CHAPTER 3
Economic Challenges Facing Contemporary Business

Chapter Summary: Key Concepts

**Opening Overview**

**Economics**
A social science that analyzes the choices people and governments make in allocating scarce resources.

**Microeconomics**
Study of small economics units, such as an individual consumers, families, and businesses.

**Macroeconomics**
Study of a nation’s overall economic issues, such as how an economy maintains and allocates resources and how a government’s policies affect the standard of living of its citizens.

**Microeconomics: The Forces of Demand and Supply**

**Demand**
The willingness and ability of buyers to purchase goods and services at different prices.

**Supply**
The willingness and ability of sellers to provide goods and services for sale at different prices.

**Factors driving demand**
A demand curve is a graph of the amount of a product buyers will purchase at different prices under a given set of conditions. Generally, as price go up, demand goes down and vice versa. However, the entire curve can shift to the right or left depending on changed conditions. These changes reflect factors such as customer preferences, number of buyers, buyer’s incomes, prices of substitute goods, prices of complementary goods, and how optimistic or pessimistic future expectations become.

**Factors driving supply**
A supply curve graphically shows the relationship between different prices and the quantities sellers will offer for sale, regardless of demand. Generally, as prices rise, the quantity sellers are willing to produce increases, and vice versa. The entire curve can also shift right or left depending on such factors as costs or availability of inputs (factors of production), costs of technologies, taxes, and the number of suppliers.

**How demand and supply interact**
The equilibrium price identifies the prevailing market price and is found at the intersection of the supply and demand curves.
Macroeconomics: Issues for the Entire Economy

Capitalism and competition

Capitalism (also called market economy or the private enterprise system) depends on competition. In this kind of economic system, different industries exhibit different competitive market structures. The four market structures are pure competition, monopolistic competition, oligopoly, and monopoly.

Planned economies: communism and socialism

In a planned economy, the government’s control determines business ownership, profits, and resource allocation to accomplish government goals rather than goals of individuals. Under communism, all property is shared equally by the people of a community under the direction of a strong central government. Under socialism, government owns and operates the major industries.

Mixed market economies

In practice, most countries implement mixed market economies: economic systems that display characteristics of both planned and market economies in varying degrees.

Evaluating Economic Performance

Flattening the business cycle

A nation’s economy tends to flow through various stages of a business cycle: prosperity, recession, depression, and recovery. While the business cycle is normal, many economists believe that society is capable of preventing future depressions.

Productivity and the nation’s GDP

Increases in productivity, which is the relationship between the goods and services produced and the inputs needed to produce them, generally leads to economic growth. The measure of these goods and services on which productivity is calculated in the Gross Domestic Product (GDP), defined as the sum of all goods and services produced within a nation’s boundaries in a given year.

Price-level changes

Price-level changes is another important indicator of an economy’s stability. Inflation is a sustained rise in prices that devalues money. It is a result of increased costs in raw material, parts, or other factors of production (cost-push inflation). It can also be caused by excessive demand (demand-pull inflation). It is commonly measured by the Consumer Price Index (CPI). Nations must also guard against deflation, a period of falling
prices when customers put off purchases, business slows, jobs are lost, and the economy weakens.

**Employment levels**
People need incomes to be consumers; the number of people who currently have jobs is an important indicator of how well the economy is doing. The unemployment rate is the total percentage of people in the workforce actively seeking work but who are currently unemployed. Unemployment can be grouped into four categories: frictional, cyclical, structural, or seasonal.

**Managing the Economy’s Performance**

**Monetary policy**
A common method of influencing economic activity is monetary policy: government action to increase or decrease the supply of money and change banking requirements and interest rates. An expansionary policy increases the money supply to stimulate business activity. A restrictive monetary policy reduces the money supply to curb rising prices, overexpansion, and overly rapid economic growth. The Federal Reserve (“the Fed”) is responsible for implementing the nation’s monetary policy.

**Fiscal policy**
Another method the government can use to influence the economy is fiscal policy: taxation and spending decisions designed to control inflation, reduce unemployment, improve the general welfare of citizens, and encourage economic growth. Increased taxes may restrict economic activity, while lowering taxes and increased government spending usually fuels economic expansion. A budget deficit occurs when the amount of money a government spends is more than the amount of money it raises through taxes. These deficits accumulate into the national debt. A budget surplus occurs when the government takes in more money than it spends. A balanced budget occurs when total tax revenues are equal to total government spending.

**Global Economic Challenges of the 21st Century**

**Important economic challenges**
As the economies of countries around the globe become increasingly interconnected, governments and businesses will face many challenges: international terrorism, a shift to a global information economy, the aging of the world’s population, the growth of China and India, and improving/enhancing the competitiveness of every country’s workforce.
Business Vocabulary

balanced budget  microeconomics
budget  mixed market economy
budget deficit  monetary policy
budget surplus  monopolistic competition
communism  monopoly
consumer price index (CPI)  national debt
core inflation rate  oligopoly
cyclical unemployment  planned economy
deflation  privatization
demand  productivity
demand curve  pure competition
economics  recession
equilibrium price  regulated monopoly
expansionary policy  restrictive monetary policy
fiscal policy  seasonal unemployment
frictional unemployment  socialism
gross domestic product (GDP)  structural unemployment
hyperinflation  supply
inflation  supply curve
macroeconomics  unemployment rate

Application of Vocabulary

Select the term from the list above that best completes the statements. Write that term in the space provided.

1. The science of allocating scarce resources is known as ____________________________.
2. The term used to describe the study of the overall operations of an economy and its various components is known as ____________________________.
3. ____________________________ refers to the study of the economic activities of a firm or an individual.
4. ____________________________ refers to people who are temporarily out of work but who are looking for a job.
5. A ____________________________ occurs when government grants exclusive rights in a single market to a single firm, such as a utility company.
6. In the United States, changes in price levels are tracked by the _____________________, which measures the monthly average changes in prices of goods and services.

7. When the federal government spends more than it gets from tax revenues, a _____________________ is the result.

8. When prices continue to increase due to costs or demand, the economy is said to be experiencing a period of ________________

9. _____________________ counts people like farm laborers or ski instructors who are out of work due to the time of year.

10. _____________________ refers to governmental measures designed to affect the level of economic activity through changes in the money supply.

11. The _____________________ depicts the difference in the amount of a good a seller will produce at various prices.

12. The _____________________ depicts the relationship between different prices and the quantity of a good buyers will purchase.

13. When people are out of work during a recession or other economic downturn, their job loss is referred to as ________________

14. The _____________________ is the price at which the demand curve and the supply curve intersect.

15. Governmental actions concerning tax revenue and expenditures of public funds are referred to as ________________

16. The _____________________ measures the number of people who are looking for work but who are unable to find jobs.

17. In a _____________________ government controls determine business ownership, profits, and resource allocation.

18. _____________________ counts those people who are unable to find work for a long period of time because their skills fail to match those needed in the workforce.

19. The ability and willingness of buyers to purchase goods and services in the economy is known as ________________

20. All else remaining unchanged, an increase in _____________________ of a product will lower its market price.

21. When the federal government generates enough revenue through taxation to cover the total proposed spending for the year, a _____________________ has been attained.

22. The _____________________ is the total cumulative borrowing by the federal government to finance budget deficits.
23. Six months or more of economic contraction counts as a _______________________.

24. Under the economic system known as ________________________, the means of production are owned and controlled by the government.

25. Under _________________________________, the government owns and operates the key industries that are considered vital to the public welfare.

26. Nearly all of the world’s economies today blend private and public ownership into what is known as a _______________________.

27. A(n) ________________________ is a market situation that features few sellers and substantial entry restrictions.

28. When a firm in the market has no competitors, it is said to have a _________________.

29. The market situation in which a large number of buyers and sellers exchange well-differentiated products is known as _________________________________.

30. In ________________________________, a large number of buyers and sellers exchange homogeneous products so no single participant has a significant influence on price.

31. An economic situation characterized by soaring prices is known as _______________________.

32. In a mixed market economy, ________________ defines the trend of replacing public ownership with private ownership.

33. _________________________ is the inflation rate of an economy after energy and food prices are removed.

34. A period of falling prices that erodes values and business confidence is known as _______________________.

35. _______________ __________________ is the government’s action to increase the money supply.

36. The widest measure of a nation’s economic activity, the ________________________, counts the dollar value of all the goods and services produced within a nation’s borders.

37. A nation’s ______________________________ measures the relationship between that nation’s output of goods and services and the inputs needed to produce them.

38. _______________ __________________ is the government’s attempt at reducing the money supply to curb rising prices, overexpansion, and rapid economic growth.

39. The _______________________ is the federal government’s plan for how it will raise and spend money during the coming year.
40. When a government takes in more money than it spends, it is said to have a _________________.

Analysis of Learning Objectives

Learning Objective 3.1: Distinguish between microeconomics and macroeconomics. Explain the factors that drive demand and supply.

True or False

1. ___ Macroeconomics deals with large issues that affect a country’s overall economy.
2. ___ Microeconomics is concerned with the economic activities of an individual or a firm.
3. ___ Government policy that impacts the overall economy is a good example of a microeconomic issue.
4. ___ While macroeconomics looks at economic policies within individual nations, it has no application in understanding the overall world economy.

Short Answer

5. List and define the factors that collectively determine demand.
   a.
   b.
   c.
   d.
   e.
   f.

6. List and define the factors that collectively determine supply.
   a.
   b.
   c.
   d.
Learning Objective 3.2: Describe each of the four different types of market structures in a private enterprise system and compare the three major types of economic systems.

**Listing.** List the four basic types of competition.

1. ____________________________ The industry is made up of many firms of similar size whose products are indistinguishable.

2. ____________________________ Producers are able to differentiate their products.

3. ____________________________ There is only one seller in the industry.

4. ____________________________ Because the industries require large capital investment, there are very few producers.

**True or False**

5. ___ Socialism is an economic system in which the government owns all the nation’s productive capacity.

6. ___ Most modern economies blend free enterprise with some degree of government regulation and are known as mixed market economies.

7. ___ Karl Marx is credited with developing the communist theory.

8. ___ Under communism, the government owns and operates only the basic industries.

9. ___ Communism and socialism are both planned economies in which government controls determine economic goals and economic allocations.

Learning Objective 3.3: Identify and describe the four stages of the business cycle. Explain how productivity, price-level changes, and employment levels affect the stability of a nation’s economy.

**Multiple Choice**

1. The stage characterized by low unemployment and strong consumer confidence is called:

   a. prosperity. c. recovery.
   b. recession. d. depression.

2. A contraction in the gross domestic product (GDP) that lasts six months or more is called:

   a. prosperity. c. recovery.
   b. recession. d. depression.
3. When an economic slowdown continues in a downward spiral over a long period of time, we have:
   
a. prosperity.    c. recovery.
   b. recession.    d. depression.

4. After an economic downturn, when consumer spending begins to increase and business activity accelerates, the country is in:

   a. prosperity.    c. recovery.
   b. recession.    d. depression.

**True or False**

5. ______ A general decline in the prices of goods and services is known as inflation.

6. ______ The most important measure of a company or nation’s efficiency and competitiveness is its level of productivity.

7. ______ Unemployment is its level of productivity.

8. ______ Inflation can result from the shortages created by excess demand and/or the increased costs of production.

9. ______ A rise in the cost of materials or labor can produce cost-push inflation.

10. ______ The most widely used measure of inflation in the United States is the Consumer Price Index (CPI)

**Learning Objective 3.4:** Discuss how monetary policy and fiscal policy are used to manage an economy’s performance.

**Short Answer**

1. Define monetary policy.

2. Define fiscal policy.
3. Give examples of how monetary and fiscal policy can be used to combat inflation and unemployment.

Learning Objective 3.5: Describe the major global economic challenges of the 21st century.

Short Answer

There are five interrelated areas on which American businesses should concentrate to meet the global economic challenges of the 21st century. Briefly list and explain each.

1.

2.

3.
Self Review

True or False

1. _____ Economics is the study of people and the choices they make in allocating scarce resources.
2. _____ Microeconomics addresses such questions as how to control inflation.
3. _____ If consumers’ incomes increase more products may be sold, in other words, the demand curve is shifted to the right.
4. _____ If the demand curve shifts to the right, then the number of buyers has decreased.
5. _____ The shift from a manufacturing to a service economy has required workers with different skills, resulting in structural unemployment.
6. _____ A restrictive monetary policy helps reduce inflation.
7. _____ As in any competitive situation, global competition focuses exclusively on keeping costs down.
8. _____ Global competitiveness depends on improving working skills to take full advantage of new technologies that enhance use, management, and control of information.
9. _____ Macroeconomics deals with the study of the overall operations of an economy and its various components.
10. _____ Policies to reduce unemployment would be primarily a concern of microeconomics.
11. _____ Generally, a decrease in the price of travel will increase the demand for travel.
12. _____ If the price of apples increases, consumers may tend to substitute other fruits for apples.

13. _____ A surplus of a product or service will bring the price of that product or service down.

14. _____ Excess demand for a product tends to generate pressure to push the price back down toward equilibrium.

15. _____ A restrictive monetary policy helps reduce unemployment.

16. _____ When the federal government runs a budget deficit, the national debt is also increased.

17. _____ In monopolistic competition, the industry requires such large capital investment that there are very few producers.

18. _____ The major difference between pure and monopolistic competition is whether the producers in the industry can differentiate their products.

19. _____ Privatization occurs when private companies are taken over and run by the government.

20. _____ The Federal Reserve sets and implements monetary policy.

**Multiple Choice**

1. Which of the following is a macroeconomic issue?
   a. inflation. c. unemployment.
   b. the business cycle. d. all of the above.

2. The common factor that directly impacts both supply and demand is:
   a. government policy. c. price.
   b. advertising. d. gross domestic product.

3. If buyer optimism improves:
   a. the demand curve shifts to the right.
   b. the demand curve shifts to the left.
   c. the supply curve shifts to the right.
   d. the supply curve shifts to the left.

4. The total dollar value of the goods and services produced in a country during a year is known as:
   a. the business cycle. c. the consumer price index.
   b. gross domestic product. d. all of the above.
5. When the United States government influences the economy through government spending and tax collections, this is referred to as:

a. tax policy.       c. fiscal policy.
b. monetary policy.  d. political maneuvering.

6. During the late fall retailers tend to hire many people, and in January lay off many of them. This results in:

a. structural unemployment.       c. seasonal unemployment.
b. cyclical unemployment          d. frictional unemployment

7. People with the necessary skills who are temporarily out of work and seeking employment are classified as:

a. structurally unemployed.       c. seasonally unemployed.
b. cyclically unemployed.         d. frictionally unemployed.

8. When the economy has contracted for six months or more, the nation is in a(n):

a. recession.       c. inflationary period.
b. recovery period. d. depression.

9. To be competitive in a global economy the United States should:

a. concentrate on developing a more highly skilled workforce.
b. be attentive to the aging of the world’s population.
c. be ready to compete with China and India for resources.
d. all of the above.

10. Microeconomics studies the economic actions of:

a. individuals.       c. individual firms.
b. families.          d. all of the above.

11. When prices continue to fall, customers and businesses lose confidence and economic activity is reduced. This phenomenon is known as:

a. prosperity.       c. deflation.
b. inflation.        d. recovery.

Application Exercises

Ron Schmidt lost his job at the plant after 10 years working as a production employee. He has been trying to find other employment for more than a year, but without success. Jobs require education or skills that he does not possess.

1. What kind of unemployment is Ron experiencing?
2. What suggestions can you make to help Ron find new employment?

Short Essay Questions

1. What is the business cycle? What is meant when we say the business cycle has been “flattened?”

2. Define communism, socialism, capitalism, and mixed market economy. How do they differ from one another?