

# chapter 2

## Understanding Economics and How It Af- fects Business

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## what's new in this edition

### **additions to the 2<sup>nd</sup> edition:**

- Connecting with Steven Levitt and Stephen Dubner, Authors of Freakonomics
- Discussion of state capitalism in section Understanding Free-Market Capitalism
- Making the Green Connection: It's Not Always Greener
- Connecting Across Borders: Africa's Evolving Economy
- Video: Opportunity International

### **revisions to the 2<sup>nd</sup> edition:**

- Statistical data and examples throughout the chapter were updated to reflect current information.
- Connecting with Small Business: Small Loan, Big Opportunity
- Making Ethical Decisions: How Corruption Harms the Economy

### **deletions from the 1<sup>st</sup> edition:**

- Getting to Know Muhammad Yunus, Founder of the Grameen Bank
- Discussion of chained consumer price index from section Key Economic Indicators
- Reaching Beyond Our Borders
- Thinking Green



# brief chapter outline and learning goals

## CHAPTER 2

# UNDERSTANDING ECONOMICS AND HOW IT AFFECTS BUSINESS

### \* Connecting with STEVEN LEVITT & STEPHEN DUBNER

#### \* learning goal 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 goal 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 goal 3

Compare socialism and communism.

### III. UNDERSTANDING SOCIALISM

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

## **IV. UNDERSTANDING COMMUNISM**

### **\* learning goal 4**

Analyze the trend toward mixed economies.

## **V. THE TREND TOWARD MIXED ECONOMIES**

### **\* learning goal 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 goal 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 the Economic Crisis that Began in 2008**

### **G. Using Monetary Policy to Keep the Economy Growing**

## **VII. SUMMARY**



*This organization lends small amounts of money to people in poor countries. For example, it loaned a woman in Uganda enough to buy a refrigerator. She was able to sell fresh food from the refrigerator and make enough money for her family to succeed. Name this organization.*

*Students should read the chapter before guessing the company's name: Foundation for International Community Assistance (FINCA)*

## ***Getting to Know* STEVEN LEVITT & STEPHEN DUBNER**

This duo made economics easy-to-understand for people new to the subject. Their bestselling book, *Freakonomics*, has sold over 4 million copies and has been translated into 35 languages. Levitt and Dubner also wrote a book sequel, maintain a blog, radio show, and podcast. *Freakonomics* was released as a documentary in 2009.

### **\* learning goal 1**

Explain basic economics.

## **I. HOW ECONOMIC CONDITIONS AFFECT BUSINESSES**

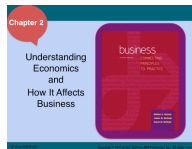
- A. An economic system either promotes or hinders business activity.
- B. Much of America's business success is due to an economic and social climate that allows businesses to operate freely.
  - 1. Any change in the U.S. economic system has a major influence on the business system.
  - 2. Also, **GLOBAL 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 serv-

## Chapter 02 - Understanding Economics and How It Affects Business

### PPT 2-1 Chapter Title



### PPT 2-2 Learning Goals



### PPT 2-3 Learning Goals



### PPT 2-4 Steven Levitt and Stephen Dubner



### PPT 2-5 Name That Company





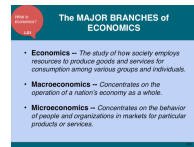
ices and distribute them for consumption among various competing groups and individuals.

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.

**PPT 2-6**  
**The Major Branches of Economics**



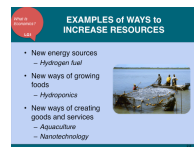
(See complete PowerPoint slide notes on page 2.46.)

**PPT 2-7**  
**Resource Development**

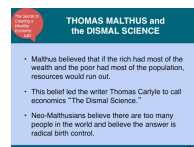


(See complete PowerPoint slide notes on page 2.47.)

**PPT 2-8**  
**Examples of Ways to Increase Resources**



**PPT 2-9**  
**Thomas Malthus and the Dismal Science**



(See complete PowerPoint slide notes on page 2.47.)

**critical thinking**  
**exercise 2-1**  
**KNOW YOUR HISTORY OF ECONOMICS**  
**lecture link 2-1**  
**INDIA'S UPCOMING ERA OF GROWTH**

This Internet exercise is designed to help students gather information about economics from a historic perspective. (See the complete exercise on page 2.73 of this manual.)

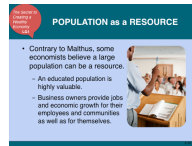
India is a burgeoning economic powerhouse with one of the fastest growing working-age populations. However, it must overcome some bumps in the road. (See the complete lecture link on page 2.66 of this manual.)

2. Others believe that a large population can be a valuable resource, especially if people are educated.
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**

**PPT 2-10**  
Population as a Resource



(See complete PowerPoint slide notes on page 2.48.)

**MAKING THE**  
**green con-**  
**nection**

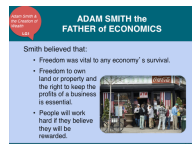
**PPT 2-11**  
It's Not Always  
Greener



**lecture link 2-2**  
**THE GRADUAL RETURN OF**  
**AMERICAN OPTIMISM**

The United States is banking on the “give a man a fish” philosophy by extending the tax cuts from the 2009 stimulus package. (See the complete lecture link on page 2.66 of this manual.)

**PPT 2-12**  
Adam Smith the Father of Economics



(See complete PowerPoint slide notes on page 2.48.)

**critical thinking**  
**exercise 2-2**  
**APPLYING ECONOMIC PRINCIPLES**  
**TO EDUCATION**

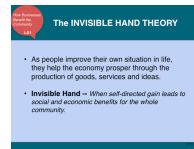
Principles such as competition and productivity apply to nonprofit organizations, such as schools, as well as businesses. (See the complete exercise on page 2.74 of this manual.)

## MODERN ECONOMICS.

### F. HOW BUSINESSES BENEFIT THE COMMUNITY

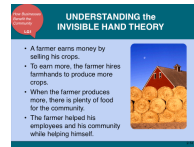
1. The **INVISIBLE HAND** is a phrase coined by Adam Smith to describe the process that turns self-directed gain into social and economic benefits for all.
2. Basically, this meant that a person working hard to make money for his or her own **PERSONAL INTEREST** would (*like an invisible hand*) also **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.

**PPT 2-13**  
The Invisible Hand Theory



(See complete PowerPoint slide notes on page 2.49.)

**PPT 2-14**  
Understanding the Invisible Hand Theory



**lecture link 2-3**  
**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 link on page 2.67 of this manual.)

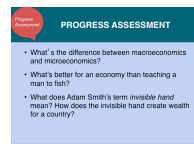
**MAKING**  
**ethical**  
**decisions**

**PPT 2-15**  
How Corruption  
Harms the Economy



**progress**  
**assessment**

**PPT 2-16**  
Progress Assessment



(See complete PowerPoint slide notes on page 2.50.)

**\* learning goal 2**

Explain what capitalism is and how free markets work.

## **II. UNDERSTANDING FREE-MARKET CAPITALISM**

- 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**

**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 2.78 of this manual.)

**PPT 2-17**  
**Capitalism**



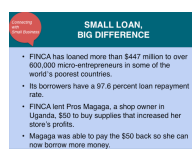
**PPT 2-18**  
**State Capitalism**



(See complete PowerPoint slide notes on page 2.50.)

**CONNECTING  
WITH  
small  
business**

**PPT 2-19**  
**Small Loan, Big  
Opportunity**





### **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
  - 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**

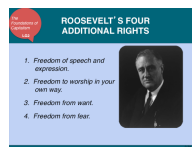
1. Prices in a free market are not determined by sell-

**PPT 2-20**  
Capitalism's Four Basic Rights



(See complete PowerPoint slide notes on page 2.51.)

**PPT 2-21**  
Roosevelt's Four Additional Rights



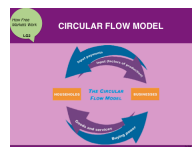
**PPT 2-22**  
Free Markets



**lecture link 2-4**  
**THE CIRCULAR FLOW MODEL**

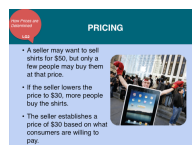
The Circular Flow Model is used to explain how businesses and individuals interact in a free-market economy. (See the complete lecture link on page 2.68 of this manual.)

**PPT 2-23**  
Circular Flow Model



(See complete PowerPoint slide notes on page 2.52.)

**PPT 2-24**  
Pricing



(See complete PowerPoint slide notes on page 2.53.)

ers; 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

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.

**TEXT FIGURE 2.1**  
The Supply Curve at Various Prices

This text figure shows a simple supply curve for T-shirts. The curve rises from left to right. The higher the price, the more will be supplied.

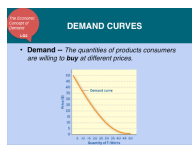
**PPT 2-25**  
Supply Curves



**TEXT FIGURE 2.2**  
Demand Curves

This is a simple demand curve showing the quantity of T-shirts demanded at different prices. The demand curve falls from left to right.

**PPT 2-26**  
Demand Curves



**TEXT FIGURE 2.3**  
The Equilibrium Point

This text figure shows the equilibrium point, the point at which the supply and demand curves intersect—where quantity demanded equals quantity supplied.

**PPT 2-27**  
Equilibrium



**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 2.75 of this manual.)

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.
  - 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. *The text uses the example of gas prices after the recent Gulf oil spill.*
4. In countries without a free-market system, there is no such mechanism, so there are often **SHORT-AGES OR SURPLUSES**.
5. 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*

**lecture link 2-5**  
**THE ECONOMIC IMPACT OF THE  
2010 OIL SPILL**

The 2010 oil leak from BP's Deepwater Horizon didn't affect only gas prices; property values and the fishing industry were also hit hard. (See the complete lecture link on page 2.68 of this manual.)

**PPT 2-28**  
**Four Degrees of Competition**



*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.*
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.

**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 2.77 of this manual.)



## 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**.
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 goal 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**.

**PPT 2-29**  
Free Market Benefits and Limitations



**PPT 2-30**  
The Government Needs . . .



(See complete PowerPoint slide notes on page 2.55.)

**PPT 2-31**  
Atypical Taxes

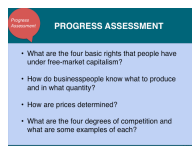
**ATYPICAL TAXES**  
Strange Taxes in Various U.S. States

State	Tax
California	Tax included if you were persecuted by the Chinese Empire and were a prisoner.
Minnesota	An expenditure that results in a violation of the state's laws is subject to a tax of \$100 per day.
Minnesota (and others)	Marijuana tax of \$5.50 per gram.
New York	Sales tax exemption for musical instruments and other items that are not for sale to the public. (e.g., musical instruments with resale).

(See complete PowerPoint slide notes on page 2.55.)

**progress**  
**assessment**

**PPT 2-32**  
Progress Assessment



(See complete PowerPoint slide notes on page 2.56.)

**PPT 2-33**  
Socialism



B. The **MAJOR BENEFIT** of socialism is **SOCIAL EQUALITY**.

1. Income is taken from the wealthier people and re-distributed 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**.
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

**PPT 2-34**  
**Benefits of Socialism**



(See complete PowerPoint slide notes on page 2.57.)

**PPT 2-35**  
**Negatives of Socialism**



**PPT 2-36**  
**Communism**



**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.
  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 goal 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 sys-

**PPT 2-37**  
Two Major Economic Systems



tems 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 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

**PPT 2-38**  
Mixed Economies

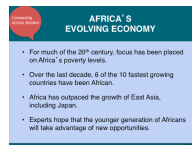


**PPT 2-39**  
Trending toward Mixed Economies



**CONNECTING  
ACROSS  
borders**

**PPT 2-40**  
Africa's Evolving  
Economy



**TEXT FIGURE 2.4**  
Comparisons of Key Economic  
Systems

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

**progress  
assessment**

**PPT 2-41**  
Progress Assessment



(See complete PowerPoint slide notes on page 2.59.)



largest employer in the U.S.

**\* learning goal 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.
- c. A major influence on the growth of GDP is how productive the workforce is.
- d. The total U.S. GDP is over \$14 trillion.

#### **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 2.6.**)
- 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.

**PPT 2-42**  
Gross Domestic Product



**PPT 2-43**  
The United States GDP



(See complete PowerPoint slide notes on page 2.60.)

**PPT 2-44**  
Playing Catch Up



(See complete PowerPoint slide notes on page 2.60.)

**PPT 2-45**  
Unemployment

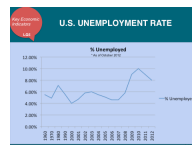


(See complete PowerPoint slide notes on page 2.60.)

**TEXT FIGURE 2.5**  
U.S. Unemployment Rate 1989–2012

This text figure shows the unemployment rate for the years from 1989 to 2012.

**PPT 2-46**  
U.S. Unemployment Rate



(See complete PowerPoint slide notes on page 2.61.)

**TEXT FIGURE 2.6**  
Four Types of Unemployment

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

**PPT 2-47**  
Best and Worst Cities for a Job Search



(See complete PowerPoint slide notes on page 2.61.)

- 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 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**—

**PPT 2-48**  
Inflation



(See complete PowerPoint slide notes on page 2.61.)

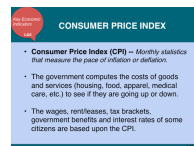
**lecture link 2-6**  
**OTHER ECONOMIC INDICATORS**

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 link on page 2.69 of this manual.)

**lecture link 2-7**  
**NEW ECONOMIC MEASURES**

Michael Gelobter thinks that the GDP, unemployment levels, and price indices should be replaced with the “genuine progress indicator (GPI).” (See the complete lecture link on page 2.70 of this manual.)

**PPT 2-49**  
Consumer Price Index



(See complete PowerPoint slide notes on page 2.62)

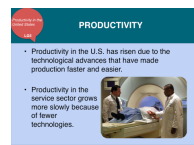
**TEXT FIGURE 2.7**  
How the Consumer Price Index Is Put Together

This text figure shows how the consumer price index is figured out and released.

**PPT 2-50**  
Producer Price Index



**PPT 2-51**  
Productivity



very labor-intensive—creating productivity issues.

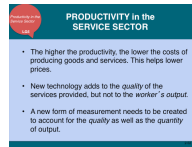
### C. **PRODUCTIVITY IN THE SERVICE SECTOR**

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.

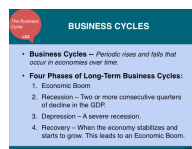
### D. **THE BUSINESS CYCLE**

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.

**PPT 2-52**  
**Productivity in the Service Sector**



**PPT 2-53**  
**Business Cycles**



(See complete PowerPoint slide notes on page 2.63.)

**lecture link 2-8**  
**CHINA'S POTENTIAL REAL ES-  
TATE BUST**

After years of growth, financial experts are afraid the Chinese real estate boom could turn into a bust. (See the complete lecture link on page 2.70 of this manual.)

**lecture link 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 link on page 2.71 of this manual.)

**\* learning goal 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 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 **\$16 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.

**PPT 2-54**  
Fiscal Policy

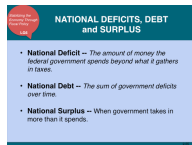


(See complete PowerPoint slide notes on page 2.63.)

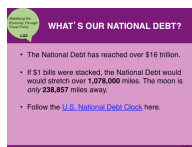
**TEXT FIGURE 2.8**  
The National Debt

This text figure shows the national debt—the sum of government deficits over time—for years 1980 to 2012.

**PPT 2-55**  
National Deficits, Debt, and Surplus



**PPT 2-56**  
What's Our National Debt?



(See complete PowerPoint slide notes on page 2.64.)



## F. FISCAL POLICY IN ACTION DURING THE RECENT 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.

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

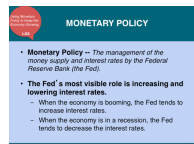
1. The **FEDERAL RESERVE SYSTEM (THE FED)** is a semiprivate organization that decides how much money to put into circulation.
2. **MONETARY POLICY** is the management of the monetary supply and interest rates; it is controlled by the Fed.
  - a. When the economy is booming, the Fed tends to **RAISE 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 2010–2012, the Fed kept interest rates near zero, but the economy remained sluggish.

**PPT 2-57**  
What Can a \_\_\_\_ Dollars Buy?



(See complete PowerPoint slide notes on page 2.64.)

**PPT 2-58**  
Monetary Policy



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.

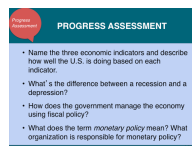
## **VII. SUMMARY**

**lecture link 2-10**  
**CONTROLLING YOUR PERSONAL  
MONEY SUPPLY**

Controlling your personal money supply is harder than you may think. (See the complete lecture link on page 2.72 of this manual.)

**progress  
assessment**

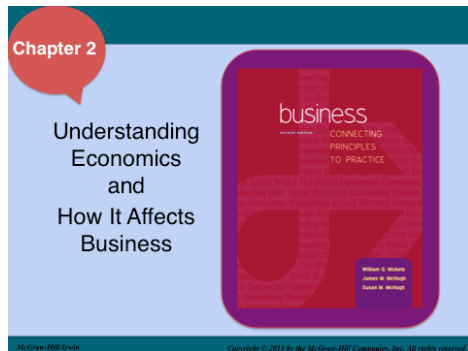
**PPT 2-59**  
**Progress Assessment**



(See complete PowerPoint slide notes on page 2.65.)

# PowerPoint slide notes

## PPT 2-1 Chapter Title



## PPT 2-2 Learning Goals



## PPT 2-3 Learning Goals



**PPT 2-4**

**Steven Levitt and Stephen Dubner**

Connecting with...

**STEVEN LEVITT and STEPHEN DUBNER**  
Freakonomics

- Made economics easy to understand with their book, [Freakonomics](#).
- Blended pop culture and sociology with economic theory.
- They also released a movie, operate a blog, radio show and podcast.



2-4

**PPT 2-5**

**Name That Company**

Organization: Foundation for International Community Assistance (FINCA)

Chapter Two

**NAME that COMPANY**

This organization lends small amounts of money to people in poor countries. For example, it loaned a woman in Uganda enough to buy a refrigerator. She was able to sell fresh food from the refrigerator and make enough money for her family to succeed.

Name that organization!

2-5

**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.

What is Economics?  
LO1

**The MAJOR BRANCHES of ECONOMICS**

- **Economics** -- *The study of how society employs resources to produce goods and services for consumption among various groups and individuals.*
- **Macroeconomics** -- *Concentrates on the operation of a nation's economy as a whole.*
- **Microeconomics** -- *Concentrates on the behavior of people and organizations in markets for particular products or services.*

2-6

### PPT 2-7 Resource Development

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

What is Economics? LG1

## RESOURCE DEVELOPMENT

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




2.7

### PPT 2-8 Examples of Ways to Increase Resources

What is Economics? LG1

## EXAMPLES of WAYS to INCREASE RESOURCES

- 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 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

The Secret to Creating a Wealthy Economy LG1

## THOMAS MALTHUS and the DISMAL SCIENCE

- 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

**PPT 2-10**  
**Population as a Resource**

**POPULATION as a RESOURCE**

- Contrary to Malthus, some economists believe a large population can be a resource.
  - An educated population is highly valuable.
  - Business owners provide jobs and economic growth for their employees and communities as well as for themselves.



2-10

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**  
**It's Not Always Greener...**

**IT'S NOT ALWAYS GREENER...**

- With public concern over the environment, companies are finding greener ways of doing business.
- Some companies are claiming they are more environmentally responsible than they actually are, a practice called "greenwashing."
- Websites such as [Greener Choices](#) and [Greenwashing Index](#) screen ads for greenwashing.


2-11

**PPT 2-12**  
**Adam Smith the Father of Economics**

**ADAM SMITH the FATHER of ECONOMICS**

Smith believed that:

- Freedom was vital to any economy's survival.
- Freedom to own land or property and the right to keep the profits of a business is essential.
- People will work hard if they believe they will be rewarded.



2-12

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 2-13**  
**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.

How Businesses Benefit the Community  
LG1

### The INVISIBLE HAND THEORY

- As people improve their own situation in life, they help the economy prosper through the production of goods, services and ideas.
- **Invisible Hand** -- When self-directed gain leads to social and economic benefits for the whole community.


2-13

**PPT 2-14**  
**Understanding the Invisible Hand Theory**

How Businesses Benefit the Community  
LG1

### UNDERSTANDING the INVISIBLE HAND THEORY

- A farmer earns money by selling his crops.
- To earn more, the farmer hires farmhands to produce more crops.
- When the farmer produces more, there is plenty of food for the community.
- The farmer helped his employees and his community while helping himself.



2-14

**PPT 2-15**  
**How Corruption Harms the Economy**

Making Ethical Decisions

### HOW CORRUPTION HARMS the ECONOMY

- In many countries, a businessperson must bribe the government to gain permission to own land, build, and conduct business operations.

*Imagine you are a restaurant owner in need of a liquor license, but have been unable to get one. You know people in government. Would you be tempted to make large contributions to their re-election campaign to receive that license?*

2-15

### PPT 2-16 Progress Assessment

Progress Assessment

#### PROGRESS ASSESSMENT

- What's the difference between macroeconomics and microeconomics?
- What's better for an economy than teaching a man to fish?
- What does Adam Smith's term *invisible hand* mean? How does the invisible hand create wealth for a country?

2-16

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 2-17 Capitalism

Understanding Free-Market Capitalism  
LG2

#### CAPITALISM

- **Capitalism** -- All or most of the land, factories and stores are owned by individuals, not the government, and operated for profit.
- **Countries with capitalist foundations:**
  - United States
  - England
  - Australia
  - Canada



2-17

### PPT 2-18 State Capitalism

Understanding Free-Market Capitalism  
LG2

#### STATE CAPITALISM

- **State Capitalism** -- When the state, rather than private owners, run some businesses.
- Well-known countries practicing state capitalism:
  - China
  - Russia
- These countries have experienced some success using capitalistic principles, but the future is still uncertain.

2-18

**PPT 2-19**  
**Small Loan, Big Opportunity**

**Connecting with Small Business**

**SMALL LOAN, BIG OPPORTUNITY**

- FINCA has loaned more than \$447 million to over 600,000 micro-entrepreneurs in some of the world's poorest countries.
- Its borrowers have a 97.6 percent loan repayment rate.
- FINCA lent Pros Magaga, a shop owner in Uganda, \$50 to buy supplies that increased her store's profits.
- Magaga was able to pay the \$50 back so she can now borrow more money.

2-19

**PPT 2-20**  
**Capitalism's Four Basic Rights**

**The Foundations of Capitalism**  
**LG2**

**CAPITALISM'S FOUR BASIC RIGHTS**

1. *The right to own private property.*
2. *The right to own a business and keep all that business's profits.*
3. *The right to freedom of competition.*
4. *The right to freedom of choice.*



2-20


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.

**PPT 2-21**  
**Roosevelt's Four Additional Rights**

**The Foundations of Capitalism**  
**LG2**

**ROOSEVELT'S FOUR ADDITIONAL RIGHTS**

1. *Freedom of speech and expression.*
2. *Freedom to worship in your own way.*
3. *Freedom from want.*
4. *Freedom from fear.*



2-21

### PPT 2-22 Free Markets

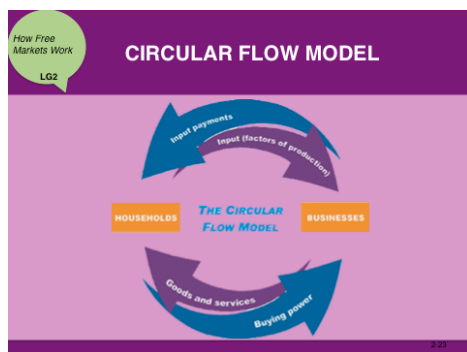
How Free Markets Work  
LG2

## FREE MARKETS

- **Free Market** -- Decisions about what and how much to produce are made by the market.
- Consumers send signals about what they like and how they like it.
- *Price* tells companies how much of a product they should produce.
- If something is wanted but hard to get, the price will rise until more products are available.

2-22

### PPT 2-23 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 resources (factors of production).
  - 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 2-24**  
**Pricing**

Prices are determined by consumers negotiating with the sellers.

*The Economic Concept of Pricing*  
LG2

### PRICING

- A seller may want to sell shirts for \$50, but only a few people may buy them at that price.
- If the seller lowers the price to \$30, more people buy the shirts.
- The seller establishes a price of \$30 based on what consumers are willing to pay.



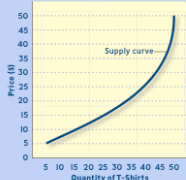
9-04

**PPT 2-25**  
**Supply Curves**

*The Economic Concept of Supply*  
LG2

### SUPPLY CURVES

- **Supply** -- The quantities of products businesses are willing to **sell** at different prices.



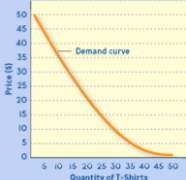
9-05

**PPT 2-26**  
**Demand Curves**

*The Economic Concept of Demand*  
LG2

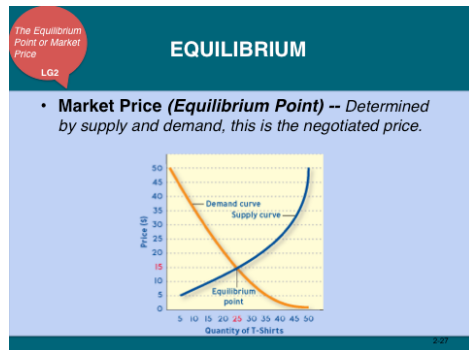
### DEMAND CURVES

- **Demand** -- The quantities of products consumers are willing to **buy** at different prices.



9-06

**PPT 2-27**  
**Equilibrium**



**PPT 2-28**  
**Four Degrees of Competition**



**PPT 2-29**  
**Free-Market Benefits and Limitations**

**FREE MARKET BENEFITS and LIMITATIONS**

*Benefits and Limitations of Free Markets*

**Benefits:**

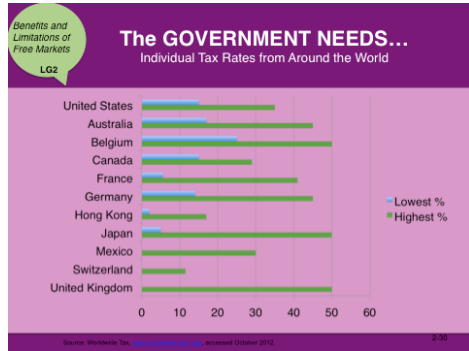
- It allows for open competition among companies.
- Provides opportunities for poor people to work their way out of poverty.

**Limitations:**

- People may start to let greed drive them.

2-29

**PPT 2-30**  
The Government Needs...



1. This slide compares some of the world's lowest and highest individual tax rates.
2. 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%.
3. 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.*)
4. 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).
  - The term *brain drain* refers to the loss of professionally trained individuals due to higher taxes.

**PPT 2-31**  
Atypical Taxes

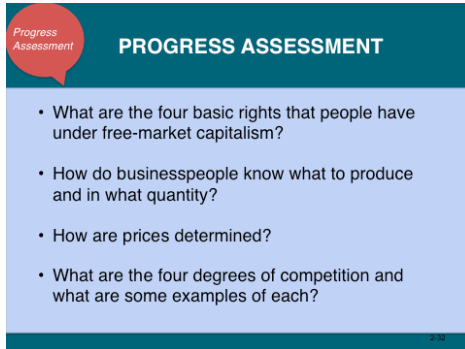
**ATYPICAL TAXES**  
Strange Taxes in Some U.S. States

State	Tax
California	Tax exclusion if you were persecuted by the Ottoman Empire and won a settlement.
Maryland	An aquaculture float credit is available for oyster fisheries, but not other shellfish.
Minnesota (and others)	Marijuana tax of \$3.50 per gram.
New York	Sales-tax exemption for musical comedies and operas if the tickets are over 10¢; can't be used by haunted houses with music.

Source: Forbes March 14, 2011. 2-31

A little bit about the lighter side of taxes.

**PPT 2-32**  
**Progress Assessment**



A presentation slide titled 'PROGRESS ASSESSMENT' with a red circular icon on the left containing the text 'Progress Assessment'. The slide has a light blue background and lists four bullet points.

- What are the four basic rights that people have under free-market capitalism?
- How do businesspeople know what to produce and in what quantity?
- How are prices determined?
- What are the four degrees of competition and what are some examples of each?

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 goods 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 2-33**  
**Socialism**



A presentation slide titled 'SOCIALISM' with a red circular icon on the left containing the text 'Understanding Socialism' and 'LG3'. The slide has a light blue background and lists four bullet points.

- **Socialism** -- *An economic system based on the premise that some basic businesses, like utilities, should be owned by the government in order to more evenly distribute profits among the people.*
- Entrepreneurs run smaller businesses.
- Citizens are highly taxed.
- Government is more involved in protecting the environment and the poor.



**PPT 2-34**  
**Benefits of Socialism**

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

The Benefits of Socialism  
LG3

### BENEFITS of SOCIALISM

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



2-34

**PPT 2-35**  
**The Negatives of Socialism**

The Negative Consequences of Socialism  
LG3

### NEGATIVES of SOCIALISM

- 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.

2-35

**PPT 2-36**  
**Communism**

Understanding Communism  
LG3

### COMMUNISM

- **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.

2-36

**PPT 2-37**

**Two Major Economic Systems**

*The Trend Toward Mixed Economies*  
LG4

### TWO MAJOR ECONOMIC SYSTEMS

- **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.*

2-37

**PPT 2-38**

**Mixed Economies**

*The Trend Toward Mixed Economies*  
LG4

### MIXED ECONOMIES

- **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.

2-38

**PPT 2-39**

**Trending toward Mixed Economies**

*The Trend Toward Mixed Economies*  
LG4

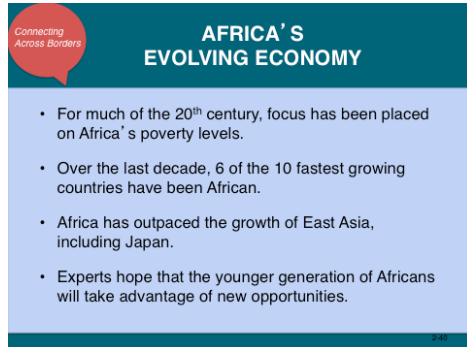
### TRENDING TOWARD MIXED ECONOMIES

- 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.



2-39

**PPT 2-40**  
**Africa's Evolving Economy**



**AFRICA'S EVOLVING ECONOMY**

- For much of the 20<sup>th</sup> century, focus has been placed on Africa's poverty levels.
- Over the last decade, 6 of the 10 fastest growing countries have been African.
- Africa has outpaced the growth of East Asia, including Japan.
- Experts hope that the younger generation of Africans will take advantage of new opportunities.

**PPT 2-41**  
**Progress Assessment**




**PROGRESS ASSESSMENT**

- What led to the emergence of socialism?
- What are the benefits and drawbacks of socialism?
- What countries still practice communism?
- What are the characteristics of a mixed economy?

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.

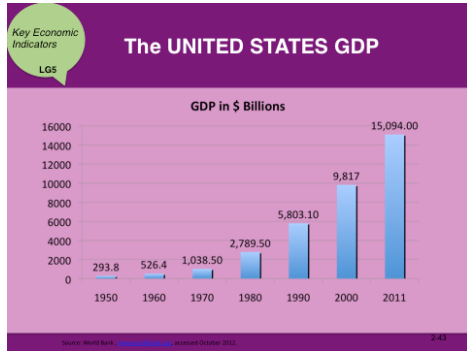
**PPT 2-42**  
**Gross Domestic Product**



**GROSS DOMESTIC PRODUCT**

- **Gross Domestic Product (GDP)** -- *Total value of final goods and services produced in a country in a given year. As long as a company is within a country's border, their numbers go into the country's GDP (even if they are foreign-owned).*
- When the GDP changes, businesses feel the effect.
- The high U.S. GDP (about \$15 trillion) is what enables us to enjoy a high standard of living.

**PPT 2-43**  
The United States GDP



1. In 2011, the U.S. gross domestic product was about \$15 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 2-44**  
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 2-45**  
Unemployment

**UNEMPLOYMENT**

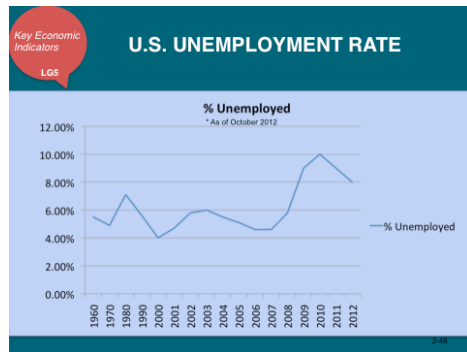
- **Unemployment Rate** -- The percentage of civilians at least 16-years-old who are unemployed and tried to find a job within the prior four weeks.
- **Four Types of Unemployment**
  1. Frictional
  2. Structural
  3. Cyclical
  4. Seasonal

Unemployment Courtesy Telephones

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.

The U.S. unemployment rate reached its lowest point in 30 years at 3.9% in 2000. By 2010, however, it had risen to over 10%. In 2011, it still hovered over 9%.

**PPT 2-46**  
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 2-47**  
Best and Worst Cities for a Job Search

**BEST and WORST CITIES for a JOB SEARCH**

Key Economic Indicators  
LGS

Best	Worst
Washington, D.C.	St. Louis, MO
San Jose, CA	Detroit, MI
New York, NY	Miami, FL

Source: Money Magazine  
2-47

**PPT 2-48**  
Inflation

- 
- INFLATION**
- Key Economic Indicators  
LGS
- **Inflation** -- The general rise in the prices of goods and services over time.
  - **Disinflation** -- When the price increases are slowing (inflation rate declining).
  - **Deflation** -- Prices are declining because too few dollars are chasing too many goods.
  - **Stagflation** -- Economy is slowing, but prices are going up.
- 2-48

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 2-49**  
**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.

Key Economic Indicators  
LG5

### CONSUMER PRICE INDEX

- **Consumer Price Index (CPI)** -- Monthly statistics that measure the pace of inflation or deflation.
- The government computes the costs of goods and services (housing, food, apparel, medical care, etc.) to see if they are going up or down.
- The wages, rent/leases, tax brackets, government benefits and interest rates of some citizens are based upon the CPI.


2-49

**PPT 2-50**  
**Price Index**

Key Economic Indicators  
LG5

### PRODUCER PRICE INDEX

- **Producer Price Index (PPI)** -- An index that measures prices at the wholesale level.




2-50

**PPT 2-51**  
**Productivity**

Productivity in the United States  
LG5

### PRODUCTIVITY

- Productivity in the U.S. has risen due to the technological advances that have made production faster and easier.
- Productivity in the service sector grows more slowly because of fewer technologies.



2-51

**PPT 2-52**

**Productivity in the Service Sector**

*Productivity in the Service Sector*  
LG5

**PRODUCTIVITY in the SERVICE SECTOR**

- The higher the productivity, the lower the costs of producing goods and services. This helps lower prices.
- New technology adds to the *quality* of the services provided, but not to the *worker's output*.
- A new form of measurement needs to be created to account for the *quality* as well as the *quantity* of output.

2-52

**PPT 2-53**

**Business Cycles**

*The Business Cycle*  
LG5

**BUSINESS CYCLES**

- **Business Cycles** -- *Periodic rises and falls that occur in economies over time.*
- **Four Phases of Long-Term Business Cycles:**
  1. Economic Boom
  2. Recession – Two or more consecutive quarters of decline in the GDP.
  3. Depression – A severe recession.
  4. Recovery – When the economy stabilizes and starts to grow. This leads to an Economic Boom.

2-53

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](http://www.nber.org), provides numerous resources to further explain this part of the business cycle.

**PPT 2-54**

**Fiscal Policy**

*Stabilizing the Economy Through Fiscal Policy*  
LG6

**FISCAL POLICY**

- **Fiscal Policy** -- *The federal government's efforts to keep the economy stable by increasing or decreasing taxes or government spending.*
- **Tools of Fiscal Policy:**
  - Taxation
  - Government Spending



2-54

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 2-55**

**National Deficits, Debt, and Surplus**

Stabilizing the Economy Through Fiscal Policy  
LGE

**NATIONAL DEFICITS, DEBT and SURPLUS**

- **National Deficit** -- *The amount of money the federal government spends beyond what it gathers in taxes.*
- **National Debt** -- *The sum of government deficits over time.*
- **National Surplus** -- *When government takes in more than it spends.*

2-55

**PPT 2-56**

**What's Our National Debt?**

Stabilizing the Economy Through Fiscal Policy  
LGE

**WHAT'S OUR NATIONAL DEBT?**

- The National Debt has reached over \$16 trillion.
- If \$1 bills were stacked, the National Debt would stretch over **1,078,000** miles. The moon is **only 238,857** miles away.
- Follow the [U.S. National Debt Clock](#) here.

2-56

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 \$4 billion per day since September 28, 2007.
3. On a per person basis, each citizen's share of this debt is roughly \$52,000.
4. A family of four shares the debt burden of about \$208,000.

**PPT 2-57**

**What Can a \_\_\_\_ Dollars Buy?**

Stabilizing the Economy Through Fiscal Policy  
LGE

**WHAT CAN a \_\_\_\_ DOLLARS BUY?**

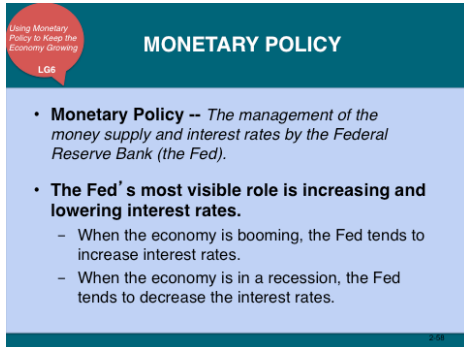
- A **million** dollars can buy an Egg McMuffin and a large coffee for President Obama and 2,000 Secret Service members every day for **six months**.
- A **billion** dollars can buy Egg McMuffins and large coffees for them for **489 years**.
- A **trillion** dollars can buy Egg McMuffins and large coffees for them for **488,992 years**.

2-57

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.



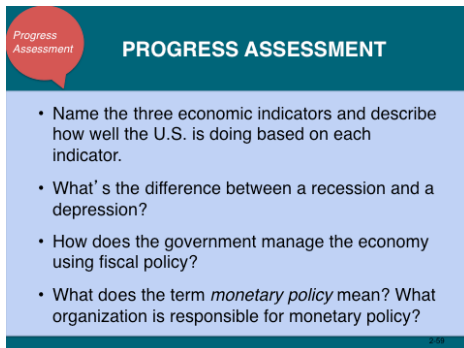
**PPT 2-58**  
**Monetary Policy**



**MONETARY POLICY**

- **Monetary Policy** -- The management of the money supply and interest rates by the Federal Reserve Bank (the Fed).
- **The Fed's most visible role is increasing and lowering interest rates.**
  - When the economy is booming, the Fed tends to increase interest rates.
  - When the economy is in a recession, the Fed tends to decrease the interest rates.

**PPT 2-59**  
**Progress Assessment**



**PROGRESS ASSESSMENT**

- Name the three economic indicators and describe how well the U.S. is doing based on each indicator.
- What's the difference between a recession and a depression?
- How does the government manage the economy using fiscal policy?
- What does the term *monetary policy* mean? What organization is responsible for monetary policy?

1. The three key economic indicators are the gross domestic product (GDP), the unemployment rate, and the price indexes. The U.S. GDP is approximately \$14 trillion. Our high GDP allows citizens to enjoy a high standard of living. In 2000, the United States reached its lowest unemployment rate in over 30 years. However, the recent recession could lead unemployment to at least 10%. 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 links

*"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 link 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.<sup>1</sup>

### lecture link 2-2

#### THE GRADUAL RETURN OF AMERICAN OPTIMISM

The debate over the Bush-era tax cuts raged in Congress for months, ending at last in December 2010 with a compromise between the Obama administration and Republicans. According to the new legislation, the tax laws instated by President Bush will continue for two more years along with a number of provisions from the 2009 stimulus package. Critics fear the extension of the cuts will deprive the govern-

ment of the cash it so desperately needs to shrink the deficit. But for big business leaders, the tax breaks and stimulus expansion are cause for newfound optimism.

The new financial law comes hot on the heels of a string of surprisingly good news for the American economy. Stocks on the S&P 500 index were up an average of 12.8% at the end of 2010. Plus, after President Obama signed the new financial legislation into law, Goldman Sachs's notoriously bearish chief economist raised his 2011 forecast of American stocks' growth from 2% to 3.4%.

Most importantly, though, the United States is reemerging as a stable, dominant force on the global market. As Europe continues to struggle to untangle a knot of sovereign debt, the worst aspects of the American financial crisis seem to be over. And while the dollar has managed to find some steady footing, inflation woes loom large over developing countries like China and India. Still, the recent economic stimulus certainly won't stay exclusively within our nation's borders. American businesses will inevitably invest a good chunk of the bill's \$858 billion into growing operations overseas. Additionally, the unencumbered growth of Chinese and Indian companies fueled by foreign cash will have global repercussions on the commodities and energy markets. As these nations' economies expand, their increased demand for resources will drive up prices around the world. So while America's economic outlook for 2011 looks relatively stable, there are several outside factors preventing it from becoming totally secure.<sup>ii</sup>

## lecture link 2-3

### 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.<sup>iii</sup>

## lecture link 2-4

### THE CIRCULAR FLOW MODEL

(PPT 2-23 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 link 2-5

### THE ECONOMIC IMPACT OF THE 2010 OIL SPILL

The crude oil that spilled from BP's Deepwater Horizon rig is one of the most tragic environmental disasters in human history. The full effect of the spill on the region's wildlife and coastlines is still speculative. The only givens at this point are that the repercussions to the region will be overwhelmingly negative and vast.

That sad fact may not be true for the nation's economy as a whole, though. According to a study by Moody's Economy, the spill isn't expected to have a significant effect on the nation's gross domestic product. The coastline of Louisiana, Florida, Alabama, and Mississippi accounts for just 1% of the GDP. The study also points out that jobs lost in the fishing industry could be made up for in oil recovery jobs. But despite what the oil spill's effect on the national economy ultimately amounts to, the local impact of the spill on the Gulf region is nothing short of catastrophic. Approximately 33% of federal waters in the

Gulf were closed off to commercial fishing, crippling the region's \$2.4 billion commercial fishing industry.

On the shore, meanwhile, commercial property values are expected to tank 10% in the next three years. Property losses could total north of \$4.3 billion on the coastline from Louisiana to Florida. Even before the spill, lot values on the 600-mile stretch were ailing as the recession leveled prices by almost 34% from the peak of U.S. residential sales. As for BP, experts estimate the spill may cost the company \$37 billion in cleanup and restitution to local businesses. We can only hope that the nation's outrage and BP's insistence on maintaining a positive public image can take a backseat until a solution to the problem is devised by a mutual collaboration between corporate America, the federal government, and the public.<sup>iv</sup>

## lecture link 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

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

## lecture link 2-7

### NEW ECONOMIC MEASURES

Michael Gelobter, the Executive Director of Redefining Progress, doesn't believe we are using the right measures of progress in the United States. He thinks that GDP, unemployment levels, and price indexes don't capture real economic progress or decline. He prefers what he calls the genuine progress indicator (GPI). To other economic measures, he would add the three E's: environment, economy, and equity. Gelobter would look at GDP, but he would also measure prison time, heart attacks, and clear-cut forests. Any increases would subtract from real progress, he believes. Furthermore, he would add to economic growth if there were more volunteerism and more time spent with families.

From GDP, he would like to subtract social costs such as crime, automobile accidents, commuting, family breakdown, lost leisure time, and underemployment. He would also subtract the depletion of nonrenewable resources, the cost of long-term environmental damage, and the cost of ozone depletion, lost farmlands, and lost wetlands. Housework and parenting would be added to the GDP, as would volunteer work.

You can see that there would be much controversy over such measures. Do you agree that such measures would help track social progress along with economic progress? Which measures do you agree with? Disagree with? Which measures do you think would be most difficult to gather?<sup>vi</sup>

## lecture link 2-8

### CHINA'S POTENTIAL REAL ESTATE BUST

In 2009, Chinese banks lent a staggering \$1.4 trillion, much of it going to the development of skyscrapers and other commercial property. At the time, government leaders championed the economic expansion. Now Chinese officials are trying to rein in commercial lending by raising the reserve requirements for the nation's banks. Why the sudden change of heart? After years of unprecedented growth, financial experts are afraid that the Chinese real estate boom could quickly turn into a bust. The office vacancy rate in Beijing clocks in at 22.4%, with over 60 office buildings sitting completely empty. Even worse, the current numbers don't include building projects that are already under way, such as the 74-story China World Tower 3 that will soon become Beijing's tallest building.

With a further 13 million square feet of office space entering the market in Beijing, the Chinese economy could sustain considerable damage if the market bottoms out. Experts predict that a 10% drop in property values would triple the number of delinquent mortgages in Shanghai alone. So far, though, Chinese officials have only dissuaded banks from issuing further real estate loans rather than ordering them to halt any current or future construction projects. In fact, some Chinese officials balk at claims of market saturation are overblown. In some cases, local governments are even spurring the growth themselves. For instance, eastern Beijing government officials are hoping to add an additional 10 million square feet of office space this year, despite a 35% vacancy rate in the area.

If China does nothing to stave off runaway development, the country could suffer a fate similar to that of Dubai. From 2002 to mid-2008, Dubai residential real estate prices quadrupled thanks to a glut of foreign buyers. Developers carelessly flipped properties as banks kept them solvent with over \$16 billion in residential mortgages. Once the recession hit, though, property values plunged 52%, emptying skyscrapers and sending much of the sheikdom's burgeoning expatriate workforce back home. Twelve percent of Dubai's 27,000 residential mortgages are expected to default. In January 2010, Barclays won Dubai's first foreclosure case, opening the floodgates for further foreclosures that could send the sheikdoms already shaky real estate market spiraling even further down.<sup>vii</sup>

## lecture link 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'."<sup>viii</sup>

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."

## lecture link 2-10

### CONTROLLING YOUR PERSONAL MONEY SUPPLY

Controlling your personal money supply is harder than you may think. In a recent study, nearly half of those asked said they lose track of how they spend its pocket cash, on average more than \$2,000 a year. The study was commissioned by the Visa credit card group, part of their campaign to get Americans to use debit cards to manage money.

A dollar here, a dollar there—everyone loses track of some cash. What surprised the survey's authors was how much cash goes unaccounted for at the end of a week. The survey asked over 2,000 respondents to estimate their “mystery spending,” or money they couldn't keep track of. Of those, 48% said they couldn't account for an average of \$2,340 a year. At the extreme end of the spectrum were 7% who said they lost track of more than \$100 per week, or \$5,000 per year.

People 34 and under are the biggest offenders. Men lost track of an average of \$50 a week, or \$3,078 a year. Over half of them said they blew the cash during a night out. Young women spent \$42 in mystery cash a week, or \$2,709 a year. Two-thirds of the women blamed shopping trips.<sup>ix</sup>



# 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 2012, 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.

<u>2012 Price</u>	<u>Amount Supplied</u>	<u>Amount Demanded</u>
\$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 2013 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 2012.
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 2013 as described above. In 2014 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 2012.*

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.

<u>2012 Price</u>	<u>Amount Supplied</u>	<u>Amount Demanded</u>
\$120	290,000	440,000
140	320,000	420,000
160	350,000	400,000
<b>180</b>	<b>380,000</b>	<b>380,000</b>
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 2013 as described above. In 2014 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.

	<b>CAPITALIST COUNTRY</b>	<b>SOCIALIST COUN- TRY</b>	<b>COMMUNIST COUNTRY</b>
Country Chosen			
Gross Domestic Product			
Consumer Prices			
Unemployment Rate			
Average Income			
Average Education			

†

**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.

## **video case**

### **OPPORTUNITY INTERNATIONAL: GIVING THE POOR A WORKING CHANCE**

**Time:** 11:15

#### **Learning objectives:**

- Explain what capitalism is and how free markets work
- Discuss the market price, or equilibrium
- Identify the factors that contribute to business growth
- Explain how wealth is created and distributed
- Explain mixed economies, capitalism, socialism, and communism

#### **Overview**

In some of the poorer countries in the world, fifty dollars would be sufficient for individuals to start a business and begin to elevate themselves out of poverty and to change their lives for the better. We take opportunity for granted in the United States; however, opportunities are relatively scarce in poor countries. In many parts of the world, people do not have the opportunities that are afforded to those in the U.S. Poverty is a complex, multidimensional issue. The video features “Opportunity International,” the global organization that provides support for economic development in emerging and poor countries. Programs have been designed to enhance free market enterprise and entrepreneurship by focusing on providing economic education and assistance to individuals in poor countries.

Opportunity International grants microloans and administers other programs to help elevate individuals, promote economic development, encourage entrepreneurship, and contribute to a rising quality of life and standard of living. Opportunity International is designed to give hope to the hopeless. They emphasize education, training, and responsibility by providing economic support to start businesses and driving them toward success. Microfinance is one large tool to help alleviate and overcome poverty.

#### **Video Case: Giving the Poor a Working Chance**

Billions of people in the world make two dollars a day or less. In fact, a billion people make less than one dollar a day. In such places, a loan of \$100 or \$200 makes a huge difference. That’s where microloans from organizations such as Opportunity International come in. Opportunity International is an organization that grants microloans to people, mostly women, in developing countries so they can invest in a business. Those investments often lead to community growth and employment, and help the owners, themselves, to prosper on a moderate scale. The borrowers must pay back the money with interest—when they do, they can borrow more and keep growing. Opportunity International, unlike some other microlending organizations, also provides a banking function where entrepreneurs can safely put their money. They can also buy some insurance to protect themselves against loss.

Opportunity International helps over a million people in over 28 countries, giving them the opportunity to change their lives for the better. This video introduces you to some of those people, but primarily explains how freedom and a little money can combine to create huge differences in people’s lives.



Adam Smith was one of the first people to point out that wealth comes from freedom, the ability to own land, and to keep the profits from what you do on that land. When people try to maximize profits, they have to hire other people to help them do the work. This provides jobs for others and wealth for the entrepreneur. And, like an Invisible Hand, the whole community benefits from the entrepreneurs' desire to earn a profit. In the video, you can see a woman in Uganda who has applied those principles to benefit her family, provide employment, and help her community.

Free market capitalism is the system where people can own their own land and businesses, and keep the profits they earn. Such a system demands that: (1) people can own their own property (not a reality in many developing nations); (2) keep the profits from any business they start; (3) compete with other businesses (it is difficult to compete with the government); and (4) work wherever and whenever they want. The key word in capitalism is freedom—freedom of religion, freedom to own land, and freedom to prosper and grow. Opportunity International is making an attempt to show people how freedom plus a few dollars can make a huge difference in an economy.

In a free market economy, price is determined by buyers and sellers negotiating over the price of a good or service. The equilibrium point is the place where buyers and sellers agree to an exchange; it is also called the market price. Without free markets, there is no way of knowing what buyers need and what sellers need to produce. Thus, in command economies, where there is no supply-and-demand mechanism in operation, there can be shortages or surpluses in food, clothing, and other necessities.

Socialism and communism are alternatives to a free market economy. Under such systems, people are more likely to have a bit of equality, but there are fewer incentives to work hard, and entrepreneurs are often lured to countries where they can make more money by working harder. The result is called a brain drain, where the best and the brightest often move to free market countries. There are advantages to socialism and communism like: free schools, free health care, and free day-care, etc. But the taxes are higher, and there is usually less innovation and higher unemployment.

The trend in the world is toward mixed economies where most of the economy is based on free market principles, but the government gets involved in things such as education, health care, and welfare. The United States has been basically a free market economy, but it is clear that there is a movement toward more government involvement. On the other hand, some countries are reducing the role of government in society and moving toward freer markets. Thus the world is moving toward mixed economies.

The United States government tries to control the money supply through the Federal Reserve and fiscal policy. Fiscal policy has to do with taxes and spending. The less the government spends, the more that is available for businesses to invest. And the lower the tax rates on entrepreneurs, the more they will invest in businesses and the faster the economy will grow.

Opportunity International shows the poorest of the poor how important entrepreneurs, freedom, opportunity, and a little bit of money are to economic growth and prosperity. You are encouraged in this video to participate in helping poor people around the world. You can do this by contributing time and money to organizations like Opportunity International. You can join the Peace Corps or other groups designed to assist less-developed countries.

### Discussion questions and answers

1. *What role could you play in helping less developed countries grow and prosper? Would you be interested in donating money or time to Opportunity International or some other nonprofit organization? Where could you find more information?*

There are many nonprofit and government organizations working in less-developed countries. You can find them on the Internet. You can make a huge difference by donating funds to Opportunity International or other microlending firms.

2. *The government in the United States is getting more and more involved in the economy, spending trillions of dollars on education, health care, welfare, and the like. Does that make the United States a socialist country? What evidence have you seen that the world is moving toward having mixed economies?*

The United States is not a socialist country in that most of the businesses are privately owned and people can own their own land. Nonetheless, the government is getting more and more involved, making the country more of a mixed economy. On the other hand, China, India, and some other countries are promoting more free-market principles and are also moving toward mixed economies.

3. *Explain what Adam Smith meant when he wrote about the Wealth of Nations.*

Adam Smith observed the early period of capitalism in the United States. He rightly observed that providing the freedom for individuals to own land and businesses, and profit from their own labor was the basis upon which a nation would thrive economically. He posited that the Invisible Hand would provide incentives for people to work harder, thus improving the overall economy for the nation. This process of the Invisible Hand essentially turns self-directed gains into benefits for all by providing goods and services, jobs, and new skill development.

## endnotes

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<sup>i</sup> Sources: Peter Coy, "If Demography Is Destiny, Then India Has the Edge," *Bloomberg Businessweek*, January 13, 2011; Madelene Pearson and Malavika Sharma, "Where Are India's Skilled Laborers?" *Bloomberg Businessweek*, January 6, 2011.

<sup>ii</sup> Source: Rich Miller and Simon Kennedy, "For the U.S., the Future Suddenly Seems Brighter," *Bloomberg Businessweek*, December 29, 2010.

<sup>iii</sup> Source: Peter Wonacott, "A New Class of Consumers Grows in Africa," *The Wall Street Journal*, May 2, 2011.

<sup>iv</sup> Sources: John Gittleston, "Oil Spill May Cost \$4.3 Billion in Property Values," *Bloomberg Businessweek*, June 11, 2010; Alice Gomstyn and Daniel Arnall, "Oil Spill Won't Hurt National Economy," *ABC News*, May 20, 2010; "Oil Spill Closes More Gulf Waters to Fishing," *The Associated Press*, June 5, 2010; Elizabeth Campbell and Yi Tian, "Shrimp Prices to Rise After BP Oil Spill Forces Fishing Curbs," *Bloomberg Businessweek*, May 3, 2010.

<sup>v</sup> 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](http://www.gpoaccess.gov).

<sup>vi</sup> Source: Scott Burns, "New Measurement of Economy Urged," *The Washington Times*, October 23, 2002, p. C9.

<sup>vii</sup> Sources: Michael Forsythe and Kevin Hamlin, "The Building Bubble in China," *Bloomberg Businessweek*, March 1, 2010; Zainab Fattah, "Dubai: The First Foreclosure," *Bloomberg Businessweek*, January 25, 2010.

<sup>viii</sup> 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.

<sup>ix</sup> Source: "Half of Americans 'Lose' \$2,000 in Cash a Year," *CNNMoney.com*, September 13, 2007.