CHAPTER 2: ECONOMICS AND BANKING

CHAPTER OPENER

Chapter 2 covers the fundamentals of economics — how business decisions are shaped by supply and demand and the degrees of competition.

Students will learn how:

- to interpret key economic indicators, such as the gross national product and price indexes.
- the government can step in to control business cycle swings through taxation, spending, and monetary policy.
- to understand the Federal Reserve, and how its actions influence the U.S. money supply.

DETAILED LECTURE OUTLINE

I. The Basics of Economics

A. Economics Defined

1. So what is economics?
   a. **Economics** is the study of how individuals and businesses make decisions to best satisfy wants, needs and desires with limited resources.
   b. There are two basic studies of economics: *microeconomics* and *macroeconomics*.
      i. **Microeconomics** is the study of how individual businesses, households and consumers make decisions to allocate their limited resources in the exchange of goods and services.
      ii. **Macroeconomics** is the study of the behavior of the overall economy.

B. Different Types of Economic Systems.

1. What are the different types of economic systems?
   a. An **economy** is a system that tries to balance the available resources of a country against the wants and needs of consumers.
   b. The world's different economies are classified into three basic economic systems: planned (or controlled) economies, market economies, and mixed economies.
      i. In a **planned economic system**, the government plays a significant role in determining the goods and services that are provided and how they are produced and distributed.
         a.) Under **communism,** the government makes all economic decisions and controls all the social services and many of the major resources required for the production of goods and services.
         b.) **Socialism** provides that the government owns or controls many basic businesses and services so that profits can be distributed evenly among the people.
         c.) Many socialist and communist countries are beginning to change their economies into free market economies through **privatization** – the conversion of government-owned production and services to privately owned, profit-seeking enterprises.
      ii. In a **market economy**, individuals are able to make their own economic decisions.

a.) **Capitalism** is an economic system that allows freedom of choice and encourages private ownership of resources required to make and provide goods and services.

b.) The production and pricing of goods and services is determined through the operation of a **market** – the mechanism by which buyers and sellers exchange goods and services.

iii. Most economic systems are **mixed economies**, which are a blend of market and planned economies.

C. Business and Economics

1. Why do business managers need to be concerned with economics?

a. Businesses need to know how much of their goods to produce or services to offer, as well as how much to charge.

b. They need to be aware of the potential impact that government decisions and the decisions of collective businesses can have on their individual business.

II. Determining Price: Supply and Demand

A. Supply

1. What is supply?

a. **Supply** refers to how much of a product or service is available.

b. Supply is derived from a producer's desire to maximize profits.

c. The **law of supply** states that the amount supplied will increase as the price increases; if the price is lower, less of the product is supplied.

d. A **supply curve** shows the relationship between supply and price.

B. Demand

1. What is demand?

a. **Demand** refers to how much people want to buy at any given time.

b. The amount demanded increases as price declines.

c. A **demand curve** illustrates the relationship between demand and price.

C. Factors that Determine Price

1. What factors determine price?

a. As a price increases, more product is likely to be supplied, but as the price decreases, more product is likely to be demanded by customers.

b. If supply exceeds demand, there is a **surplus**.

c. If demand exceeds supply, there is a **shortage**.

d. The price at which supply equals demand is the **market price** or the **equilibrium price**.

D. Factors That Shift Supply

1. What makes supply change?

a. **Determinants of supply** include:

i. Technology Changes – Technology improvements enable suppliers to produce their goods or services more efficiently and with fewer costs.

ii. Changes in Resource Prices – The price of resources used to produce a good or service affects the cost of production.

iii. Price Expectations – These reflect the producer's best guess at the *future* price of a product.

a.) If prices are expected to increase, the supplier may reduce supply now to supply more at a later time when prices are higher.

b.) If prices are expected to decrease, the supplier may attempt to deplete supplies now at the higher price.

iv. Number of Suppliers – The supply of a good or service increases as the number of competitors increases.
v. Price of Substitute Goods – If there are other equally comparable substitute goods available at a lower price, this affects the supply of goods.

b. Changes in any of these factors shift the supply curve to the left (have a negative impact on supply) or to the right (have a positive impact on supply).

E. Factors That Affect Demand

1. What factors affect demand?

a. **Determinants of demand** include:

i. Changes in Income Levels – When income levels increase, people are able to buy more products. When income levels decrease, most people buy fewer products.
ii. Population Changes – Increases in population create a greater demand.
iii. Consumer Preferences – Demand for a product can change based on what is popular at any given moment.
iv. Complementary Goods – Products or services that go with each other and are consumed together are considered **complementary goods**.
v. Substitute Goods – Goods that can be used in place of other goods are **substitute goods**.

b. A positive change in any of these determinants of demand shifts the demand curve to the right. A negative change shifts the demand curve to the left.

III. Degrees of Competition

A. Monopolies

1. What is a monopoly?

a. A **monopoly** occurs when there is only one provider of a service or good and no substitutes exist.

2. Why aren't there many monopolies?

a. In the United States, as well as in other countries, large monopolies are rarely allowed.
b. Without competition, the monopoly supplier can charge a higher price and may be less responsive to consumer needs.

B. Duopolies and Oligopolies

1. What happens when one or two other companies enters a monopolistic market?

a. A **duopoly** is where only two suppliers exist, or only two firms have dominant control over a market.
b. An **oligopoly** is a form of competition in which only a few sellers exist and each seller has a fairly large share of the market.

C. Monopolistic competition

1. What happens when there isn't much differentiation between products?

a. **Monopolistic competition** occurs when there are many buyers and sellers and little differentiation between the products themselves, but there is a *perceived* difference among consumers.

D. Perfect competition

1. What happens when products are almost identical?

a. **Perfect competition** occurs when there are many buyers and sellers of products that are virtually identical and any seller can easily enter and exit the market.
b. No single supplier can influence the price.

IV. Economic Indicators

A. The Gross Domestic Product

1. How do we determine the health of an economy?
   a. Economists primarily use three **economic indicators** to determine how well businesses are performing overall: the gross domestic product (GDP); consumer and producer price indices; and the unemployment rate
   b. The **gross domestic product (GDP)** measures the overall market value of final goods and services produced in a country in a year.
2. What's the difference between GNP and GDP?
   a. The **gross national product (GNP)** attributes earnings to the country where the firm was owned, not where the product was manufactured.
3. How does the GDP act as an economic indicator?
   a. When the GDP goes up, the indication is that the economy is in a positive state. A downward-moving GDP indicates with problems with the economy because fewer goods are being produced.

B. Consumer and Producer Price Indices

1. What else is used to gauge the health of an economy?
   a. The **consumer price index (CPI)** and **producer price index (PPI)** are used as economic indicators. They measure purchasing power and determine the rate at which consumer and wholesale prices change.
      i. **Inflation** is a rise in the general level of prices over time.
      ii. A decrease in the rate of inflation is **disinflation**.
      iii. A continuous decrease in prices over time is **deflation**.
2. How are changes in the price of consumer products measured?
   a. The CPI tracks changes in prices over time by measuring changes in prices of goods in services that consumers purchase.
   b. The CPI measures price changes by creating a "market basket" of a specific set of goods and services that represent the average buying pattern of urban households.
3. What goods and services are included in the CPI?
   a. The expenditure items fall into 8 major groups: housing, food and beverages, recreation, medical care, education and communication, transportation, and other goods and services (Figure 2.8).
4. Does the CPI measure the change in price of all goods?
   a. The CPI measures the change in prices of consumer goods only.
   b. The PPI tracks the average change in prices at the wholesale level.
      i. It tracks the prices of goods sellers use to create products, such as raw materials, product components that require further processing, and finished goods sold to retailers.
5. Why are price indices important?
   a. The CPI and PPI are important because they measure purchasing power and consequently trigger business decisions.

C. The Unemployment Rate

1. What other indicators are used to measure the economy?
   a. The **unemployment rate** measures the number of workers who are at least 16 years old, are not working, and who have been trying to find a job within the past four weeks and still haven't found one.
   b. There are different measurements of unemployment:

i. **Frictional unemployment** measures temporary unemployment in which workers move between jobs, careers, and locations.
ii. **Structural unemployment** measures permanent unemployment associated when an industry changes and jobs are terminated completely.
iii. **Cyclical unemployment** measures unemployment caused by a lack of demand for those who want to work.
iv. **Seasonal unemployment** measures those out of work during the off-season.

2. Why is unemployment an important economic measure?
   a. High unemployment results in an increase in unemployment benefits and government spending on social programs.
   b. If the unemployment drops too low, the concern is that more workers have increased buying power and spend more, causing prices to rise and increasing inflation.

D. Productivity
1. How is the productivity of the workforce measured?
   a. **Productivity** measures the quantity of goods and services that human and physical resources can produce in a given time period.
2. Why is measuring productivity important to businesses?
   a. An increase in productivity indicates that workers are producing more goods or services in the same amount of time, resulting in lower costs and lower prices.

V. Government and the Economy

A. Economic Policies
1. Why does the state of the economy change?
   a. Over time, the economy naturally goes through periodic increases and decreases, called the **business cycle**. There are four stages (Figure 2.9):
      i. **Peak** occurs when the economy is at its most robust point.
      ii. **Recession** is a decline in the GDP for two or more successive quarters of a year. A very severe or long recession is a **depression**.
      iii. A **trough** occurs when the recession hits bottom and the economy begins to expand again.
      iv. **Expansion** or **recovery** refers to the phase when the economy begins to grow after a recession or depression.
2. How does the government control swings in the business cycle?
   a. To smooth out the swings in the business cycle, the government influences the economy through its fiscal policy and monetary policy.
   b. With **fiscal policy**, the government determines the appropriate level of taxes and spending.
   c. With **monetary policy**, the government manages the supply of money.

B. Fiscal Policy
1. Why does the government increase taxes to influence the economy?
   a. Increases in taxes are used to offset rising inflation, because higher taxes translate into less consumer spending, which in turn slows down the growth of businesses and the economy.
2. How does government spending help stimulate the economy?
   a. Decreasing taxes does not have the opposite effect on the economy. Instead, to stimulate the economy, the government uses another form of fiscal policy: government spending.
   b. Government spending increases cash flow to the economy faster than decreasing taxes because it is an immediate injection of funds into the system.

C. Monetary Policy
   1. What else can be done to control the economy?
      a. The second tool to manage the economy is monetary policy.
      b. The **Federal Reserve System (the Fed)** is the central banking system of the United States.
         i. It includes 12 regional Federal Reserve Banks, a Board of Governors, and the **Federal Open Market Committee (FOMC)**, which sets the policies of the Fed, including monetary policy.
   2. What is the money supply?
      a. Through its monetary policy, the Fed affects the nation's **money supply** – the combined amount of money available within an economy.
      b. There are different components to the money supply:
         i. **M-1**: Coins and bills (**currency**), traveler's checks, and checking accounts.
         ii. **M-2**: M-1 plus savings deposits, money market accounts and certificates of deposit.
         iii. **M-3**: M-1, M-2 and less liquid funds such as larger CDs, money market accounts, and U.S. dollars deposited in banks outside the U.S.
   3. Why is the money supply important?
      a. Money has a direct effect on the economy because an expanding money supply may result in inflation. However, a limited money supply can result in either disinflation or deflation.
      b. The Fed uses three tools to affect money supply: reserve requirements, short-term interest rates, and open market operations.
D. Reserve Requirements
   1. What are reserve requirements?
      a. The **reserve requirement,** determined by the Fed, is the minimum amount of money banks must hold in reserve to cover deposits.
      b. The Fed can ease or tighten the money supply by increasing or decreasing the reserve requirement.
E. Short-Term Interest Rates
   1. What is the discount rate?
      a. When commercial banks borrow funds from the Fed, they are charged an interest rate called the **discount rate**.
      b. The Fed has the power to increase or decrease the discount rate in its efforts to control money supply.
   2. Is the discount rate the same as the Fed Funds rate?
      a. The **Fed Funds rate** is the interest rate that banks charge other banks when they borrow funds overnight from one another.
F. Open Market Operations
   1. What are open market operations?
      a. The primary tools the Fed uses in its monetary policy is **open market operations**, buying and selling U.S. Treasury and federal agency bonds on the "open market".
      b. When the Fed buys or sells U.S. securities, it is changing the level of monetary reserves in the banking system by adding or taking away money from the system.

NOTE: End the lecture by asking students to write down the muddiest points or main points of the lecture. This will allow you to know what might need to be reviewed during the next lecture.

SUPPLEMENTAL ACTIVITIES

Supplemental In-Class Activity

Comparing Economic Systems

Activity Overview: This activity gets students talking about how similar and different the U.S. economic system is to other systems.

Time Limit: 30 minutes

What to Do:

1. Divide the class into small groups. Ask the groups to assume they have just overheard a classmate say, "The United States is becoming more socialist every day—with all the government control." Have each group list reasons why the statement could be true and reasons why the statement could be false. (15 minutes)

2. Reassemble the class and discuss each group's thoughts. (15 minutes)

Don't Forget: Remind students that a government's level of control distinguishes capitalism from socialism. If you have foreign students in your class, you may want them to say a bit about the economic system in their native country.

Wrap-Up: Wrap up the discussion by reminding students that the U.S. economic system and a socialist system have certain similarities and many differences. For example, workers in socialist economies often work fewer hours, have longer vacations, and receive more health, education, and child-care benefits than do workers in capitalist economies. On the other hand, the federal government does control some basic services in the United States as well as various aspects of the market through agencies, such as the Food and Drug Administration (FDA) and The Federal Communication Commission (FCC).

Supplemental Homework Activity

Let's Go Shopping!

Homework Assignment: Visit a local shopping mall or shopping area. List each store that you see and determine what degree of competition it faces in its immediate environment. For example, if there is only one store in the mall that sells shoes, that store represents a monopoly. Note those businesses with direct competitors (e.g. two jewelry stores) and show how they compete with one another.

Deliverable: A brief paper reporting on degrees of competition and the tactics stores use to compete with each other. Answers will vary, but students should recognize different levels of competition and how stores respond to competition by advertising, reducing prices, etc.

At-Home Completion Time: 1 to 2 hours.

ENHANCING THE ONLINE COURSE

Online Lecture: Define the terms "microeconomics" and "macroeconomics" and use examples to distinguish between the two disciplines. Video tape yourself giving the short "mini-lecture". Many institutions have video cameras for your use in the library or you can use a digital camera with the help of another professor. Load the short video online (using procedures as specified by your online platform). Have your students watch the short video and do a quiz afterward.

Economics Model Search: Ask students to search the Internet to illustrate each of the boxes in Table 2.1. Require students to develop and send in a table with graphics and examples in each of the cells to illustrate the differences between the systems of economics.

Create a Model: Ask your students to use photos or other graphics to show the relationship of supply and demand. Limit the written discussion (in words) to one page to be emailed back to the discussion board. Ask the students to relate the content of their responses to current events posted on the Internet.

Price Points: Require your students to check the prices of products for 3 weeks in a row. (Suggested products: bread, eggs, chicken, tomatoes, milk, oranges, coffee, potato chips, and gasoline) What could account for the changes in price? Ask your students to report back on the findings of their "study", to analyze the price differences, and, using the information in the text, to develop some ideas about what has caused the price differences. Students can post the reports via the discussion board.

ANSWERS TO END OF CHAPTER MATERIALS

Self Test

Multiple Choice

1. a
2. c
3. a
4. b
5. b
6. c
7. b
8. a
9. d
10. c

True/False

1. True
2. False
3. False
4. True
5. False

Critical Thinking Questions: Suggested Answers

1. Answers will vary depending on the phase of the business cycle currently underway. Although economic indicators are closely watched by many people, the driving force behind changes in these indicators is the amount of overall demand, or total spending, on products. If total spending (the demand for products) rises, then businesses will produce more products to satisfy this increase in demand. More production generates a greater demand for workers and pushes the unemployment rate down. A greater percentage of the labor force employed translates into a higher overall income level for households. This usually means that more people will be out shopping. Increased spending generates still more sales, more production, more jobs and more income to spend. This is what happens during an expansionary phase of the business cycle. On the other hand, a decrease in total spending in the national economy results in fewer business sales. Businesses respond by cutting back on production and laying off workers. Then, the unemployment rate rises. As unemployment rises, people have less income to spend. Spending and sales fall. Businesses produce less, and production falls further, generating still more unemployment and less income to spend, etc. This is what happens during a recession. Economic indicators try to forecast changes in total spending in an economy in an attempt to forecast changes in the business cycle.

2. Monopolies are situations in which there is basically a single seller of the good or service, with no close substitutes for that product. Without competition, the monopoly supplier can charge a higher price and may be less responsive to consumer needs. The NFL (National Football League) and the MLB (Major League Baseball) can be seen as "unofficial" monopolies; for instance, a jury found for a fledging football league, the USFL, stating that the NFL had violated anti-trust laws and made itself a monopoly. Interestingly, the NFL wants to be protected from antitrust suits because it claims that teams act – in business – as a single entity.

3. Although GDP is often used to indicate the economic well-being of a country, it really measures only how much we *spend* and, therefore, *produce*. It doesn't really indicate the *well-being* of a society or economy. It's a subtle distinction, but critics point out the GDP includes expenditures that address some of the negative aspects of the economy, such as cleaning up the environment

after a bad oil spill, the costs associated with fighting crime, or treating illnesses associated with smoking. These expenditures increase GDP and we may be better off because of them.

On the other hand, the GDP does not include the economic activity associated with goods produced at home but not sold (i.e., cooking, gardening, crafts), the sale of used goods, or charitable donations and volunteerism. A case in point is Hurricane Katrina in 2005. Oddly enough, if we factor in the increases in the construction, equipment, service, and industrial supply industries used to rebuild New Orleans and the other regions severely damaged by the hurricane, the disaster will end up having a positive impact on the nation's GDP, even though the *well-being* of that region has been negatively impacted. In addition, we do not factor in the massive amounts of donations of money, supplies and volunteer time directed to the region. The positive impact of the volunteer efforts, the significant amounts of donations and grants attributed to Hurricane Katrina and other disasters do not show up in the GDP and do not reflect the activity of our society, since these volunteer and donated activities do not produce a final good or service to be purchased.

Since these variations are difficult to measure domestically, and to compare internationally, the current method of computing GDP is adequate — a solid economic measure.

Team Time

The Great Debate

Answers will vary. However, the point of the exercise is to help students understand the process of monetary regulation and to discuss who has a right to regulate how money flows in the U.S. economy.

Ethics and Corporate Social Responsibility

Economic Inequality

Answers will vary. However, be sure to have students consider how the type of economy in which they are currently living (capitalism) influences their answers to this question. Would students living in a planned economy, such as communism or socialism, answer the questions in the same way?