* the economy changes. Stock market returns are a leading indicator, as the stock market usually begins to fall before the economy declines and they improve before the economy begins to pull out of a recession. Housing starts and the consumer confidence index are other leading economic indicators.[v]

lecture enhancer 2-7

HOW ACCURATE IS THE GDP?

In today's modern economy, statistics are supreme. GDP, unemployment and interest rates all play dominant roles in the allocation of the government's budget. No spending bill can hope to pass into law without a battery of statistics and figures charting how such legislation will benefit the country. But just how accurately do those numbers reflect the world we live in?

Take GDP, for instance. The famous figure has only been reliably collected in the U.S. since the 1930s and didn't become the primary indicator of the nation's economic health until 1991. Yet despite such a short history, economists and legislators treat GDPs of any stripe with devotion. For instance, global financial markets recently went into uproar when China reported its GDP at 7.7 percent rather than the expected 8 percent. That missing 0.3 percent may seem negligible, but it was enough to ruffle the feathers of analysts across the world who now had to readjust their projections. But if the accuracy of the U.S.'s GDP is merely suspect, China's is outright unreliable. Only gathered for less than 20 years, the Chinese GDP fails to account for many key factors, such as the political pressure of its five-year plans or the enormous private loan industry.

Other figures present similar problems. In trade stat terms, every time an iPhone leaves a Chinese factory and lands on American shores, $200 is added to our trade deficit with China. In reality, though, the components of that same iPhone have been produced all over the world, not just China. A more accurate figure would take all those other manufacturers into account and ascribe value accordingly. Instead, current guidelines grant sole credit to the country where the product is "assembled." Ultimately, statistical hiccups like this demonstrate just how much the world has changed since these figures became prominent. Decades ago, it was safe to assume that a product was fully assembled in one place. That is simply not the case today as complex supply chains send items crisscrossing around the world. So while statistics like these no doubt provide relevant information, the conclusions they reach are perhaps not so concrete as to justify basing entire economies around their slight shifts in value.[vi]

lecture enhancer 2-8

HONDA BECOMES AN AMERICAN EXPORTER

The slow reemergence of American manufacturing has been touted by politicians on both sides of the aisle as an essential force in the recent economic recovery. But in many cases, the manufacturers driving production across the nation aren't American at all. In fact, Honda recently announced that it built and shipped more cars from the U.S. than it imported here from Japan.

According to Honda executives, the company's current status as an American exporting power wasn't the intention when it set up shop on these shores 30 years ago. "We did not set out to be a net exporter," says Rich Schostek, senior vice president of Honda North America. "What we did set out to do was become self-reliant in North America." Just as General Motors has invested heavily in China, Honda adapted a "produce-where-you-sell" model as it expanded operations throughout the country. Last year, Honda's 10 U.S. plants, staffed by approximately 28,000 American workers, produced 1.3 million cars, most of which were sold domestically. However, more than 100,000 vehicles were exported to developing markets throughout the world, a number that eclipsed the 88,500 cars imported by the U.S. from Japan.

To some, including President Obama, Honda serves as a prime example of a foreign company providing jobs rather than taking them away. But critics on both the right and left are worried companies like Honda are an exception rather than the rule and that American jobs could be at stake if foreign trade is encouraged any further. Then again, the state of industry in this country has been troubled for some time, and any capable job creator could be beneficial, regardless of their country of origin.[vii]

lecture enhancer 2-9

WHAT IS A DEPRESSION?

In 2009 with the stock market falling, banks failing, and unemployment soaring, many people wondered if the U.S. economy was suffering not from a recession, but from a much worse condition, a depression. Economists say that a depression is, well, nobody really has a formal description for a depression. A depression is when things are really, really bad.

While recessions are easy to define, there are no firm rules for what makes a depression. Everyone at least seems to agree there hasn't been one since the epic hardship of the 1930s. According to economist Peter Morici, a business professor at the University of Maryland, you'll know you've been in a recession when you see it behind you. "It's not going to be acknowledged until years go by."

No one disputes the definition of a recession, and the economic downturn of 2008–2010 surely qualified. Recessions have two handy definitions—two straight quarters of economic contraction, or when the National Bureau of Economic Research makes the call.

Declaring a depression is much trickier.

- By one definition, it is a downturn of three years or more with a 10% drop in economic output and unemployment above 10%.
- Another definition says a depression is a sustained recession during which the populace has to dispose of tangible assets to pay for everyday living.
- Morici says a depression is a recession that "does not self-correct" because of fundamental structural problems in the economy, such as broken banks or a huge trade deficit.
- Or maybe a depression is whatever corporate America says it is.

The Great Depression still maintains top ranking. Unemployment peaked at more than 25%. From 1929 to 1933, the economy shrank 27%. The stock market lost 90% of its value from boom to bust. The 2008–2010 recession came nowhere near those figures. And government policy makers argue that safeguards in place today weren't there in the 1930s: deposit insurance, unemployment insurance, and an ability by government to hurl trillions of dollars at the problem.

Before the 1930s, any serious economic downturn was called a depression or a *panic*. The term *recession* didn't come into common use until *depression* became burdened by memories of the 1930s. When the economy collapsed again in 1937, people didn't want to call that a new depression, and that's when the term *recession* was first used. According to Millsaps College professor Robert McElvaine, "People also use 'downward blip.' Alan Greenspan once called it a 'sideways waffle'."[viii]

Government officials are extremely cautious in using the D-word. Alfred Kahn, a top economic advisor to President Carter, learned that lesson in 1978 when he warned that rampaging inflation might lead to a recession or even “deep depression.” When presidential aides asked him to use another term, Kahn promised he’d come up with something completely different.

“We’re in danger,” he said, “of having the worst banana in 45 years.”

critical thinking exercises

Name: ____________________________

Date: ____________________________

critical thinking exercise 2-1

KNOW YOUR HISTORY OF ECONOMICS

Go to the Internet and look up the following economists: Adam Smith, Jeremy Bentham, David Ricardo, and T. R. Malthus. Choose one of these economists and answer the following questions that describe their contributions to the field of economics.

1. Describe the personality of your chosen economist.

2. What major contributions did this chosen economist contribute to the field of economics regarding:

   a. Microeconomics

   b. Macroeconomics

3. How does the works of your chosen economist have any relevance to our economy today?

4. How did your chosen economist further the field of economic study?

Name: ___________________________

Date: ___________________________

critical thinking exercise 2-2

APPLYING ECONOMIC PRINCIPLES TO EDUCATION

Recently, the U.S. Supreme Court ruled that cities could have voucher programs that give money directly to parents, and the parents can then choose between competing schools: public and private. The idea for promoting such a ruling was to create competition among schools. As with businesses, schools were expected to improve their products (how effectively they teach) to win students from competitors. Supposedly, that would mean an improvement in all schools, private and public, and would benefit many students.

1. Do you believe that such economic principles apply in both private and public organizations? Be prepared to defend your answer.

2. Are there other public functions that might benefit from more competition, including competition from private firms?

Name: ____________________________

Date: ____________________________

critical thinking exercise 2-3

FINDING THE EQUILIBRIUM POINT

In 2014, Knight Electronics sold 350,000 digital video recorders (DVRs). Based on the company's analysis of the DVR market, the company believed that $160 was the equilibrium price based on the following supply and demand schedules.

2014 Price	Amount Supplied	Amount Demanded
$120	290,000	390,000
140	320,000	370,000
160	350,000	350,000
180	380,000	330,000
200	410,000	310,000
220	440,000	290,000

As the price of gasoline rose and the economy hit the skids, consumers began driving less and going out less frequently for entertainment. With more people staying at home, DVR usages increased. In 2015 Knight revised its estimate of the amount of product demanded. At each of the above price points, it estimates that consumers will purchase (demand) 50,000 more DVRs. For instance, at $140, now 420,000 DVRs will be sold. The price–amount supplied relationship remains the same.

1. Describe what has happened to the supply and demand curves for Knight DVRs in 2014.

2. What is the new equilibrium price?

3. How many DVRs will be produced at the new equilibrium price?

4. Knight revised its estimate of the amount of product demanded for 2015 as described above. In 2016 a new technology became available enabling DVRs to communicate over cell phones and the Internet. Knight's competitors are selling this new DVR, called SuperDVR, for $150. What will happen to the supply and demand curves for Knight DVRs now?

notes on critical thinking exercise 2-3

1. *Describe what has happened to the supply and demand curves for Knight DVRs in 2014.*

Supply remained unchanged. Demand shifted right, showing the increased quantity demanded at every price.

2. *What is the new equilibrium price?*

The quantity demanded and quantity supplied are now identical at $180, a higher price. At that price the quantity supplied remains stable at 380,000. However, the quantity demanded at that price is increased by 50,000 to 380,000. The equilibrium price will now be $180.

2014 Price	Amount Supplied	Amount Demanded
$120	290,000	440,000
140	320,000	420,000
160	350,000	400,000
180	***380,000***	***380,000***
200	410,000	360,000
220	440,000	350,000

3. *How many DVRs will be produced at the new equilibrium price?*

At $180, 380,000 DVRs will be produced.

4. *Knight revised its estimate of the amount of product demanded for 2015 as described above. In 2016 a new technology became available enabling DVRs to communicate over cell phones and the Internet. Knight's competition are selling this new DVR, called SuperDVR, for $150. What will happen to the supply and demand curves for Knight DVRs now?*

With a more advanced DVR available from competitors, demand for Knight DVRs will decrease at the same price. The demand curve shifts to the left, and the equilibrium price falls.

Name: ____________________________

Date: ____________________________

critical thinking exercise 2-4
STANDARD OF LIVING COMPARISON

Is the standard of living different in capitalist, socialist, and communist economies? Which economic system provides the highest standard of living? One way of answering these questions is by comparing economic data you might find in the library or on the Internet. (*Hint:* Try the CIA website.) Choose one capitalist country, one socialist country, and one communist country. Use the following chart to record your findings.

	CAPITALIST COUNTRY	SOCIALIST COUNTRY	COMMUNIST COUNTRY
Country Chosen			
Gross Domestic Product			
Consumer Prices			
Unemployment Rate			
Average Income			
Average Education			

bonus case

bonus case 2-1

FOUNDATIONS OF THE CAPITALIST SYSTEM

Throughout the history of capitalism there has been one persistent criticism: The whole system seems to be based on selfishness—the more one works, the more one prospers. If a person is unable to work, the system seems to have no answer to his or her problems. Furthermore, there does not seem to be any moral or spiritual foundation to the system. Where do businesses get their values? What about concepts such as sharing, helping neighbors, and protecting the environment?

It is important to make a distinction between plain capitalism and democratic capitalism. Democratic capitalism is a system based on three components: (1) free enterprise—that is, freedom to own your own businesses and farms and freedom to keep the profits; (2) a freely elected government that has internal checks and balances; and (3) moral, ethical, and spiritual values that are part of the very fabric of the country and the business system. Plain capitalism is a system where there is free enterprise, but no freely elected government and no foundation of moral, ethical, and spiritual values. There are several "capitalist" countries headed by right-wing dictators that do not have democratic capitalism and do not have the relative prosperity and social justice that we have in the United States.

Let's explore democratic capitalism in more detail so that you can understand how the system works. One of the most important elements of democratic capitalism is its moral and spiritual base. When the United States was being settled, there was so much religious debate and rivalry among religions that people were tortured and killed for their beliefs. When it came time to establish a free and separate United States, however, the founding fathers were adamant about freedom of religion. They were very religious people themselves.

Thomas Jefferson was proud of his religious heritage and his fight for religious freedom in the United States He asked that his epitaph read: "Author of the Declaration of Independence, of the Statute of Virginia for Religious Freedom, and Father of the University of Virginia." Jefferson felt that freedom of religion was one of his most important contributions. He felt it was as important as being president of the United States.

Democratic capitalism cannot work effectively and fairly without all three components. With all three, the democratic capitalist system can become the fairest and most equitable economic system in the world. Not everyone agrees on the role of government in the democratic system and on how much of the total gross national product the government should control. (Recent history indicates that somewhere between 20% and 25% of GDP gives the government the funds it needs to create more social justice and more equitable distribution of wealth.) A freely elected government is important to democratic capitalism because if the people feel that the system is not fair, they can elect new politicians to change the rules.

discussion questions for bonus case 2-1

1. Do you see any evidence that the moral, ethical, and spiritual foundation of the American democratic capitalist system is eroding? How does that affect the ability of capitalist proponents to promote capitalism in other countries such as China and India?

2. Why is it so necessary to have a freely elected government for democratic capitalism to create a prosperous and fair economy?

3. Go through the three components of democratic capitalism and picture an economy without each one. What happens to freedom, fairness, and moral and ethical behavior? Which part of the system seems weakest today? What can be done about it?

notes on discussion questions for bonus case 2-1

1. *Do you see any evidence that the moral, ethical, and spiritual foundation of the American democratic capitalist system is eroding? How does that affect the ability of capitalist proponents to promote capitalism in other countries such as China and India?*

When one of the authors was in elementary school, the codes of what was moral forbid him to see *The Moon Is Blue* because the movie used the word *virgin* in it. Now movies include more adult language and more violence and sexual content. In fact, many such movies are now available in prime time on TV. There does seem to be an erosion of moral and ethical behavior in business, witness the Merck, Enron, WorldCom, Tyco, and Martha Stewart scandals. It could be a function of more media reporting of such behavior, but the impression is clear—moral decay is spreading.

When other countries see moral decay in capitalist countries, they are hesitant to adopt capitalism. They do not want the immorality, the crime, and the music that they see as corrupting of the spiritual values of their countries.

2. *Why is it so necessary to have a freely elected government for democratic capitalism to create a prosperous and fair economy?*

Because any kind of dictatorship hinders the operation of free markets, or at least tends to do so. Free choice in the market is based on a value system that includes free choice in it, including free choice of leaders.

3. *Go through the three components of democratic capitalism and picture an economy without each one. What happens to freedom, fairness, and moral and ethical behavior? Which part of the system seems weakest today? What can be done about it?*

Without free enterprise, shortages develop and the whole economy tends to slow. Poverty, hunger and starvation often result. Without a freely elected government, the arbitrary allocation of resources can lead to the same problems as an absence of free markets. But what is needed in any economy is a moral and ethical base. Without that base, the market mechanism falters.

endnotes

[i] *Sources:* Peter Coy, "If Demography Is Destiny, Then India Has the Edge," *Bloomberg Businessweek,* January 13,

[ii] *Source:* Peter Wonacott, "A New Class of Consumers Grows in Africa," *The Wall Street Journal*, May 2, 2011.

[iii] *Source:* Joshua Zumbrun, More Americans Work in the Underground Economy," *Bloomberg BusinessWeek*, March 28, 2013.

[iv] *Source:* Josh Zumbrun, "Sex, Drugs and GDP: the Challenge of Measuring the Shadow Economy," *The Wall Street Journal*, June 8, 2014.

[v] *Sources*: Mike Moffatt, "A Beginner's Guide to Economic Indicators," About.com, May 16, 2006; "Economic Indicators," Investopedia.com; "Leading Indicators Index Shows Economy Braking," *The Clarion-Ledger*, May 19, 2006, p. 3C; and "Economic Indicators," GPOAccess, Council of Economic Advisors, www.gpoaccess.gov.

[vi] *Source:* Zachary Karabell, "It's an Old Numbers Game. What if They're Wrong?" *The Washington Post*, April 19, 2013.

[vii] *Sources:* Howard Schneider, "Honda Becomes a U.S. Exporter," *The Washington Post*, January 29, 2014.

[viii] *Sources:* Tom Raym "The D-Word: Will Recession Become Something Worse?" *ABC News*, March 2, 2009; and "Fed's Yellen: Economy Similar to Great Depression," CNNMoney.com, February 7, 2009.