

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.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Global Economic Crisis: How Did this Happen?

Difficulty Level: Easy

Learning Objective: 2-1

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.)

BUSPROG: Analytic

Bloom's: Knowledge

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Easy

Learning Objective: 2-2

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).

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Economics: Navigating a Crisis

Difficulty Level: Moderate

Learning Objective: 2-1

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.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Easy

Learning Objective 2-2

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.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Capitalism: The Free Market System

Difficulty Level: Easy

Learning Objective: 2-3

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

<i>Degree of competition</i>	<i>Examples</i>
<i>Pure competition:</i> 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
<i>Monopolistic competition:</i> 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
<i>Oligopoly:</i> 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
<i>Monopoly:</i> 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.

BUSPROG: Analytic

Bloom's: Knowledge

Topic: Four Degrees of Competition

Difficulty Level: Moderate

Learning Objective: 2-3

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.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Supply and Demand: Fundamental Principles of a Free Market System

Difficulty Level: Moderate

Learning Objective: 2-3

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.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Planned Economies: Socialism and Communism

Difficulty Level: Moderate

Learning Objective: 2-4

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.

BUSPROG: Analytic

Bloom's: Analysis

Topic: Mixed Economies: The Story of the Future

Difficulty Level: Easy

Learning Objective: 2-5

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.

BUSPROG: Analytic

Bloom's: Analysis

Topic: Evaluating Economic Performance: What's Working

Difficulty Level: Moderate

Learning Objective: 2-6

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.

BUSPROG: Analytic

Bloom's: Synthesis

Topic: Evaluating Economic Performance: What's Working

Difficulty Level: Moderate

Learning Objective: 2-6

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.

BUSPROG: Analytic

Bloom's: Synthesis

Topic: Evaluating Economic Performance: What's Working

Difficulty Level: Challenging

Learning Objective: 2-6

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.

BUSPROG: Analytic

Bloom's: Knowledge

Topic: The Business Cycle

Difficulty Level: Easy

Learning Objective: 2-6

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

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

BUSPROG: Analytic

Bloom's: Application

Topic: Supply and Demand: Fundamental Principles of a Free Market System

Difficulty Level: Moderate

Learning Objective: 2-3

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. Also, the Wikipedia article on 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.

BUSPROG: Analytic

Bloom's: Evaluation

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Challenging

Learning Objective: 2-2

Team Project

In summer 2011, President Obama and Congress spent several weeks locked in fierce debate about whether to raise the Federal debt ceiling. As the deadline loomed, it became clear that if the debt ceiling were not raised on time, the government would lack nearly half the cash it needed to pay its short-term bills. Break into groups of no more than 5 people. Identify the top payees. Determine which five groups you will pay first and why. Remember to ground your thinking in business and economics rather than politics and political thinking. Share your recommendations with the class. Prepare for a passionate even contentious discussion, and remember to be respectful of different viewpoints.

Clearly, recommendations among the various groups will vary dramatically. Responses should incorporate the moral implications of each decision, remembering that promises of payment have been made long before checks are due to be cut. From an economic standpoint, if enough people don't get paid, they clearly won't be able to spend, which may send the economy spiraling further downhill. Also, if the government reneges on its debts, it may have trouble borrowing at reasonable rates, which might drive up interest rates for everyone, further harming the overall economy.

BUSPROG: Analytic

Bloom's: Analysis, and Evaluation

Topic: Fiscal Policy

Difficulty Level: Challenging

Learning Objective: 2-2

Case Connections

Debtocalypse Now?

At \$14 billion and growing, (nearly \$50,000 per citizen), no one can argue that the Federal debt isn't a problem. Year after year, with only a handful of exceptions, Congress has approved a Federal budget that includes more spending than revenue. But in order to access the funds via borrowing, Congress must vote to approve a "debt ceiling" that is high enough to cover the borrowed amount. Typically, increasing the debt ceiling has been a formality, which happened with little or no fanfare, 18 times under Ronald Reagan, eight times under Bill Clinton, seven times under George W. Bush, and two times under Barak Obama. This is not surprising since the debt limit does not control or limit the ability of the federal government to run deficits or incur obligations; rather, it is a limit on the ability to pay obligations already incurred via the budgetary process. But the story changed in 2011. Raising the debt limit came under unprecedented scrutiny due to pressure from the Tea Party movement and a new Republican House majority. After a month of acrimonious negotiation, Congress did vote to raise the debt ceiling on July 31, 2011, as part of a complex deal that both raised the debt ceiling and reduced future government spending. While the problem was averted for the short term, many analysts anticipate that a similar debate will unfold again and again over the next few years, offering an incentive to evaluate the arguments.

In favor of raising the debt ceiling:

- In 2011, the Federal government experienced a revenue shortfall of \$125 billion per month, which meant that without the authority to borrow more, the government would not be able to pay some of its bills. For instance, the government could have used one month's tax revenue to pay interest on the debt; Medicare, Medicaid and Social Security; unemployment insurance; and defense contractors – but that would leave a number of other parties unpaid, including active-duty soldiers, veterans, taxpayers due refunds and federal workers.
- If the debt ceiling weren't raised, the Treasury Department would be responsible for determining who gets what priority in terms of payment, which would give extraordinary political power to an unelected official.
- Not raising the debt ceiling puts the U.S. credit rating in jeopardy of further downgrades, which could endanger the interconnected world economy and throw the U.S. economy into another sharp, painful recession.

Against raising the debt ceiling:

- Many Americans believe that taxes are too high and that spending is wasteful and out-of-control – even unethical. A limit on the debt ceiling would force immediate, drastic cuts in government spending.
- Some believe that the potential dire consequences of not raising the debt ceiling may be exaggerated, and they point out that other countries – such as Argentina – have recovered from defaulting on their debt.

You decide:

- After evaluating the arguments, which course of action do you think makes the most sense? Why?

Clearly student perspectives on this issue will differ, but all students should recognize that the debt ceiling is a somewhat artificial construct and that the actual federal debt is determined by Congress via the legislative process. Students should also acknowledge that either course of action has potentially dire negative consequences.

BUSPROG Analytic

Bloom's: Analysis, and Evaluation

Topic: Managing the Economy through Fiscal and Monetary Policy

Difficulty Level: Challenging

Learning Objective: 2-2

- If you were the Secretary of the Treasury how would you prioritize payments if the debt ceiling were not raised? How would you justify your choices to Congress and the general public?

Obviously, students' priorities will differ significantly based on personal and political values, but they should understand that, while the Secretary of the Treasury would take the lead in this process, he or she is appointed by the President, who would ultimately be accountable to Congress and the public. The justification of the choices should be based on both ethics/morals and economics.

BUSPROG: Analytic

Bloom's: Analysis, and Evaluation

Topic: Managing the Economy through Fiscal and Monetary Policy

Difficulty Level: Challenging

Learning Objective: 2-2

Sources: 10 craziest things about the debt-ceiling crisis by Rex Nutting, July 25, 2011, MarketWatch website, <http://www.marketwatch.com/story/10-craziest-things-about-the-debt-ceiling-crisis-2011-07-25>, accessed August 18, 2011; <http://www.marketwatch.com/story/10-craziest-things-about-the-debt-ceiling-crisis-2011-07-25>; Government Accountability Office (February 22, 2011). "Debt Limit: Delays Create Debt Management Challenges and Increase Uncertainty in the Treasury Market". <http://www.gao.gov/products/GAO-11-203>, accessed August 18, 2011; Debt ceiling: Chaos if Congress blows it by Jeanne Sahadi, July 14, 2011, CNNMoney website, http://money.cnn.com/2011/07/13/news/economy/debt_ceiling_fallout/index.htm, accessed August 18, 2011.