

Chapter 2 – Economics: The Framework for Business

Opening Activity: Begin by breaking students into groups of five. Ask them to review the scenario below and work with their team to answer the questions. Remind them to identify and gain agreement on their assumptions behind each answer. Compare and contrast answers among the groups—you may be surprised at the wide range of ideas. As you move through the chapter, you can refer back to the students’ ideas to illustrate key points.

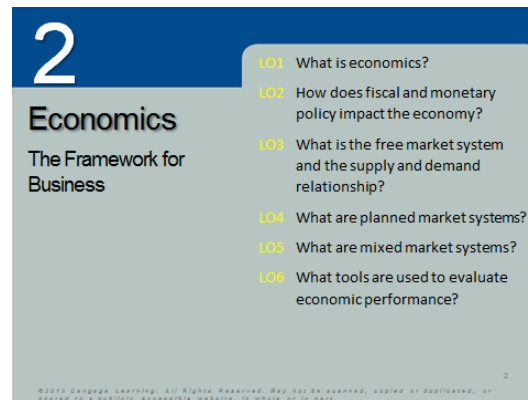
Scenario: Your team runs a small food market in an up-and-coming urban neighborhood. Your main source of income is custom-blended teas and coffees, which you also sell to some nearby restaurants. You have just learned that a national upscale grocery chain is about to open a branch in the neighborhood. This chain sells its own specially blended coffees and teas, and its branches also sell them to local restaurants for less money than you charge for your own store brands. How should you respond? Clarify your assumptions as you answer each of the questions below.

- How do the characteristics of the neighborhood affect your business?
- How will the branch of the national chain affect your business? Why?
- Should you adjust your prices? Why? How?
- What other steps should you take to increase demand for your coffees and teas? Why?

Slide 1

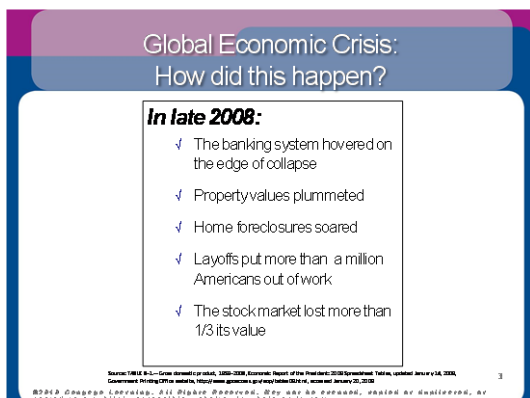


Slide 2



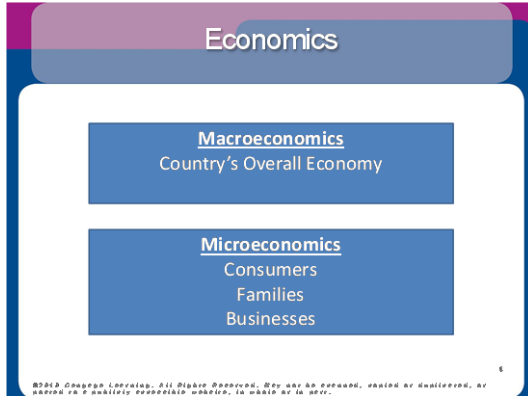
Encourage students to look for the answers to these questions as you move through the lecture.

Slide 3



After reviewing the causes of the global economic crisis, make sure that students can explain what subprime mortgages and mortgage-backed securities are and how they set the recent housing crisis in motion.

Slide 4

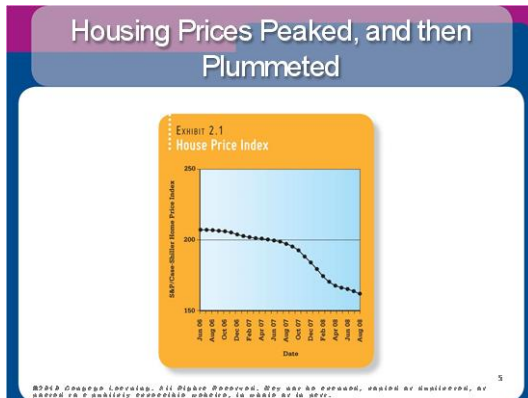


A new federal tax cut has been passed to try to help stimulate the economy during a downturn. Ask students to draw on the points made on the slide and the definitions given in the text. Then ask them to identify how an economist would study the impact of the tax cut on consumption, first from a macroeconomic perspective and then from a microeconomic perspective.

Lecture Booster: Share with students the fact that according to the National Center for Education Statistics (part of the U.S. Department of Education), more than 20% of bachelor's degrees awarded in 2008–2009 were in

business, making it the most popular major that year.¹

Slide 5



This exhibit demonstrates how housing prices peaked in 2006, then began falling precipitously in the months that followed.

Slide 6

- Unprecedented Action by the Federal Government**
- The Federal Reserve (FED) intervened with financial institutions
 - The FED bailed out insurance giant AIG
 - Congress passed the Troubled Assets Relief Program (TARP)
 - The Treasury Department spent money on an auto industry bailout
 - The American Recovery and Reinvestment Act was signed by Congress to turn around the economy
 - These *fiscal* and *monetary* actions slowly began to improve the economy
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The textbook discusses the steps that the federal government took to intervene regarding the economy to prevent total financial disaster. This slide lists some of the most important measures and introduces the ideas of *fiscal* policy and *monetary* policy.

Slide 7

A Trillion Dollars?

- If you had started spending a million dollars – every day, without fail – at the start of the Roman Empire, you still wouldn't have spent a trillion dollars by 2010.
- One trillion dollars laid end-to-end would stretch farther than the distance from the earth to the sun.
- You could wrap your chain of bills more than 12,000 times around the earth's equator.
- If you flew a jet at the speed of sound, spooling out a roll of dollar bills behind you, it would take you more than fourteen years to release a trillion dollars.

Source: One Trillion Dollars by Michael S. Green, January 26, 2009, News, p. 27-31


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Students might have a hard time picturing what a trillion dollars means. (Well, just about *anyone* might have trouble getting a handle on such a huge amount of money.) To help them understand, share the light-hearted facts on this slide concerning this very serious amount of money. At least it will make things a little more concrete.

Slide 8

Federal Reserve



- **Conduct Monetary Policy:**
 - ✓ Changes in the Discount Rate
 - ✓ Changes in Reserve Requirement
 - ✓ Open Market Operations
- Check Clearing Process
- Banking Services for Government and other banks

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Be sure that students know how the Fed would use each tool in the face of either inflation or recession. Regarding the check-clearing process, explain that the Check Clearing for the Twenty-First Century Act, which became effective in 2004, allows banks to process checks electronically.

This makes the process more efficient—so it is more important than ever to avoid bouncing a check. If students pay their bills by check, their banks can now deduct funds from their accounts more quickly than in the past, usually in less than a day. So it would be best to

remind them that they'd better be sure they have enough money in their accounts *before* writing a check.

Slide 9

Managing the Economy Through Fiscal and Monetary Policy

Fiscal Policy – government efforts to influence the economy:

- ✓ Taxation
- ✓ Government Spending
- ✓ Controlled by Congress/Budget Process

Monetary Policy – Federal Reserve actions to shape the economy:

- ✓ Supply and Demand of Money
 - Cost of Credit
- ✓ Controlled by the Federal Reserve (FED)
 - Seven Member Board
 - Chairman

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Fiscal Policy: Discuss the thinking behind the approaches to fiscal policy. Many economists believe that lower taxes boost the economy by leaving consumers and businesses with more money to spend. Others believe that more government spending—fueled by taxes—will drive the economy more effectively.

Monetary Policy: From a broad perspective, discuss the role of the Federal Reserve in influencing the money supply and the cost of credit. And the expertise of the people in charge is crucial to the Fed's operations. Be sure to make sure students know that Ben Bernanke is the

current chairperson of the Fed.

Lecture Booster: One way of evaluating tax levels is to measure overall taxes as a percentage of a nation's GDP. A 2010 study of 33 nations by the Organization of Economic Cooperation and Development found that Denmark had the highest tax-to-GDP ratio, at 47.9%. Mexico had the lowest ratio, at 16.5 percent. The United States was fourth lowest at 26.0%. A lower level of taxes means more money in the hands of the populace and less money in the hands of the government.²

Slide 10

The textbook defines *fiscal policy* as government efforts to influence the economy through taxation and spending. Make sure students understand the difference between “deficit” and “debt.”

Lecture Booster: Here’s a chance for students to test their understanding regarding just what a trillion dollars looks like. The U.S. Treasury reported a \$1.29 trillion deficit for fiscal year 2010. Although this is a large number, it was still less than the deficit for 2009, which was \$1.42 trillion and gave rise to hopes that the economy was recovering. However, the Congressional Budget Office projected a

\$1.5 trillion deficit for 2011—the highest ever. To put these figures in context, remind students that the year 2000 was the first year that the U.S. government’s entire budget—the total it spent, not the deficit—had ever cleared \$1.8 trillion.³

Web Connection: Click the icon at the top right corner of the slide to watch the U.S. National debt grow. (The National Debt is at the top left of the page.) The Debt Clock provides not only the latest debt figures but also the debt per citizen and per taxpayer. Ask students how the debt per citizen and per taxpayer help them see the national debt in a more personal light.

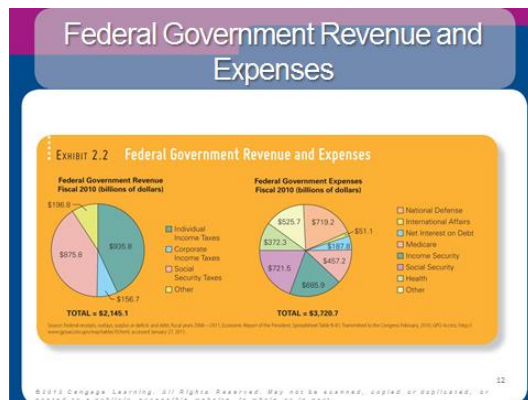
Slide 11

Point out that in actual practice, the term *money supply* most often refers to M2 as defined in the textbook. You may want to note that credit cards are not part of the money supply, although they clearly play a vital role in the flow of money through the economy. You also may want to remind students that CDs are low-risk savings vehicles with a fixed term.

Lecture Booster: Most people would probably guess that if only you had your fair share of all the currency in circulation, you’d be pretty well set. But don’t be fooled! Paper bills and metal coins make up a surprisingly small

portion of the U.S. money supply. As of August 2011, about \$1.03 trillion worth of currency was in circulation. That translates to only about \$3,300 for every American—a much smaller fortune than you might imagine. The reason that the amount of currency in circulation is relatively small is that so many of our transactions are now performed by electronic fund transfers in the form of credit card and debit card transactions and bill payments made online or by phone.⁴

Slide 12

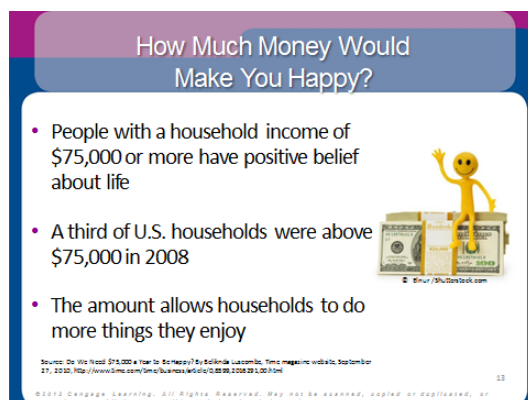


You may want to remind students that the deficit equals the difference between total income and total expenses. You can also emphasize that the net interest portion of expenses is likely to grow rapidly as the federal debt continues to increase.

Lecture Booster: Ask students to compare the federal budget with their own personal budget. What happens when they overspend in any given month? Does that overspending become credit card debt? Most students will quickly see—if they haven't already experienced it firsthand—that having to pay off that debt limits their

flexibility in future months as interest and payments mount. Now ask them to take that thinking to the federal level. Among current proposals to reduce the federal deficit are the following: gradually raising the mandatory retirement age, raising Medicare fees, decreasing defense spending, decreasing farm subsidies.⁵

Slide 13



This slide summarizes the analysis of a Gallup/Healthways poll of 450,000 Americans in 2008–2009. Although \$75,000 a year doesn't have much influence on your day-to-day mood, it can affect your overall sense of well-being—in large part because it allows you to do more things that you enjoy, such as going out with your friends.

Lecture Booster: Apparently money and happiness don't necessarily go together. A recent study by a team of Cornell University researchers found that when asked to choose between a job with a higher salary but long hours and one with a lower salary and more reasonable hours,

many people will choose the higher-paying job, even at the cost of their personal happiness. Sometimes happiness is only one of several variables that people consider. Alex Rees-Jones, one of the authors of the study, says, “You might think of happiness as the ultimate goal that people pursue, but actually people think of goals like health, family happiness, social status, and sense of purpose as sometimes competing with happiness.”⁶

Slide 14

Open Market Operations

- Buying and selling government securities
 - *Treasury bonds, notes, bills*
- When the economy is weak
 - *The FED circulates money by buying government securities*
- Operations are managed by Federal Open Market Committee
 - *Seven member board of governors*

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This slide summarizes some of the operations the Fed engages in when applying its most frequently used tool. Make sure students understand when and why the Fed buys or sells government securities on the open market and how each operation affects the money supply.

Slide 15

Looking to multiply your money? Look no further than your local bank

The bank must hold 10% of your deposit based on Federal Reserve Requirements.

You deposit \$5,000

The bank loans Anne \$4,500

Anne buys a car from Jake for \$4,500

Jake deposits the \$4,500


Although you still have \$5,000, the money supply has increased to **\$9,500**

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Explain this concept by using actual students in your class, and extend the exercise through a number of transactions. After each transaction, ask students how much money they have, add up the growing “money supply,” and point out that there is still only \$5,000 in cold, hard cash. This will introduce the thinking behind the FDIC. Students will quickly see that they’d be out of luck if they all demanded their cold, hard cash at the same time. You can then explain how the FDIC would avert such a crisis in the real world.

Slide 16

Federal Deposit Insurance Corporation (FDIC)



- The FDIC insures deposits in banks and thrift institutions up to \$100,000
- The amount was increased to \$250,000 at the end of 2008
- Since 1934, no depositor has lost a single cent of insured funds because of bank failure

Source: What is the FDIC? FDIC website, October 27, 2008, <http://www.fdic.gov/what/fdic/index.html>, accessed January 22, 2009

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You can use this slide as a follow-up to Slide 15, because it summarizes the purpose and activities of the FDIC. Remind students that actual runs on the banks in 1930 and 1931 caused waves of devastating bank failures, with the result that millions of people lost their life savings and the Great Depression grew even worse. Even though bank failures have occurred since the FDIC was established in 1934, not one depositor has lost a single cent of insured funds.

Slide 17

More FED Functions

- **Discount Rate Changes**
 - ◉ Banks borrow money from the FED
 - ◉ The discount rate is the interest rate the FED charges banks
 - ◉ The rate impacts how much businesses and individuals will borrow
- **Reserve Requirements Changes**
 - ◉ FED requires bank hold funds called reserves
 - ◉ Impacts bank availability of funds to loan

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Make sure students understand how the discount rate that the Fed sets for banks that borrow from it *also* affects how much individuals and businesses will borrow. The textbook notes that in the wake of the financial crisis of 2008, the Fed is likely to impose more stringent regulations on business activities.

Slide 18

Capitalism: The Free Market System

The Free Market:

- Private Ownership
- Economic Freedom
- Fair Competition
- Innovation and Hard Work

Businesses offer Value to:

- Customers
- Employees
- Suppliers

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Emphasize how free market economies can raise the standard of living for virtually everyone involved. Highlight the role of free choice—within limits, of course—for both businesses and individuals. To succeed in a free market economy, businesses must offer value to customers who could choose to go elsewhere, as well as to employees and suppliers who could just as easily serve others. You may wish to emphasize another key point: the limited role of government in capitalism.

Slide 19

The Fundamental Rights of Capitalism

1. The right to own a business and keep after-tax profits
2. The right to private property
3. The right to free choice
4. The right to fair competition

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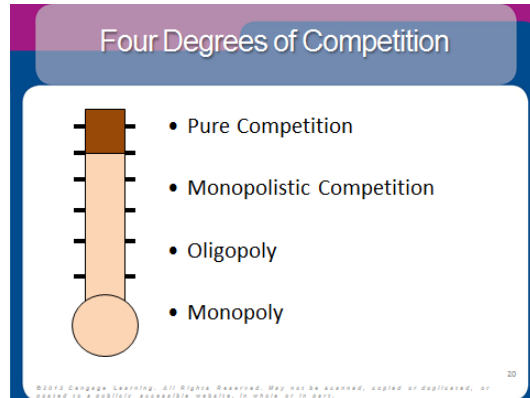
Discuss the rights listed on this slide:

- Remind students that capitalism doesn't *guarantee* that anyone will actually earn profits. Nor does it promise that they *won't* have to pay taxes. But people who do earn profits can keep their after-tax income and spend it however they see fit. The impact on motivation is huge!
- Individuals and private businesses can buy, sell, and use property in any way that makes sense to them (within the limits of the law, of course).
- Freedom of choice—what to buy and sell, and where to

live and work—has a direct effect on competition. Most important, it is a strong force in motivating businesses to offer the best goods and services at the lowest prices.

- *Fair* competition is crucial to capitalism in order to drive higher quality, lower prices, and more choices. The government's role is to ensure a level playing field through regulation and enforcement.

Slide 20



Not all competition works the same way. After you explain the different degrees of competition, ask students to name examples of each type of competition.

Possibilities include:

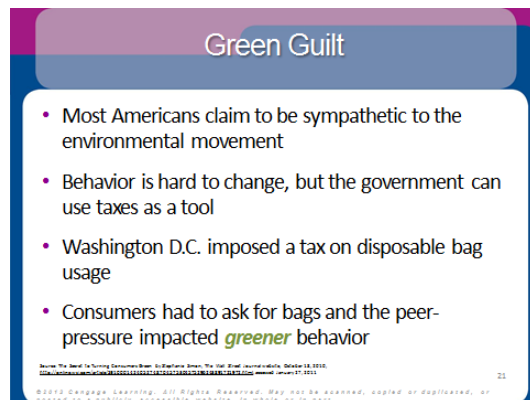
- Pure competition: Agriculture probably comes closest, but true examples are rare in today's economy.
- Monopolistic competition: The tee-shirt business, the restaurant business. Be sure students know that monopolist competition is not the same as a monopoly.
- Oligopoly: Examples would include movie theater chains, and the computer industry.

- Monopoly: Although Microsoft isn't a monopoly, it was convicted of monopolistic practices in the mid-1990s. More recently, Google was accused of monopolistic search-engine practices.⁷

Lecture Booster: Over the last two decades, a number of agricultural producers have broken free of pure competition, creating a meaningful difference in—and commanding higher prices for—entire categories, such as hormone-free and lactose-free milk and organic produce, and for individual brands such as Dole pineapples and Chiquita bananas. But many other agricultural products, such as carrots and pears, remain undifferentiated.

Break students into small groups. Ask each group to choose one undifferentiated agricultural product. Have them create and develop a strategy to differentiate that product in the minds of consumers. After the groups present their ideas, ask students if they would be willing to pay more for the newly proposed approaches. Why or why not?

Slide 21



Although most Americans claim to be sympathetic to the environmental movement, their behavior is hard to change. Some local governments have used a combination of taxes and peer pressure to change people's habits.

Lecture Booster: Ask students for some examples of environmental problems on campus. These might include inefficient recycling methods, littering, and so on.

Although they can't tax their fellow students, you can ask your class for some examples of peer pressure to

encourage eco-friendly behavior.

Slide 22

Supply and Demand: Fundamental Principles of a Free Market

The Foundation of the Free Market

- ✓ How much can we make/sell?
- ✓ How much will consumers buy?
- ✓ At what price?

Interaction of buyers & sellers

- ✓ Impact prices
- ✓ Competition

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Introduce the concept of supply and demand. Help students understand from an intuitive standpoint that the continual interaction between buyers and sellers determines the selection of products and prices available in a free market economy.


Lecture Booster: The theories of supply and demand are based on the assumption that people and businesses make logical, rational choices after considering all the information available to them at any given time. But in the real world, people make silly choices all the time. Ask students, for instance, to think of a time when they

overpaid for something without bothering to comparison shop.

Slide 23

Supply and Demand: Fundamental Principles of a Free Market

- **Supply:** the relationship between the price of a good and the quantity sellers are willing/able to offer
Sellers tend to supply a greater quantity as the price rises.
- **Supply curve:** a graph of the supply relationship
The supply curve slopes upward to the right showing that quantity supplied increases as price rises.



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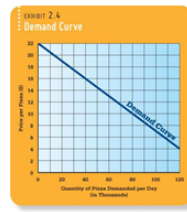
Ask students to consider why the quantity supplied rises as prices rise.

Lecture Booster: Help students understand how supply works from an intuitive perspective. Ask students to imagine that they are corn farmers, and they notice that the price of wheat is rising. Ask them what they would do. One or two will quickly see that they would most likely plow under the corn and start growing wheat as soon as possible. This simple example seems to help many students understand the complex relationship between price and quantity from a producer perspective.

Slide 24

Supply and Demand: Fundamental Principles of a Free Market

- **Demand:** the relationship between the price of a good and the quantity buyers are willing and can afford to buy
When price falls, consumers tend to buy more.
- **Demand curve:** a graph of the demand relationship
The demand curve slopes downward showing that quantity demanded increases as price falls.



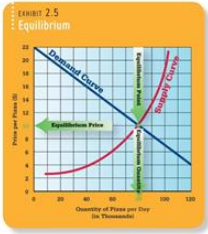
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Help students understand how demand also works from an intuitive perspective. The pizza example from the text may be helpful. If the price of pizza suddenly doubled, what would they do? Many will answer that they would simply stop buying pizza, especially with so many other fast-food choices available.

Slide 25

Supply and Demand: Fundamental Principles of a Free Market

- Forces of supply and demand drive equilibrium price
- The point where supply and demand intersect
- Market price adjusts to the equilibrium price



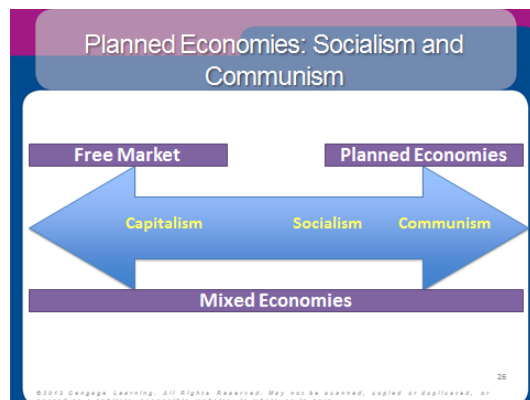
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Encourage students to see that in the real world, supply and demand don't operate in a vacuum. The constant interaction between these two forces helps determine the market price in any given category.

Lecture Booster: Share this real-world example of supply and demand with students. The Toyota Prius is the most popular hybrid vehicle sold in the U.S. The catastrophic earthquake and tsunami that struck Japan on March 11, 2011 brought production to a stop, drastically limiting the supply of vehicles. However, with fuel prices on the rise, the Prius is in high demand, and many U.S. dealers have

waiting lists of buyers. Although Toyota rushed to rebuild its supply of the cars once the factories reopened, dealers were selling the car for \$3,000 more than before the earthquake. Ask students what they think might happen to prices once Toyota comes closer to meeting the U.S. demand for the Prius.⁸

Slide 26



You may wish to point out the relationships among high or low taxes, the profit incentive, and the distribution of wealth. Be sure students can distinguish socialism and communism.

Slide 27

Planned Economies: Socialism and Communism

Communism

- Public Ownership of Enterprise
- Strong Central Government

Socialism

- Government Control Key Enterprises
- Higher Taxes

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You may want to point out how the *lack* of free choice—too much government control—has played a pivotal role in the lack of success of planned economies. Consider using the Soviet Union and the former Soviet satellite countries—or Cuba or North Korea, currently the world's strictest planned economies—to support your points.

Slide 28

Mixed Economies: The Story of the Future

Market and Planned Economies don't meet all needs

- Neither planned nor market economies meet all needs
- Planned Economies will not create enough value

As a market dominant economy, the U.S. government still owns/supports enterprises

- Postal Service
- Universities
- Parks
- Libraries

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Ask students how the very old, the very young, the sick and disabled, and the environment could suffer under a pure market economy. They typically come up with excellent examples, relevant to their local communities. To provide contrast and help students understand the lack of value in planned economies, you could point to the skyrocketing level of poverty in Cuba and the devastating famines in North Korea.

Slide 29

Evaluating Economic Performance: What's Working?

- Gross Domestic Product
- Unemployment Rate
- Consumer Price Index
- Producer Price Index
- Productivity

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As you discuss each term on the slide, you may want to point out that no one measure captures all the dimensions of economic performance. A full understanding requires a range of measures. Some additional points to consider:

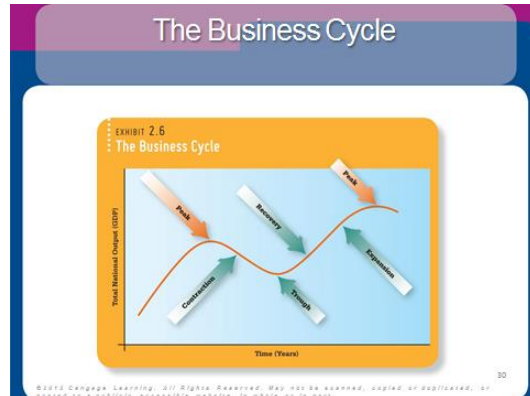
- **Gross Domestic Product:** Remind students that GDP levels tend to be understated, because they include neither illegal activities (such as paying undocumented workers), nor legal goods that are not reported to avoid taxation, nor output produced within households. You might also want to point out that the U.S. has the

highest GDP in the world.

- **Unemployment Rate:** During the global recession, the U.S. unemployment rate has shot up from between 4 and 6 percent to close to 10 percent. Distinguish the different types of unemployment that contribute to the total number: frictional, structural, cyclical, and seasonal.
- **Productivity:** Be sure to cover the productivity equation (output/input = productivity). You also may want to point out that productivity, an excellent measure of efficiency, does not measure quality—another good reason to examine multiple measures of economic health.
- **Consumer and Producer Price Indices:** Use these measures as an opportunity to define and discuss inflation. Most students don't seem to realize that mild inflation may be a sign of a healthy economy. You also may want to cover hyperinflation, disinflation, and deflation.

Web Connection: Click the icon at the top right corner of the slide to explore how the U.S. Bureau of Labor Statistics measures labor market activity, working conditions, and price changes in the economy. Ask students how these statistics reflect economic performance.

Slide 30



Point out that two key words of the business cycle *are expansion and contraction*. A contraction is called a recession when GDP decreases for two consecutive quarters. A depression is an especially deep and long-lasting recession.

Lecture Booster: Tell students that there is no official gauge of a depression, but that Harry Truman developed a measure that still resonates: “It’s a recession when your neighbor loses his job; it’s a depression when you lose your own.”

Slide 31



Modern Shed, a construction firm in the Seattle area, specializes in building small, eco-friendly residences and backyard sheds that can function as studios, guest quarters, or storage space. Discuss the business opportunities associated with this company.

Slide 32

Gather Around the Water Cooler: Let's Talk

- What factors affect demand for Modern Shed residential solutions?
- Is Modern Shed's business plan consistent with what you'd expect for a period of economic contraction? Why or why not?
- Why is an economic downturn creating new business opportunities for Modern Shed?

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Use these questions to talk about how Modern Shed plans to take advantage of the opportunities offered by the current economic downturn.

Slide 33

Inflation

The rate of price changes across the economy is an economic measure

- Inflation means that prices are rising
- Hyperinflation is when average prices increase more than 50% per month
- Disinflation is when prices increase slowly
- Deflation is when average prices actually decrease.

*The government measures prices using the **Consumer Price Index (CPI)** and the **Producer Price Index (PPI)***

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Point out to students that deflation is a sign of serious economic trouble because it's linked with high unemployment. You might also note that U.S. consumer prices have dropped only slightly during the global recession and that a good part of that roughly 2% decline is due to the extraordinarily high energy prices that plagued the economy during the summer of 2008. Ask students why prices haven't dropped despite high unemployment. This is also a good opportunity to review the differences among inflation, hyperinflation, disinflation, and deflation. Also review the functions of the Consumer Price Index (CPI) and the Producer Price

Index (PPI).


Slide 34

Productivity

The relationship between inputs and outputs is productivity

A high level of productivity correlates with healthy GDP.

The U.S. has experienced strong productivity growth due to technology.



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Note that although high productivity *usually* correlates with high GDP, it doesn't *always* do so. Sometimes it isn't the introduction of new technology that increases worker efficiency, which in turn boosts productivity, but the slashing of payrolls so that fewer workers are doing the same amount of work.

Lecture Booster: In the second quarter of 2011, productivity grew at an annual rate of 1.8%, surpassing economists' estimates of 1.7%. In the first quarter of 2011, productivity had increased 2.9%. However, in April 2011, unemployment was the highest in eight months,

indicating a weaker job market.⁹

Slide 35

Is Productivity Keeping Unemployment High?

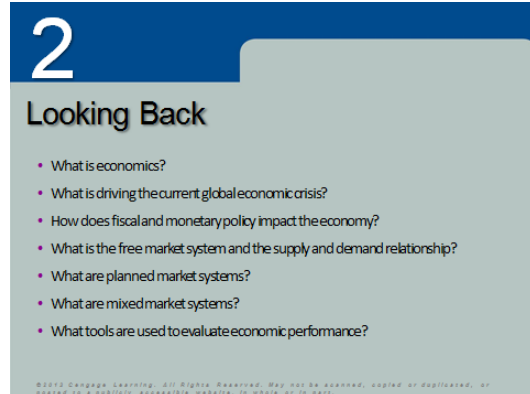
- Regardless of high unemployment, the private sector is very strong
- Business output is up 6.3% since 2009
- Labor productivity has risen 7.8%
- The goal of management is efficiency
- Are productivity gains a cause of continued unemployment?
- How has technology contributed to this dilemma?

Source: Bureau of Economic Analysis
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Davidson Institute

U.S. workers are the most productive in the world, but some observers think that the technological advances behind this productivity are costing jobs that the workforce badly needs. And the fewer people who are employed, the less chance they have of raising the standard of living for everyone.¹⁰

Slide 36



2

Looking Back

- What is economics?
- What is driving the current global economic crisis?
- How does fiscal and monetary policy impact the economy?
- What is the free market system and the supply and demand relationship?
- What are planned market systems?
- What are mixed market systems?
- What tools are used to evaluate economic performance?

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To review the chapter, ask students to volunteer answers to these questions.

Closing Activity: This team activity is meant to help students work with their classmates to flex their creative muscles, in keeping with a key theme of the textbook—the growing importance of innovation.

Break students into groups of three to five people. Ask them to choose a product or service that (1) they are all familiar with; and (2) they all agree is headed downhill. (Possibilities could include anything from a clothing line to

the local pizza place.)

The Assignment: Have teams write a brief description of how the product is positioned in the marketplace relative to its competition. Then have them work together to figure out how you can change the product so that it better meets customer needs. Consider changing everything from the product's features to the advertising venues. Write a paragraph that describes the revamped product, and draft a new slogan. Share your results with the class.

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