SOLUTIONS MANUAL

Chapter Two
Economics: The Framework for Business

Review Questions

1. How did the global economic crisis unfold?

   As the economic prosperity of the 1990s began to look shaky in 2000/2001, the Federal Reserve dropped interest rates dramatically. This move mitigated a downturn, but sparked fueled explosive growth in risky subprime mortgage loans, which now offered lenders a better return than most other investments. Millions of Americans used this opportunity to buy homes that they simply couldn't afford over the long term.

   Meanwhile, banks sold these high risk loans to investment houses and hedge funds, which traded them as specialized securities. When the housing bubble burst in 2006, homes lost value and the foreclosure rate skyrocketed. Correspondingly, the mortgaged-backed securities were now worth a fraction of their original value, driving financial institutions to the brink of collapse. With the banking system in crisis, other businesses could no longer finance their operations, leaving to massive layoffs and rising unemployment.

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

   Both the Federal government and the Federal Reserve intervened at an unprecedented level of prevent total financial disaster. They worked together to bail out businesses that were "too big to fail" (e.g. AIG Insurance, GM), and Congress passed a massive economic stimulus package.

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

   Macroeconomics is the study of a country's overall economic issues, such as the unemployment rate, the gross domestic product, and taxation policies. Microeconomics, on the other hand, focuses on smaller economic units such as individual consumers, families, and individual businesses. The two dimensions of economics clearly interrelate. For instance, if income taxes were to decrease by 50% (a macroeconomic shift), you might decide to go to Starbucks every day, rather than making your coffee at home (a microeconomic decision).

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

   Fiscal policy refers to government efforts to influence the economy through taxation and spending decisions that are designed to encourage growth, boost employment, and curb inflation. Monetary policy, managed by the Federal Reserve System (the Fed), refers to efforts to shape the economy by influencing interest rates and the supply of money.

Politics plays a much stronger role in fiscal policy, since the president proposes a taxation and spending plan that Congress must approve, implement, and oversee. Both the president and Congress are elected, of course, and must answer directly to their constituents. The governors of the Fed, on the other hand, are appointed by the president and approved by Congress, but they serve single 14-year terms. Since their terms are staggered, no single president can appoint all of the members. This structure helps ensure that the governors act in the best long- term interests of the economy, and do not simply respond to the political pressures of the moment.

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

   The fundamental elements of the free market system are private ownership, economic freedom, and fair competition. Key principles include the paramount importance of individuals, innovation, and hard work. The profit motive provides the incentive to achieve. To thrive in a free market system, companies must offer value to their customers—otherwise their customers will choose to go elsewhere. Businesses must also offer value to their employees and suppliers in order to attract top-quality talent and supplies.

6. Describe the 4 degrees of competition within the free market system. Offer 2 to 3 examples of each type of competition.

Degree of competition	***Examples***
Pure competition*: A market structure with many competitors selling virtually identical products. Since customers can't distinguish one product from another, no single producer has any control over prices. And new producers can easily enter and leave the market.*	*Pork bellies, milk, corn*
Monopolistic competition*: A market structure with many competitors selling differentiated products. Producers have some control over prices. And new producers can enter and leave the market fairly easily.*	*Clothing, restaurants, Web design services*
Oligopoly*: A market structure with only a handful of competitors selling products which are either similar or different. Entering the market is difficult for new producers.*	*Soft drinks, cell phone service providers, network television*

Monopoly: *A market structure with just a single producer completely dominating the industry. With a few exceptions, monopolies are illegal in the U.S. because they stifle competition.*	*Microsoft was recently convicted of monopolistic practices. Cable television franchises and utility companies are usually set up as legal, highly regulated monopolies.*

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

   Since businesses seek to make as much profit as possible, they are likely to produce more of a product that commands a higher market price, and less of a product that commands a lower price. This tendency leads to an increase in the quantity supplied when prices are higher and a decrease in the quantity supplied when prices are lower. Consumers, on the other hand, generally seek to get the products they need (or want) at the lowest possible prices, so they buy more of products with lower prices and less of products with higher prices. This causes an increase in the quantity demanded when prices are lower and a decrease in the quantity demanded when prices are higher.

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

   Socialism is an economic system based on the principle that the government should own and operate key enterprises that directly affect public welfare, such as healthcare. The goal is to run these enterprises in the best interest of the overall public, although in practice, inefficiencies and corruption often interfere with effectiveness.

   Communism is an economic and political system that calls for public ownership of virtually all enterprises, under the planning and direction of a strong central government. The goal is to dramatically improve the lot of the worker at the expense of the super rich. But in practice, communist economies have produced crippling shortages and excessive corruption, leading to a lower standard of living for everyone.

   Too much government control tends to reduce economic opportunity by creating inefficiency, corruption, and a disincentive to innovate.

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

   All countries have mixed economies in order to meet the needs of their citizens. A pure market economy would make insufficient provision for the old, the young, the sick, and the environment. A pure planned economy would not create enough value to support its people over the long term. The trend toward the market end of the spectrum seems likely to continue since in most cases it has boosted economic growth rates, raising the standard of living for millions of people.

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

    During a contraction in the business cycle, gross domestic product falls, unemployment rises, and the inflation rate typically holds steady or even drops. During an expansion in the business cycle, gross domestic product rises, unemployment falls, and the inflation rate typically rises. Predicting changes in the business cycle is difficult (if not impossible)—even for experts—because an astonishingly complex web of factors affects the economy and many of those factors are constantly changing.

Application Questions

1. Americans are known for their long-term love affair with their cars. But as gasoline prices soar and concern about the environment mounts, the need to conserve gasoline has become increasingly clear. What would it take to reduce the overall demand for gasoline in the United States? Consider the full range of possibilities from the availability of bike paths to the cost of car insurance. Develop a conservation strategy that you think could reduce overall demand for gasoline in your community. Who (if anyone) should implement it? Why? Do you think it would succeed long term?

   Students will have plenty of creative ideas in response to this question, but their answers will probably include the following:

   - *Boost the development and lower the price of public transportation.*
   - *Build better, safer bike paths and walking paths.*
   - *Increase taxes on gasoline and car insurance.*
   - *Invest in alternative fuel cars.*
   - *Offer incentives for driving alternative fuel cars (e.g., tax rebates).*
   - *Advertise the benefits of conservation.*

   Answers will vary regarding specific plans for your local community.

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

   Here, too, student plans are typically excellent. While answers will vary based on the products student choose, encourage them to stretch their creativity and to consider a full range of options from the product itself, to labeling and packaging, to advertising.

3. Interview a local business owner who has weathered a recession. How did the recession impact the business? What strategies seemed to work particularly well? What (if anything) would the owner do differently next time? Why?

   Answers will vary depending on who the students interview. However, many may find that small business owners cut costs and advertising during the recession, and regretted the lost customers in the recovery that followed.

4. Major events in our country and around the world tend to have economic advantages for some segments of society and disadvantages for others. Determining who benefits can be tough for negative events, but it's especially important in order to prevent the unscrupulous from capitalizing on them. Consider the following events and trends, and determine possible winners and losers from an economic standpoint:

   - The Hurricane Katrina aftermath
   - The influx of illegal immigrants in the U.S.
   - The 30% U.S. high school dropout rate
   - The aging population in the U.S., Europe, and China
   - The rising price of oil worldwide

Event or Trend	***Examples of Economic Winners***	***Examples of Economic Losers***
Hurricane Katrina	*Construction companies, portable housing developers*	*Residents of New Orleans, insurance companies, tourist based businesses*
Influx of illegal immigrants	*Unscrupulous employers, phone card suppliers, money wiring services, low end retailers*	*Scrupulous employers, unskilled legal workers, organized labor*
30% U.S. high school dropout rate	*Credit card companies, low end retailers*	*Employers of high skill workers, high end retailers, real estate*
Aging population in U.S., Europe, and China	*Healthcare providers, pharmaceutical firms, cruise lines, financial planners*	*Employers, trendy fashion providers, amusement parks*
Rising price of oil	*Oil companies (short term), alternative fuel providers, mass transit systems*	*General public, gasoline-powered car makers, interstate trucking*

5. With the current size of the U.S. federal debt, you might think that it has been around forever, but the outsized federal debt is actually a fairly recent phenomenon. Use the Internet to research the history of the federal debt. What triggered the periods of growth and decline? How do you think the federal debt will affect you? Do you believe it will ever go down to zero? Why or why not?

   Students can find a history of the U.S. federal debt at the following Treasury Department website: http://www.treasurydirect.gov/govt/reports/pd/histdebt/histdebt.htm. Also, the Wikipedia article on United States public debt (http://en.wikipedia.org/wiki/United_States_public_debt) contains a wealth of high quality references that students might find helpful. Browsing through the data, students will probably notice that the debt has spiked most dramatically in response to war spending. But after World War II, the debt rose pretty much in line with inflation, until it spiked again in the 1980s due to the combination of tax cuts and Cold War spending. After a brief respite in the 1990s due to strong economic performance, the debt has spiked again with the war on terror and the Iraq War. The response to the recent economic crisis fueled yet another dramatic spike in debt. Students should understand that the debt will affect them because as interest obligations mount, the government will be unable to provide the same level of services without raising taxes. More broadly, extreme debt impacts the health of the economy, which eventually limits opportunities for virtually everyone. Opinions will differ about whether debt will ever go down to zero, but most economists believe that it will not.

Team Project

Break into groups of no more than 5 people. Review the scenario below, and work with your team to answer the questions, using the economic concepts from the chapter. Be sure to gain agreement on your assumptions behind each answer. Compare and contrast answers with other groups in your class. You may be surprised at the wide range of ideas among the various teams.

Scenario: Your team runs a small gift shop in the main shopping district of a desert resort town outside Los Angeles, California. Your key source of revenue is turquoise and silver jewelry, handcrafted by a large Indian tribe in the local area. The tribe also supplies very similar pieces to many of the other shops in the business district. You and your team just heard that the tribe is planning to open a visitor's center at one of the local natural attractions that they manage. They are sure to sell many similar pieces, at a significantly lower price than you. How should you respond, from both the supply side and the demand side? Clarify your assumptions as you answer each of the questions below.

- How do the characteristics of the town impact your business?
- Which category of competition does your gift shop compete in (monopoly, oligopoly, monopolistic competition, or pure competition)? Why?
- How will the visitor's center affect your business? Why?
- Should you change your prices? Why? How?
- Should you take other steps to increase demand for the jewelry in your store? If so, what steps? Why?

Answers will vary based on the assumptions and strategies that each team develops. But all teams should identify their competitive arena as monopolistic (many suppliers, low barriers to entry, similar—but not identical—products). The visitor's center will clearly impact their business, leaving them vulnerable. In response they could change their prices, change suppliers, change advertising, and add additional products or services, among many other possibilities.

Case Connections

A Weighty Issue

Obesity among America's children has reached epic proportions. A stunning 17% of kids are overweight or obese, and another 15% are at risk. The economic impact is extraordinary. Data from the U.S. Surgeon General's office suggests that the cost of obesity—in terms of health care, lost wages, and premature death—totals about $117 billion. The dollars will swell yet larger as today's chunky children enter adulthood.

Health experts pin the problem on too many calories and too little exercise. More specifically, many have fingered soda as a key calorie culprit. Research suggests that teens between 15 and 19 year old, for instance, guzzle an average of 24 ounces of soda *every day*, which means a staggering 1.5 pounds of sugar every week.

While personal choices are at the core of the problem, soda companies and schools have certainly contributed by making soda readily available to kids on campus. But no longer. In a groundbreaking deal brokered by Bill Clinton and the American Heart Association, the world's three largest soda makers—the Coca-Cola Company, PepsiCo, and Cadbury Schweppes—agreed to pull all soda out of schools and to reduce the portion sizes on the juices, milks, and other more healthy drinks that will still be available. The distribution rollback affected 75% of U.S. schools during the 2008–2009 school year, and will affect 100% by the 2009–2010 school year. The agreement, negotiated on a drink-by-drink basis, sets uniform size and content standards for all schools.

Yet not everyone applauds the deal. Some say that the ban on soda doesn't go far enough—that it's good PR, but not much more. They point out that sugary drinks will still be available at after-school events such as games and plays that parents attend. And kids can still get soda from the local convenience stores before and after school, or even during lunch. Others contend that the whole idea of a ban is wrong. Their arguments:

- Students can't learn to make good choices in the real world without having real world options at school.
- High school students who are old enough to enlist in the military should surely be free to buy themselves a soda.
- Soda at school is only a small part of the obesity problem, but a big part of the revenue steam for many schools, which rely on the extra dollars.

You Decide

- After considering the arguments, do you think the plan to pull soda from schools is positive or negative overall? Why? Do you think this will lead to similar deals with candy and snack manufacturers?

- Short term, this agreement will likely decrease revenue (at least slightly) for the soda giants. But what do they stand to gain? Consider issues such as PR, national standards, and the potential for government regulation.

- How can schools that rely on extra money from soda sales raise demand for the healthier drinks such as water and milk? As you develop your answer, consider the concepts from the supply and demand section of the text.

The purpose of the "Case Connections" exercises is to encourage students to take a stand on relevant issues, and to use the information in the case to support their perspective. Clearly, there are no "right" answers. But this approach does require students to engage in critical thinking as they develop coherent, persuasive viewpoints about each issue. Classroom testing suggests that - while actual answers will vary widely – most students will learn over time to support their views remarkably well.

Communication Connection

- Imagine for a moment that you're a Coca-Cola salesperson in your town. You're concerned about losing business at the local high school, because you believe that student demand for water and other healthy drinks won't be nearly as high as it was for soda. Write a letter to the principal of the school recommending your strategy for boosting demand.

Sources: "Soda Distributors to End Most School Sales by Maria Newman," *New York Times*, May 3, 2006, http://www.nytimes.com/2006/05/03/health/03cnd-soda.html?ex=1147579200&en=fa16575f596484dd&ei=5070; "How Bill Put the Fizz in the Fight Against Fat by Jeffery Kluger," *Time* magazine, May 7, 2006, http://www.time.com/time/magazine/printout/0,8816,1191823,00.html; "What Are the Costs Associated with Overweight and Obesity?" Overweight and Obesity Frequently Asked Questions, Centers for Disease Control and Prevention, *http://www.cdc.gov/nccdphp/dnpa/obesity/faq.htm*, accessed May 12, 2006; "Soda Distributors to End Most School Sales," by Samantha Gross, Associated Press via Yahoo News, May 3, 2006, http://news.yahoo.com/s/ap/20060503/ap_on_re_us/soft_drinks_schools.

