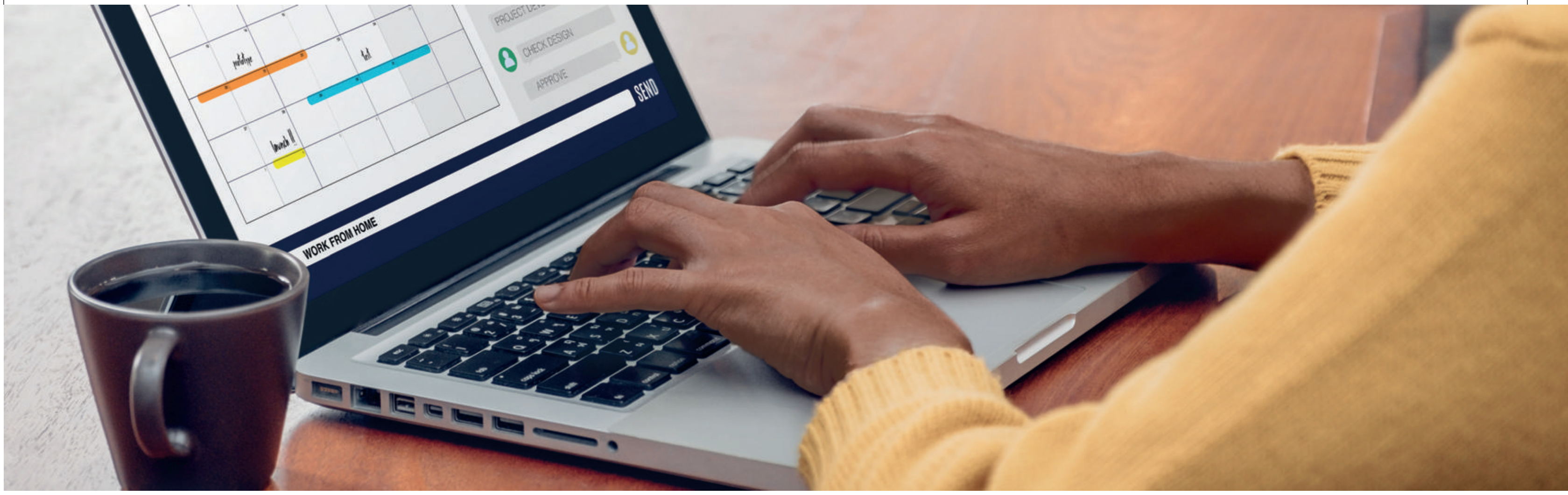

BUSN 12

Introduction to Business

Marce Kelly
Santa Monica College

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CENGAGE

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Production Service: MPS Limited

Designer: Sara Greenwood

Cover Image Source: Weedezign/iStock/ Getty Images Plus/Getty Images

Library of Congress Control Number: 2021920194

ISBN: 978-0-357-12294-5

Cengage
200 Pier 4 Boulevard
Boston, MA 02210
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Printed in the United States of America
Print Number: 01 Print Year: 2022

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BUSN 12

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Part 5
Managing a Business

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With love and appreciation
to my amazing children
who make all things possible!

—Marce Kelly

To Jenny,
the book is done, let's play!

—Chuck Williams

Letter to Students

The idea for this book—a whole new way of learning—began with students like you across the country. We paid attention to students who wanted to learn about business without slogging through endless pages of dry text. We listened to students who wanted to sit through class without craving a triple espresso. We responded to students who wanted to use their favorite gadgets to prepare for tests.

So, we are confident that BUSN will meet your needs. The short, lively text covers all the key concepts without the fluff. The examples are relevant and engaging, and the visual style makes the book fun to read. But the text is only part of the package. You can access a rich variety of study tools via computer or iPad—the choice is yours.

Marce Kelly

Chuck Williams

We did one other thing we hope you'll like. We paid a lot of attention to students' concerns about the high price of college textbooks. We made it our mission to ensure that our package not only meets your needs but does so without busting your budget!

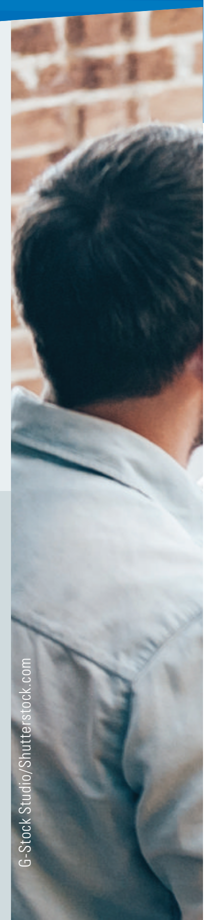
This innovative, student-focused package was developed by the authors—Marce Kelly and Chuck Williams—and the experienced Cengage Learning publishers. The Cengage team contributed a deep understanding of students and professors across the nation, and the authors brought years of teaching and business experience.

Marce Kelly, who earned her MBA from UCLA's Anderson School of Management, spent the first 14 years of her career in marketing by building brands for Neutrogena and The Walt Disney Corporation. But her true love is teaching, so in 2000 she accepted a full-time teaching position at Santa Monica College. Professor Kelly has received seven Outstanding Instructor awards from the International Education Center and has been named four times to *Who's Who Among American Teachers*.

Chuck Williams' interests include employee recruitment and turnover, performance appraisal, and employee training and goal setting. Most recently, he was the Dean of Butler University's College of Business. He has taught in executive development programs at Oklahoma State University, the University of Oklahoma, Texas Christian University, and the University of the Pacific. Dr. Williams was honored by TCU's M.J. Neeley School of Business with the undergraduate Outstanding Faculty Teaching Award, was a recipient of TCU's Dean's Teaching Award, and was TCU's nominee for the U.S. Professor of the Year competition sponsored by the Carnegie Foundation for the Advancement of Teaching. He has written three other textbooks: *Management, Effective Management: A Multimedia Approach,* and *MGMT*.

We would appreciate any comments or suggestions you want to offer about this package. You can reach Chuck Williams at chuck.1.williams@gmail.com, and Marce Kelly at marcella.kelly@gmail.com. We wish you a fun, positive, productive term, and look forward to your feedback!

1 Business Now: Change Is the Only Constant



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Learning Objectives

After studying this chapter, you will be able to:

- **1-1** Discuss the role of business in the economy
- **1-2** Explain the evolution of modern business
- **1-3** Discuss the role of nonprofit organizations in the economy
- **1-4** Outline the core factors of production and how they affect the economy
- **1-5** Describe today's business environment and each key dimension
- **1-6** Explain how current business trends might affect your career choices

1-1 Business Now: Moving at Breakneck Speed

Day by day, the business world simply spins faster. Industries rise—and sometimes fall—in the course of a few short months. Technologies forge instant connections across the globe. Powerful new trends surface and submerge, sometimes within less than a year. In this fast-paced, fluid environment, change is the only constant. According to Charles Darwin, it is not the strongest of the species that survive, nor the most intelligent, but the one most responsive to change. And so it is with business.

Successful firms lean forward and embrace the change. They seek the opportunities and avoid the pitfalls. They carefully evaluate risks. They completely understand their market, and they adhere to ethical practices. Their core goal: to generate long-term profits by delivering unsurpassed **value** to their customers.

value The relationship between the price of a good or a service and the benefits that it offers its customers.

The business environment faced an onslaught of changes in the first two decades of the twenty-first century, including the Great Recession in 2008, the explosive growth of social media, the appearance of the #MeToo movement, the growing prominence of Generation Z in the workplace, the breakneck growth of artificial intelligence, historic tax reform, and the growing dominance of China's goliath online retailer Alibaba.

But the pivot point came with the year that none of us will ever forget: 2020. In late 2019, a new, highly contagious,

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> "When the ideas are coming, I don't stop until the ideas stop because that train doesn't come along all the time."
>
> —Dr. Dre, Rapper, Record Producer, Entrepreneur

and deadly respiratory virus, later dubbed COVID-19, was discovered in Wuhan, China. As the virus spread around the world in the first months of 2020, the World Health Organization declared a worldwide pandemic. Countries shut down, schools closed, and the death toll mounted. By early March 2020, COVID-19 had hit the United States hard. State after state declared a "state of emergency," initiating mandatory stay-at-home orders in an effort to slow the spread and minimize the death toll. Unsurprisingly, one result was that the longest-ever U.S. economic expansion came to a screeching halt, followed by the steepest quarterly drop in economic output on record. Unemployment skyrocketed, along with food and housing insecurity. By the end of 2020, hope was in sight, as the pharmaceutical industry, working hand-in-glove with the federal government, had developed and tested two different COVID-19 vaccines; daunting logistical challenges remained, however, in terms of how to roll out the vaccines to the population at large, many of whom did not trust it.

In late May, 2020, George Floyd, an unarmed Black man, was brutally killed by police in Minneapolis, Minnesota. Video footage of the killing went viral, triggering massive protests against racism and police violence in virtually every city in the county. The protests continued throughout the summer, fueled by the high-profile unjust shootings of more Black people.

In response to the heightened national awareness of systemic racism, a number of U.S. businesses began to examine their policies and products in an effort to root out racism. Examples:

- **Starbucks:** In 2020, Starbucks hired its first chief inclusion and diversity officer, Nzinga "Zing" Shaw, and committed $1 million in Neighborhood Grants to promote racial equity and create more inclusive and just communities.[1]
- **Quaker Oats:** After 130 years, Quaker Oats decided to retire the Aunt Jemima brand and logo, recognizing that "Aunt Jemima's origins are based

on a racial stereotype," and that, "we also must take a hard look at our portfolio of brands and ensure they reflect our values and meet our consumers' expectations."[2]

- **Washington Redskins:** The owner of this DC NFL team, Dan Snyder, finally agreed to change its name, a racial slur against Native Americans. The deciding factor seemed to be pressure from two of the team's key sponsors, FedEx and Nike. Options under consideration at the time of writing were Redtails, Red Hogs, Warriors, and Red Wolves.[3]

1-1a Business Basics: Some Key Definitions

business Any organization or activity that provides goods and services in an effort to earn a profit.

profit The money that a business earns in sales (or revenue), minus expenses, such as the cost of goods and the cost of salaries. Revenue − Expenses = Profit (or Loss).

loss When a business incurs expenses that are greater than its revenue.

entrepreneurs People who risk their time, money, and other resources to start and manage a business.

While you can certainly recognize a business when you see one, more formal definitions may help as you read through this book. A **business** is any organization or activity that provides goods and services in an effort to earn a profit. **Profit** is the financial reward that comes from starting and running a business. More specifically, profit is the money that a business earns in sales (or revenue), minus expenses such as the cost of goods and the cost of salaries. But clearly, not every business earns a profit all the time. When a business brings in less money than it needs to cover expenses, it incurs a **loss**. If you launch a music label, for instance, you'll need to pay your artists, lease a studio, and purchase equipment, among other expenses. If your label generates hits, you'll earn more than enough to cover all your expenses and make yourself rich. But a series of duds could leave you holding the bag. Just the possibility of earning a profit provides a powerful incentive for people of all backgrounds to launch their own enterprises.[4] People who do risk their time, money, and other resources to start and manage a business are called **entrepreneurs**.

Interestingly, as entrepreneurs create wealth for themselves, they produce a ripple effect that enriches everyone around them. For instance, if your new website becomes the next Facebook, who will benefit? Clearly, *you* will. And you'll probably spend at least some of that money enriching your local clubs, clothing stores, and car dealerships. But others will benefit, too, including your members, advertisers on your site and the staff who support them, contractors who build your facilities, and the government that collects your taxes. The impact of one successful entrepreneur can extend to the far reaches of the economy. In fact, fast-growing new firms generate about 10% of all new jobs in any given year.[5] Multiply the impact by thousands of entrepreneurs—each working in their own self-interest—and you can see how the profit motive benefits virtually everyone.

Oops! What Were They Thinking?

Not Every Dumb Move Is an Utter Disaster…

In the wake of disastrous mismanagement and outrageous mistakes across our economy, it might be hard to remember that some goofs are actually kind of funny. Some examples to help remind you:

- **Kim Kardashian "kimono": Woman's shapewear is underwear that is designed to hold a part of the body in a particular form. In 2019, Kim Kardashian tried to copywrite the name "kimono" for her line of shapewear, even though it had nothing to do with the traditional Japanese garment that dates back to nearly 800 B.C.**
- **Instagram *swipe bait*: A clever sneaker manufacturer from China, called Kaiwei Ni, published a Black Friday ad on Instagram Stories in 2017 with a stray hair right in the middle of the screen. The designer of the ad made it look like it was a stray hair on the phone screen of the person viewing it, to get users to swipe up their screen in the attempt to clear the stray hair. Sneaky. Instagram removed this ad immediately for violating its policies and disabled the account from advertising.**
- **Socially distant arches: McDonald's Brazil responded to COVID-19 pandemic by separating its iconic golden arches to remind customers to engage in social distancing. They featured the new logo in television advertising and across social media. Consumers were NOT impressed, and they expressed their disdain for the "precious arches" loudly via Twitter, condemning the move for being tone deaf and exploitative.[6]**

From a bigger-picture perspective, business drives up the **standard of living** for people worldwide, contributing to a higher **quality of life**. Businesses not only provide the products and services that people enjoy but also provide the jobs that people need. Beyond the obvious, business contributes to society through innovation—think cars, TVs, and tablet computers. Business also helps raise the standard of living through taxes, which the government spends on projects that range from streetlights to environmental cleanup. Socially responsible firms contribute even more by actively advocating for the well-being of the society that feeds their success.

1-2 The History of Business: Putting It All in Context

You may be surprised to learn that—unlike today—business hasn't always been focused on what the customer wants. In fact, business in the United States has changed rather dramatically over the past 200–300 years. Most business historians divide the history of American business into five distinct eras, which overlap during the periods of transition:

- **The Industrial Revolution:** Technological advances fueled a period of rapid industrialization in America from the mid-1700s to the mid-1800s. As mass production took hold, huge factories replaced skilled artisan workshops. The factories hired large numbers of semiskilled workers who specialized in a limited number of tasks. The result was unprecedented production efficiency but also a loss of individual ownership and personal pride in the production process.

Shawshots/Alamy Stock Photo

Henry Ford's assembly line began operation on December 1, 1913. Initially developed for the Model T, this new production system allowed manufacturers of all kinds to output products like never before.

- **The Entrepreneurship Era:** Building on the foundation of the Industrial Revolution, large-scale entrepreneurs emerged in the second half of the 1800s, building business empires. These industrial titans—such as Andrew Carnegie, Cornelius Vanderbilt, JP Morgan, and Nelson Rockefeller—created enormous wealth, raising the overall standard of living across the country. But many also dominated their markets, forcing out competitors, manipulating prices, exploiting workers, and decimating the environment. Toward the end of the 1800s, the government stepped into the business realm, passing laws to regulate business and protect consumers and workers, creating more balance in the economy.
- **The Production Era:** In the early part of the 1900s, major businesses focused on further refining the production process and creating greater efficiencies. Jobs became even more specialized, increasing productivity and lowering costs and prices. In 1913, Henry Ford introduced the assembly line, which quickly became standard across major manufacturing industries. With managers focused on efficiency, the customer was an afterthought. But when customers tightened their belts during the Great Depression and World War II, businesses took notice. The "hard sell" emerged: aggressive persuasion designed to separate consumers from their cash.
- **The Marketing Era:** After World War II, the balance of power shifted away from producers and toward consumers, flooding the market with enticing choices. To differentiate themselves from their competitors, businesses began to develop brands, or distinctive identities, to help consumers understand the differences among various products. The *marketing concept* emerged: a consumer focus that permeates successful companies in every department, at every level. This approach continues to influence business decisions today as global competition heats up to unprecedented levels.
- **The Relationship Era:** Building on the marketing concept, today, leading-edge firms look beyond each immediate transaction

standard of living The quality and quantity of goods and services available to a population.

quality of life The overall sense of well-being experienced by either an individual or a group.

with a customer and aim to build long-term relationships. Satisfied customers can become advocates for a business, spreading the word with more speed and credibility than even the best promotional campaign. According to technology entrepreneur, Lisa Masiello, "Happy customers are your biggest advocates and can become your most successful sales team." And cultivating current customers is more profitable than constantly seeking new ones. One key tool is technology. Using digital resources, businesses collect enormous amounts of data, allowing them to better serve customers.

1-3 Nonprofits and the Economy: The Business of Doing Good

Nonprofit organizations play a critical role in the economy, often working hand in hand with businesses to improve the quality of life in our society. Focusing on areas such as health, human services, education, art, religion, and culture, **nonprofits** are business-*like* establishments, but their primary goals do not include profits. Chuck Bean, former executive director of the Nonprofit Roundtable, explains: "By definition, nonprofits are not in the business of financial gain. We're in the business of doing good. However, nonprofits are still businesses in every other sense—they employ people, they take in revenue, they produce goods and services and contribute in significant ways to our region's economic stability and growth." Nationwide, nonprofits employ about one in ten workers, accounting for more paid workers than the entire construction industry and more than the finance, insurance, and real-estate sectors combined. And nonprofit museums, schools, theaters, and orchestras have become economic magnets for many communities, drawing additional investment.[7]

nonprofits Business-like establishments that employ people and produce goods and services with the fundamental goal of contributing to the community rather than generating financial gain.

factors of production Four fundamental elements—natural resources, capital, human resources, and entrepreneurship—that businesses need to achieve their objectives.

1-4 Factors of Production: The Basic Building Blocks

Both businesses and nonprofits rely on **factors of production**—four fundamental resources—to achieve their objectives. Some combination of these factors is crucial for an economic system to work and create wealth. As you read through the factors, keep in mind that they don't come free of charge. Human resources, for instance, require wages, while entrepreneurs need a profit incentive.

- **Natural Resources:** This factor includes all inputs that offer value in their natural state, such as land, fresh water, wind, and mineral deposits. Most natural resources must be extracted, purified, or harnessed; people cannot actually create them. (Note that agricultural products, which people do create through planting and tending, are not a natural resource.)

From Basement Dwellers...to Elite Esports Athletes

Not long ago, the best an intense video game player could hope for was a comfy berth in the basement, a superfast internet connection, a respite from nagging, and a fresh bag of Doritos. But video gamers today often have bigger goals—the esports industry has ignited the imagination of millions, and filled their wallets, too. Esports tournaments pack iconic stadiums such as The Staples Center in Los Angeles and Madison Square Garden in New York. Top players can earn as much as $3.5 million annually, while streamers can make more than $1 million a month. The industry overall is expected to rake in more than $1.5 billion in advertising, media rights, and sponsorships by 2021.

Clearly, most gamers won't make it to the big leagues. But according to long-time gamer, Zandr Rose, even recreational players will hone a skillset that applies directly to both school and the workplace:

- **Strategic thinking: Many games require players to think several moves ahead, which requires planning skills.**
- **Performing under pressure: Most games require players to consider and respond to multiple variables under a short deadline.**
- **Teamwork: No matter how skilled an individual player may be, many games will not allow him or her to succeed without effective team cooperation.**

So, let the video games begin![8]

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Many businesses work with nonprofits to boost their impact in the community.

The value of all-natural resources tends to rise with high demand, low supply, or both.

- **Capital:** This factor includes machines, tools, buildings, information, and technology—the synthetic resources that a business needs to produce goods or services. Computers and telecommunications capability have become pivotal elements of capital across a surprising range of industries, from financial services to professional sports. You may be surprised to learn that in this context, capital does not include money, but, clearly, businesses use money to acquire, maintain, and upgrade their capital.
- **Human Resources:** This factor encompasses the physical, intellectual, and creative contributions of everyone who works within an economy. As technology replaces a growing number of manual labor jobs, education and motivation have become increasingly important to human resource development. Given the importance of knowledge to workforce effectiveness, some business experts, such as management guru Peter Drucker, break out knowledge as its own category, separate from human resources.
- **Entrepreneurship:** Entrepreneurs are people who take the risk of launching and operating their own businesses, largely in response to the profit incentive. They tend to see opportunities where others don't, and they use their own resources to capitalize on that potential. Entrepreneurial enterprises can kick-start an economy, creating a tidal wave of opportunity by harnessing the other factors of production. But entrepreneurs don't thrive in an environment that doesn't support them. The key ingredient is economic freedom: freedom of choice (whom to hire, for instance, or what to produce), freedom from excess regulation, and freedom from too much taxation. Protection from corruption and unfair competition is another entrepreneurial "must."

Clearly, all of these factors must be in place for an economy to thrive. But which factor is most important? One way to answer that question is to examine current economies around the world. Russia and China are both rich in natural resources and human resources, and both countries have a solid level of capital (growing in China, and deteriorating in Russia). Yet, neither country is wealthy; both rank relatively low in terms of gross national income per person. The missing ingredient seems to be entrepreneurship, limited in Russia largely through corruption and in China through government interference and taxes. Contrast those examples with, say, Hong Kong. The population is small, and the natural resources are severely limited, yet Hong Kong has consistently ranked among the richest regions in Asia. The reason: operating for many years under the British legal and economic system, the government actively encouraged entrepreneurship, which fueled the creation of wealth. Recognizing the potential of entrepreneurship, China has recently done more to relax regulations and support free enterprise. The result has been tremendous growth, which may yet bring China into the ranks of the wealthier nations.[9]

1-5 The Business Environment: The Context for Success

No business operates in a vacuum. Outside factors play a vital role in determining whether each individual business succeeds or fails. Likewise, the broader **business environment** can make the critical difference in whether an overall economy thrives or disintegrates. The five key dimensions of the business environment are the economic environment, the competitive environment, the technological environment, the social environment, and the global environment, as shown in Exhibit 1.1.

business environment The setting in which business operates. The five key components are economic environment, competitive environment, technological environment, social environment, and global environment.

Exhibit 1.1
The Business Environment

Each dimension of the business environment affects both individual businesses and the economy in general.

1-5a The Economic Environment

In September 2008, the U.S. economy plunged into the worst fiscal crisis since the Great Depression. Huge, venerable financial institutions faced collapse, spurring unprecedented bailouts by the federal government and the Federal Reserve. By the end of the year, the stock market had lost more than a third of its value, and 11.1 million Americans were out of work. Housing prices fell precipitously, and foreclosure rates reached record levels. As fear swept through the banking industry, many businesses and individuals could not borrow money to meet their needs. Economic turmoil in the United States spread quickly around the world, fueling a global economic crisis.

The U.S. economy continued to stagger through 2010 and 2011, with unemployment remaining stubbornly high, although signs of recovery began to emerge in late 2012, and certainly in 2013. The Federal Reserve—the U.S. central banking system—took unprecedented, proactive steps to encourage an economic turnaround. And former President Barack Obama spearheaded passage of a massive economic stimulus package, designed not only to create jobs but also to build infrastructure—with a focus on renewable energy—to position the U.S. economy for stability and growth in the decades to come. (The price, of course, was more national debt, which will ultimately counterbalance some of the benefits.) Ultimately, the United States experienced the longest economic expansion ever recorded—ended by the COVID-19 pandemic in early 2020, which crippled the growing economy. The critical question is: how and when will the economy recover, and what scars will remain?[10]

The government also takes active steps on an ongoing basis to reduce the risks of starting and running a business. The result: free enterprise and fair competition flourish. Despite the economic crisis, research suggests that most budding entrepreneurs still plan to launch their firms in the next three years. One government policy that supports business is the relatively low federal tax rate, both for individuals and businesses. A number of states—from Alabama to Nevada—make their local economies even more appealing by providing special tax deals to attract new firms. The federal government also runs entire agencies that support business, such as the Small Business Administration. Other branches of the government, such as the Federal Trade Commission, actively promote fair competitive practices, which help give every enterprise a chance to succeed.

Another key element of the U.S. economic environment is legislation that supports enforceable contracts. For instance, if you contract a baker to supply your health food company with 10,000 pounds of raw kale chips at $1.00 per pound, that firm must comply or face legal consequences. The firm can't wait until a day before delivery and jack up the price to $10.00 per pound because you would almost certainly respond with a successful lawsuit. Many U.S. businesspeople take enforceable contracts for granted, but in a number of developing countries—which offer some of today's largest business

> "A banker is a fellow who lends you his umbrella when the sun is shining, but wants it back the minute it begins to rain."
>
> —Mark Twain, American Author

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opportunities—contracts are often not enforceable (at least not in day-to-day practice).

Corruption also affects the economic environment. A low level of corruption and bribery dramatically reduces the risks of running a business by ensuring that everyone plays by the same set of rules—rules that are clearly visible to every player. Fortunately, U.S. laws keep domestic corruption mostly—but not completely—at bay. Other ethical lapses, such as shady accounting, can also increase the cost of doing business for everyone involved. But in the wake of corporate ethical meltdowns such as Enron, the federal government has passed tough-minded new regulations to increase corporate accountability. If the new legislation effectively curbs illegal and unethical practices, every business will have a fair chance at success.

Upcoming chapters on economics and ethics will address these economic challenges and their significance in more depth. But bottom line, we have reason for cautious (some would say very cautious) optimism. The American economy has a proven track record of flexibility and resilience, which will surely help us navigate this crisis and uncover new opportunities.

1-5b The Competitive Environment

As global competition intensifies yet further, leading-edge companies have focused on customer satisfaction like never before. The goal: to develop long-term, mutually beneficial relationships with customers. Getting current customers to buy more of your product is a lot less expensive than convincing potential customers to try your product for the first time. And if you transform your current customers into loyal advocates—vocal promoters of your product or service—they'll get those new customers for you more effectively than any advertising or discount program. Companies such as Amazon, Coca-Cola, and Northwestern Mutual life insurance lead their industries in customer satisfaction, which translates into higher profits even when the competition is tough.[11]

Customer satisfaction comes in large part from delivering unsurpassed value. The best measure of value is the size of the gap between product benefits and price. A product has value when its benefits to the customer are equal to or greater than the price that the customer pays. Keep in mind that the cheapest product doesn't necessarily represent the best value. If a 99-cent toy from Big Lots breaks in a day, customers may be willing to pay several dollars more for a similar toy from somewhere else. But if that 99-cent toy lasts all year, customers will be delighted by the value and will likely encourage their friends and family to shop at Big Lots. The key to value is quality, and

Exhibit 1.2 Global Brand Champions

Most Valuable	Biggest Gainers	Percentage Growth
Apple	Amazon	+60%
Amazon	Microsoft	+53%
Microsoft	Spotify	+52%
Google	Adobe	+41%
Samsung	Netflix	+41%
Coca-Cola	PayPal	+38%
Toyota	Salesforce	+34%
Mercedes-Benz	Nintendo	+31%
McDonald's	Mastercard	+17%
Disney	Visa	+15%

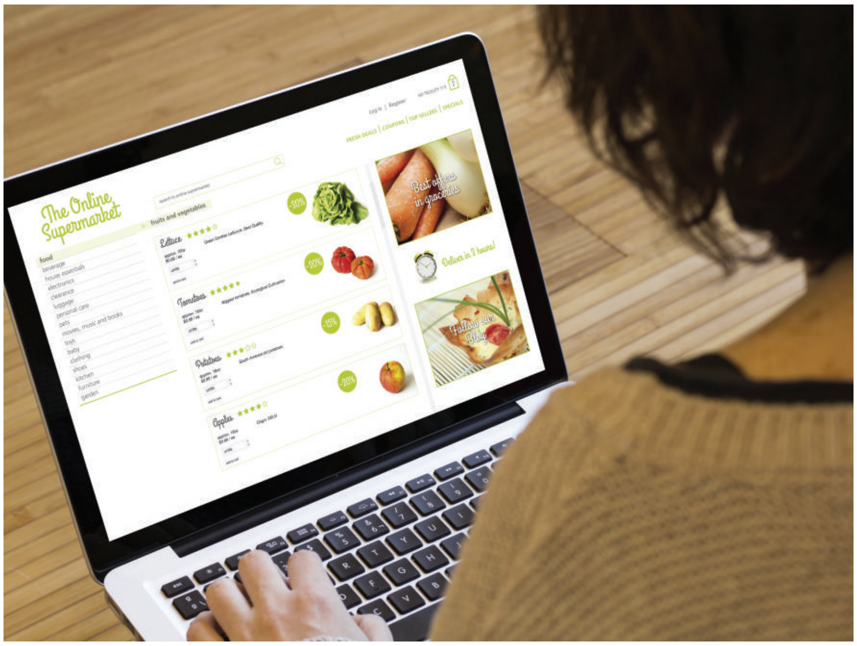
Source: Interbrand Best Global Brands 2020, https://interbrand.com/best-global-brands/, accessed January 6, 2021.

virtually all successful firms offer top-quality products relative to their direct competitors.

A recent ranking study by consulting firm Interbrand highlights brands that use imagination and innovation to deliver value to their customers. Exhibit 1.2 shows the winners and the up-and-comers in the race to capture the hearts, minds, and dollars of consumers around the world.

Leading Edge versus Bleeding Edge **Speed-to-market**—the rate at which a firm transforms concepts into actual products—can be another key source of competitive advantage. And the pace of change just keeps getting faster. In this tumultuous setting, companies that stay ahead of the pack often enjoy a distinct advantage. But keep in mind that there's a difference between leading edge and bleeding edge. Bleeding-edge firms launch products that fail because they're too far ahead of the market. During the late 1990s, for example, in the heart of the dot.com boom, Webvan, a grocery delivery service, launched to huge fanfare. But the firm went bankrupt just a few years later in 2001, partly because customers weren't yet ready to dump traditional grocery stores in favor of cyber-shopping. (Online grocery shopping finally came into its own during the COVID-19 pandemic, with research indicating that 68% of American consumers ordered groceries online between April and August 2020.)[12] Leading-edge firms, on the other hand, offer products just as the market becomes ready to embrace them.[13]

speed-to-market The rate at which a new product moves from conception to commercialization.



McLittle Stock/Shutterstock.com

Apple provides an excellent example of leading edge. You may be surprised to learn that Apple—which controls about 70%[14] of the digital music player market—did not offer the first MP3 player. Instead, it surveyed the existing market to help develop a new product, the iPod, which was far superior in terms of design and ease-of-use. But Apple didn't stop with one successful MP3 player. Racing to stay ahead, they soon introduced the colorful, more affordable iPod mini. And before sales reached their peak, they launched the iPod Nano, which essentially pulled the rug from under the blockbuster iPod mini just a few short months before the holiday selling season. Why? If they hadn't done it, someone else may well have done it instead. And Apple is almost maniacally focused on maintaining its competitive lead.[15]

1-5c The Workforce Advantage

Employees can contribute another key dimension to a firm's competitive edge. Human resources firm Glassdoor published summaries of six recent studies that show clearly that investing in worker satisfaction yields tangible, bottom-line results. For each 1-star increase in a company's overall rating by employees on Glassdoor, researchers found a 7.9% average jump in the market value of a company—a powerful financial impact.[16]

While the critical difference in performance most likely stemmed from employee satisfaction, other factors—such as excellent product and superb top management—likely *also* played a role in both employee satisfaction and strong stock performance.[17]

Finding and holding the best talent will likely become a crucial competitive issue in the next decade as the baby boom generation begins to retire. The 500 largest U.S. companies anticipate losing about half of their senior managers over the next five to six years. Since January 1, 2011, approximately 10,000 baby boomers began to turn 65 (the traditional retirement age) every day, and the Pew Research Center anticipates that this trend will continue for 19 years. Replacing the skills and experience these workers bring to their jobs may be tough: baby boomers include about 77 million people, while the generation that follows includes only 46 million. Firms that cultivate human resources now will find themselves better able to compete as the market for top talent tightens.[18] However, job market contraction may not be an issue, because a growing number of baby boomers opt to either postpone retirement or continue working part-time during retirement, in the face of inadequate financial resources.

business technology Any tools—especially computers, telecommunications, and other digital products—that businesses can use to become more efficient and effective.

1-5d The Technological Environment

The broad definition of **business technology** includes any tools that businesses can use to become more efficient and effective. But more specifically, in today's world, business technology usually refers to computers, telecommunications, and other digital tools. Over the past few decades, the impact of digital technology on business has been utterly transformative. New industries have emerged, while others have disappeared. And some fields—such as travel, banking, and music—have changed dramatically. Even in categories with relatively unchanged products, companies have leveraged technology to streamline production and create new efficiencies. Examples include new processes such as computerized billing, digital animation, and robotic manufacturing. For fast-moving firms, the technological environment represents a rich source of competitive advantage, but it clearly can be a major threat for companies that are slow to adopt or to integrate new approaches.

Spacing Out

Although rich retirees in your parents' generation may have opted to cruise the seven seas for a relaxing vacation, you or your children may opt instead to cruise through zero gravity. The space tourism industry—individuals traveling in space for recreation—stands ready to grow explosively. Experts estimate that the potential market value is $30 billion dollars by 2030.

There are two basic categories of space tourism: orbital and suborbital. Suborbital travel gives passengers just a few minutes in zero gravity, while orbital travel allows travelers to spend a week or even more in space. Although this industry has not quite blasted off, the competition is already fierce. And the key players will probably sound familiar:

- **Virgin Galactic: Richard Branson, flamboyant entrepreneur, and creator of the Virgin Group, founded Virgin Galactic with the goal of initiating suborbital Space tourism. He expects to have private paying passengers by next year. The price of a zero-gravity trip will probably be in the neighborhood of $200,000 to $250,000 each.**
- **Blue Origin: Jeff Bezos, founder of Amazon, launched Blue Origin, which he funded privately, with the goal of introducing suborbital space tourism. He has not yet announced pricing, but he anticipates the prices will be comparable to the competition.**
- **Space X: Elon Musk, founder of Tesla, launched Space X with the goal of orbital space tourism. He aims to take passengers to space for about a week, for a price of roughly $50 million per person.**

Clearly, the pricing for space travel is out of reach for most people. But the target market at least for the first few years is high-net-worth individuals who have demonstrated very strong demand for this luxury experience. Over time, all three entrepreneurs expect the price will drop, bringing outer space into reach for most of us. It doesn't hurt to hope! As Norman Vincent Peale once said, "Shoot for the moon. Even if you miss, you'll land among the stars."[19]

The creation of the **internet** has transformed not only business but also people's lives. Anyone, anywhere, anytime can use the web to send and receive images and data (as long as access is available). One result is the rise of **e-commerce** or online sales, which allow businesses to tap into a worldwide community of potential customers. In the wake of the global economic crisis, e-commerce slowed from the breakneck 20%+ growth rates of the previous five years, but unsurprisingly, the COVID-19 pandemic reignited explosive growth rates. Business-to-business selling comprises the vast majority of total e-commerce sales (and an even larger share of the profits). A growing number of businesses have also connected their digital networks with suppliers and distributors to create a more seamless flow of goods and services.[20]

Alternative selling strategies thrive on the internet, giving rise to a more individualized buying experience. If you've browsed seller reviews on eBay or received shopping recommendations from Amazon, you'll have a sense of how personal web marketing can feel. Online technology also allows leading-edge firms to offer customized products at prices that are comparable to standardized products. On the Burton website, for instance, customers can "custom build" professional quality "Custom X" snowboards while sitting at home in their pajamas. Nike offers a similar service for NikeID shoes, clothing, and gear.

As technology continues to evolve at breakneck speed, the scope of change—both in everyday life and business operations—is almost unimaginable. In this environment, companies that welcome change and manage it well will clearly be the winners.

1-5e The Social Environment

The social environment embodies the values, attitudes, customs, and beliefs shared by groups of people. It also covers **demographics**, or the measurable characteristics of a population. Demographic factors include population size and density and specific traits such as age, gender, race, education, and income. Clearly, given all these influences, the social environment changes dramatically from country to country. And a nation as diverse as the United States features a number of different social environments. Rather than cover the full spectrum, this section focuses on the broad social trends that have the strongest impact on American business. Understanding the various dimensions of the social environment is crucial since successful businesses must offer goods and services that respond to it.

internet The service that allows computer users to easily access and share information in the form of text, graphics, video, apps, and animation.

e-commerce Business transactions conducted online, typically via the internet.

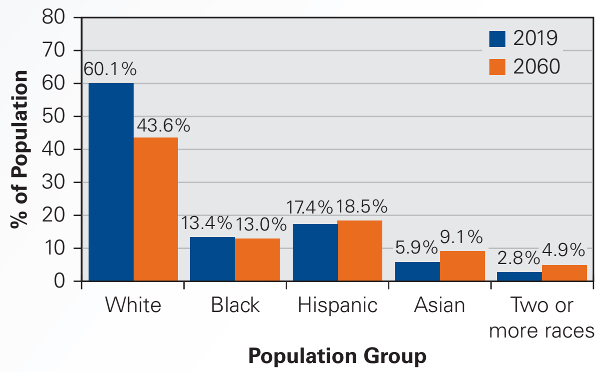
demographics The measurable characteristics of a population. Demographic factors include population size and density, as well as specific traits such as age, gender, and race.

Diversity While the American population has always included an array of different cultures, the United States has become more ethnically diverse in recent years. Whites continue to represent the largest chunk of the population at 60%, but according to the director of the U.S. Census Bureau, "The next half century marks a turning point in continuing trends—the U.S. will become a plurality nation, where the non-Hispanic White population remains the largest single group, but no group is in the majority." This will probably happen in about 2045. The year that different populations hit "marginalized majority" status will differ dramatically by age—the number of non-White children currently surpasses the number of White children. For those age 18-29–members of the younger labor force and voting age populations—the number of non-White people will likely surpass the number of White people by 2027.[21]

The Hispanic and Asian populations will probably continue to grow faster than any other ethnic groups. By 2060, nearly one in three U.S. residents will be Hispanic, up from about one in six today. This will happen even though the overwhelming wave of immigration from Mexico to the United States has stalled and even begun to reverse in the past few years.[22] Exhibit 1.3 demonstrates the shifting population breakdown.

So, what does this mean for business? Growing ethnic populations offer robust profit potential for firms that pursue them. For instance, a number of major brands such as Coca-Cola, General Mills, Ford, Nestlé, Purina, and Walmart have invested heavily in the Hispanic market. Japanese automakers have begun targeting the Hispanic market, recognizing the potential of them. Because of these efforts, Hispanic customers are reportedly 15% more likely than any other group to buy a Japanese-made car. Toyota, in particular, has been the top-selling brand among Latinos for more than ten years thanks to its highly targeted marketing. Targeting an ethnic market can also yield remarkable results for products that cross over into mainstream culture. Black rapper and songwriter, Pharrell Williams, for instance, created a streetwear empire with his Billionaire Boys Club brand.[23]

Exhibit 1.3
U.S. Population Estimates



Source: U.S. Census QuickFacts, Population Estimates, July 1, 2019, https://www.census.gov/quickfacts/fact/table/US#, accessed January 7, 2021.

Do You Do It?

Eric Broder Van Dyke/Shutterstock.com

More than 1,000 times a minute, someone in America bites into a Jack in the Box taco—one of more than a million Jack in the Box tacos sold every day. With such numbers, you might think that Jack unearthed the secret to the perfect-tasting taco . . . but you'd be wrong. Jack's taco has been variously described by its fans as:

- **"a wet envelope of cat food"**
- **"vile and amazing"**
- **"disgusting and delectable"**
- **"repulsive and yet irresistible"**

So why does the Jack in the Box taco do so well? Food writer Sophie Egan offers three possible reasons. First, it's cheap. At two for $.99 it's a real deal. Second, it's fried. As much as we like the idea of fruits and vegetables—fried stuff tastes good! Finally, it's a metaphorical flip of the bird to the "food police," who many believe are attempting to exert too much control over our rights to eat whatever we please.[24]

Growing diversity also affects the workforce. A diverse staff—one that reflects an increasingly diverse marketplace—can yield a powerful competitive advantage in terms of both innovation and ability to reach a broad customer base. Leading edge companies are responding—propelled in part by the social justice movement in 2020 and by recognition of their own shortcomings—by reworking their employment and hiring policies with an eye toward greater diversity and inclusion. Facebook, for example, pledged to have 50% of its workforce come from underrepresented communities by 2024. As part of this goal, Facebook says it wants to double the number of Black and Hispanic employees in the United States. Currently, Black and Hispanic women each account for less than 1% of Facebook executives. The social media goliath will clearly benefit from the influx of diverse talent into its homogenous ranks.[25]

> In Asia, the average person's living standards are currently set to rise by 10,000% in one lifetime!
>
> —Newsweek

In some cases, the call for greater diversity and inclusion has come directly from employees who are fed up with racism. Workers at Adidas, for example, presented senior management with a list of demands, including:

- 31% representation of Black and Latinx employees across all levels of the company by the end of 2021
- Overall commitment of $50 million of global sales to funding Black communities
- Partner with vetted external nonprofits to raise $100 million annually to end systematic racism and injustice for Black people

The workers implied that if the Adidas' response was insufficient, they would continue their scathing public exposing of the company's racist internal environment. Employee Aaron Ture explained his frustration in a letter to senior management: "We are an organization that exploits minorities, [B]lack, queer and so many others for commercial profit, without aiming to empower them at the workspace and in their own communities."

Adidas responded to the worker demands with a promised $20 million investment into Black American communities over the next four years and outlined investments in university scholarships for Black employees and a commitment to filling 30% of all new positions in the United States with Black and Latinx people. Ultimately, Adidas and other corporations may not respond fully to worker calls for diversity and inclusion, but many are endeavoring to head in a more positive direction.[26]

It's important to remember that true diversity also includes differences in gender, age, religion, and nationality, among other areas. Leading-edge firms have also taken proactive steps to train their entire workforce to manage diversity for top performance.[27]

Effectively managing diversity should only become easier as time goes by. Multiple studies demonstrate that young American adults are the most tolerant age group, and they are moving in a more tolerant direction than earlier generations regarding racial differences, immigrants, and homosexuality. As this generation gathers influence and experience in the workforce, they are likely to leverage diversity in their organizations to hone their edge in a fiercely competitive marketplace.[28]

Aging Population As life spans increase and birthrates decrease, the American population is rapidly aging. The U.S. Census Bureau projects that the nation's population age 65 and older will more than double between 2005 and 2060. By 2060, older Americans will represent just over one in five residents, up from one in seven today. Also, the number of working-age Americans will shrink from 63% to 57% of the population, dramatically increasing the number of people who are depending on each working American. And the United States isn't alone in this trend. The population is aging across the developed world, from Western Europe to Japan. China faces the same issue, magnified by its huge population. Demographers estimate that in the next 20 years the number of people in China over the age of 60 will double, leading to a nation where the retired will outnumber the entire population of Western Europe. There are currently six workers to every retiree, but China's one-child policy—in place from the early 1980s until roughly 2014—suggests that the number of people providing for the old will rapidly collapse.[29]

The rapidly aging population brings opportunities and threats for business. Companies in fields that cater to the elderly—such as healthcare, pharmaceuticals, travel, recreation, and financial management—will clearly boom. But creative companies in other fields will capitalize on the trend as well by reimagining their current products to serve older clients. Possibilities include books and movies—maybe even video games—with mature characters; low-impact fitness programs such as water aerobics; and cell phones and PDAs with more readable screens. Again, the potential payoff of age diversity is clear: companies with older employees are more likely to find innovative ways to reach the aging consumer market.

But the larger numbers of retired people also pose significant threats to overall business success. With a smaller labor pool, companies will need to compete even harder for top talent, driving up recruitment and payroll costs. As state and federal governments stretch to serve the aging population, taxes may increase, putting an additional burden on business. And as mid-career workers spend more on elder care, they may find themselves with less to spend on other goods and services, shrinking the size of the consumer market.

Rising Worker Expectations Workers of all ages continue to seek flexibility from their employers. Moreover, following massive corporate layoffs in the early 2000s, employees are much less apt to be loyal to their firms. According to the Bureau of Labor Statistics, the median number of years workers had been with their current employer was only 4.1 as of 2020.[30] As young people today enter the workforce, they bring higher expectations for their employers in terms of salary, job responsibility, and flexibility—and less willingness to pay dues by working extra-long hours or doing a high volume of "grunt work." Smart firms are responding to the change in worker expectations by forging a new partnership with their employees. The goal is a greater level of mutual respect through open communication, information sharing, and training. And the not-so-hidden agenda, of course, is stronger long-term performance.[31]

Ethics and Social Responsibility With high-profile ethical meltdowns dominating the headlines in the past few years, workers, consumers, and government alike have begun to hold businesses—and the people who run them—to a higher standard. Federal legislation demands transparent financial management and more accountability from senior executives. And recognizing their key role in business success, a growing number of consumers and workers have begun to insist that companies play a proactive role in making their communities—and often the world community—better places. Sustainability—doing business today without harming the ability of future generations to meet their needs—has become a core issue in the marketplace, driving business policies, investment decisions, and consumer purchases on an unprecedented scale. Going beyond simply recycling, a number of innovative brands are engaged in upcycling—making use of their waste to enter entirely new markets. Swedish hosiery brand, Swedish Stockings, transforms used tights into commercial grease tanks and furniture.[32]

free trade An international economic and political movement designed to help goods and services flow more freely across international boundaries.

General Agreement on Tariffs and Trade (GATT) An international trade agreement that has taken bold steps to lower tariffs and promote free trade worldwide.

1-5f The Global Environment

The U.S. economy operates within the context of the global environment, interacting continually with other economies. In fact, over the past two decades, technology and free trade have blurred the lines between individual economies around the world. Technology has forged unprecedented links among countries, making it cost effective—even efficient—to establish computer help centers in Mumbai to serve customers in Boston, or to hire programmers in Buenos Aires to make websites for companies in Stockholm. Not surprisingly, jobs have migrated to the lowest bidder with the highest quality—regardless of where that bidder is based.

Often, the lowest bidder is based in China or India. Both economies are growing at breakneck speed, largely because they attract enormous foreign investment. Over the past couple of decades, China has been a magnet for manufacturing jobs because of the high population and low wages—about $5.50 per hour (including government-mandated benefits) versus about $27.00 in the United States—although the gap is rapidly closing due to double-digit annual wage inflation in China.[33] And India has been especially adept at attracting high-tech jobs, in part because of their world-class, English-speaking university graduates who are willing to work for less than their counterparts around the globe.[34]

The migration of jobs relates closely to the global movement toward **free trade**. In 1995, a renegotiation of the **General Agreement on Tariffs and Trade (GATT)**—signed by 125 countries—took bold steps to lower tariffs (taxes on imports) and to reduce trade restrictions worldwide. The result: goods move more freely than ever across international boundaries. Individual groups of countries have gone even further, creating blocs of nations with virtually unrestricted trade. Mexico, Canada, and the United States have laid the groundwork for a free-trade mega-market through the United States–Mexico–Canada–Agreement (USMCA), the successor to the North

Milles Studio/Shutterstock.com

American Free Trade Agreement (NAFTA), and 27 European countries have created a powerful free-trading bloc through the European Union (EU), which has been weakened by a severe, ongoing financial crisis. The free-trade movement has lowered prices and increased quality across virtually every product category as competition becomes truly global. We'll discuss these issues and their implications in more depth in Chapter 3.

A Multi-Pronged Threat In the past decade alone, war, terrorism, disease, and natural disasters have taken a horrific toll on human lives across the globe. The economic toll has been devastating as well, affecting businesses around the world. The 9/11 terrorist attacks in New York and Washington, D.C., decimated the travel industry and led to multibillion-dollar government outlays for Homeland Security. In 2002, a terrorist bombing at an Indonesian nightclub killed nearly 200 people, destroying tourism on the holiday island of Bali. Similarly, the 2015 terror attacks in Paris dealt a devastating blow to tourism throughout Europe, which was already struggling to handle an overwhelming refugee crisis. The 2003 deadly epidemic of the SARS flu dealt a powerful blow to the economies of Hong Kong, Beijing, and Toronto. And the Ebola outbreak of 2014 had a catastrophic impact on several impoverished African economies that could least afford the hit. Less than two years later, the Indian Ocean tsunami wiped out the fishing industry on long swaths of the Indian and Sri Lankan coastlines and crippled the booming Thai tourism industry. That same year, in 2005, Hurricane Katrina destroyed homes and businesses alike and brought the Gulf Coast oil industry to a virtual standstill. In 2012, Hurricane Sandy wreaked $50 billion of economic damage on the eastern seaboard states. And in 2013, Typhoon Haiyan decimated the Philippines. The wars in Afghanistan and Iraq—while a boon to the defense industry—have dampened the economic potential of both areas. With nationalism on the rise, and growing religious and ethnic tensions around the world, the global economy may continue to suffer collateral damage.[35]

1-6 Business and You: Making It Personal

Whatever your career choice—from video game developer to real-estate agent, to web designer—business will affect your life. Both the broader economy and your own business skills will influence the level of your personal financial success. In light of these factors, making the right career choice can be a bit scary. But the good news is that experts advise graduating students to "Do what you love." This is a hardheaded strategy, not softhearted puffery. Following your passion makes dollars and sense in today's environment, which values less-routine abilities such as creativity, communication, and caring. These abilities tend to be more rewarding for most people than routine, programmable skills that computers can easily emulate. Following your passion doesn't guarantee a fat paycheck, but it does boost your chances of both financial and personal success.[36]

The Big Picture

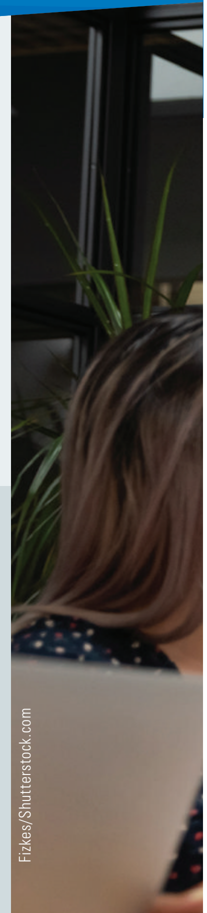
Business today is complex, global, and faster moving than ever before. Looking forward, it's hard to imagine how the global economy—especially the United States—will recover from the blow of the COVID-19 pandemic. Technology will continue to change the business landscape. And a new focus on ethics and social responsibility—especially diversity and inclusion—will likely transform the role of business in society. This book will focus on the impact of change in every facet of business, from management to marketing, to money, with an emphasis on how the elements of business relate to each other and how business as a whole relates to you.

Careers in Business

Manager of New Media

Work with marketing team to determine what motivates and inspires consumers. Lead development and execution of digital marketing campaigns across a variety of platforms to build a deep, meaningful, and genuine relationship with consumers. Develop and manage interactive viral campaigns, integrate interactive media into the overall business strategy. According to Glassdoor, the median base salary for social media marketing managers in 2020 was $65,834, although there was significant variation based on company, location, industry, experience, and benefits. Most new media positions require experience in the field and a four-year degree in either business or communication. Many also prefer a master's degree in business (an MBA).

2 Economics: The Framework for Business



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Learning Objectives

After studying this chapter, you will be able to:

- **2-1** Define economics and discuss the global economic crisis
- **2-2** Analyze the roots of the Great Recession and identify its impact on the economy
- **2-3** Discuss the impact of fiscal and monetary policy on the economy
- **2-4** Evaluate the free market system and supply and demand
- **2-5** Evaluate planned market systems
- **2-6** Describe the trend toward mixed market systems
- **2-7** Discuss key terms and tools to evaluate economic performance

2-1 Economics: Navigating a Crisis

Understanding economics—and the role of the government, businesses, and individuals—requires understanding some basic definitions: The **economy** is essentially a financial and social system. It represents the flow of resources through society, from production to distribution, to consumption. **Economics** is the study of the choices that people, companies, and governments make in allocating those resources. The field of economics falls into two core categories: macroeconomics and microeconomics. **Macroeconomics** is the study of a country's overall economic dynamics, such as the employment rate, the gross domestic product, and taxation policies. While macroeconomic issues may seem abstract, they directly affect your day-to-day life, influencing key variables such as what jobs will

economy A financial and social system of how resources flow through society, from production to distribution, to consumption.

economics The study of the choices that people, companies, and governments make in allocating society's resources.

macroeconomics The study of a country's overall economic dynamics, such as the employment rate, the gross domestic product, and taxation policies.

be available for you, how much cash you'll actually take home after taxes, or how much you can buy with that cash in any given month. **Microeconomics** focuses on smaller economic units such as individual consumers, families, and individual businesses. Both macroeconomics and microeconomics play an integral role in the global economy.

"Every time you spend money, you're casting a vote for the kind of world you want."

—Anna Lappe, Sustainable Food Advocate

The U.S. economy experienced the longest expansion in recorded history from 2009 until early 2020. The unprecedented growth jolted to a halt when COVID-19 cases reached a dangerous level, prompting government-mandated lockdowns. In March 2020, the U.S. economy experienced the biggest ever downturn in response to the government-mandated economic lockdowns. Millions of workers were thrust into unemployment, thousands of businesses closed their doors permanently, and most chilling of all, more than 400,000 Americans had lost their lives to the virus as of January, 2021.

The Federal response to the crisis was mixed, at best. Federal relief spending kept hunger and homelessness at bay, at least temporarily, and also fueled a short-term economic rebound three months into the pandemic. But a year after the pandemic hit, the need for strategic economic recovery planning had become painfully clear. The obvious first step was COVID-19 vaccinations to allow the economy to reopen. By the end of 2020,

microeconomics The study of smaller economic units such as individual consumers, families, and individual businesses.

the pharmaceutical industry had developed, tested, and gained emergency FDA approval for two different COVID-19 vaccinations. Distributing those vaccinations was among the highest priorities of the incoming Biden administration in early 2021. The logistics were daunting—especially since much of the population did not trust that the vaccines would be either effective or harmless.

2-2 Economics and the Great Recession

A deep understanding of today's economy requires a look back at the Great Recession and its historical roots. Through the last half of the 1990s, America enjoyed unprecedented growth. Unemployment was low, productivity was high, inflation was low, and the real standard of living for the average American rose significantly. The American economy grew by more than $2.4 trillion, a jump of nearly 33% in just five years. But the scene changed for the worse when the dot-com bubble burst in 2000, followed by the 9/11 terrorist attacks in 2001. As the stock market dropped and unemployment rose, economic experts feared that the country was hovering on the brink of a full-blown recession.[1]

2-2a Managing the Crisis

In an effort to avert a recession by increasing the money supply and encouraging investment, the Federal Reserve—the nation's central bank—decreased interest rates from 6.5% in mid-2000 to 1.25% by the end of 2002. As a result, the economy was awash with money, but opportunities to invest yielded paltry returns. This is when *subprime mortgage loans* came into play. Most experts define subprime mortgages as loans to borrowers with low credit scores, high debt-to-income ratios, or other signs of a reduced ability to repay the money they borrow.

These subprime mortgage loans were attractive to borrowers and lenders alike. For the borrowers, getting a loan suddenly became a cinch, and for the first time ever, hundreds of thousands of people could afford homes. The lenders were all too willing to give them mortgage loans, sometimes with little or no documentation (such as proof of income), and sometimes with little or no money down. As demand for homes skyrocketed, prices continued to rise year after year. Borrowers took on adjustable-rate loans assuming that when their loans adjusted up—usually sharply up—they could simply refinance their now-more-valuable homes for a new low starter rate and maybe even pull out some cash.

> "The financial crisis is a stark reminder that transparency and disclosure are essential in today's marketplace."
>
> —U.S. Senator Jack Reed

A Trillion Dollars? Say What?

Between stimulating the economy and managing the federal debt, "a trillion dollars" is a figure you may have heard a lot lately. But getting your mind around what that actually means may be a little tricky, since it's just so much money. To understand the true magnitude of a trillion dollars, consider this:

- **If you had started spending a million dollars a day—every day, without fail—at the start of the Roman Empire, you still wouldn't have spent a trillion dollars by 2020; in fact, you'd have more than $250 billion left over.**
- **One trillion dollars, laid end-to-end, would stretch farther than the distance from the earth to the sun. You could also wrap your chain of bills more than 12,000 times around the earth's equator.**
- **If you were to fly a jet at the speed of sound, spooling out a roll of dollar bills behind you, it would take you more than 14 years to release a trillion dollars. But your plane probably couldn't carry the roll, since it would weigh more than one million tons.**

Turning the economy around may take even more than a trillion dollars, but make no mistake when you hear those numbers thrown around on the news—a trillion dollars is an awful lot of money![2]

istock.com/Selensergen

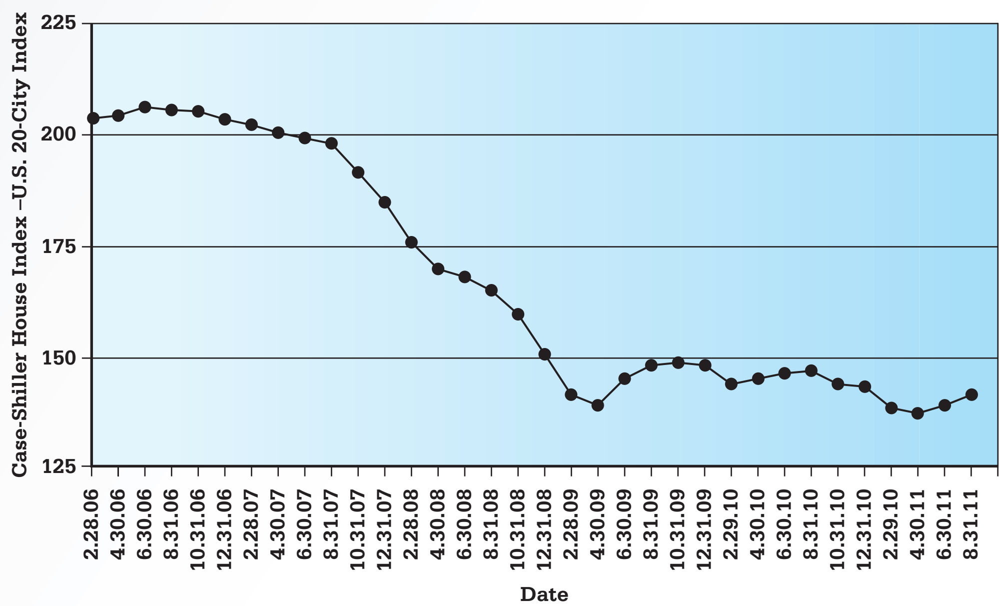
Subprime loans were attractive to lenders because they provided a higher return than many other investments, and—given the growth in housing prices—they seemed relatively low risk. Banks and investment houses invented a range of stunningly complex financial instruments to slice up and resell the mortgages as specialized securities. Hedge funds swapped the new securities, convinced that they were virtually risk-free. With a lack of regulation—or any other government oversight—financial institutions did *not* maintain sufficient reserves in case those mortgage-backed funds lost value.

And they did indeed lose value. In 2006, housing prices peaked, and in the months that followed, prices began falling precipitously (refer to Exhibit 2.1), dropping nearly 35% from the market peak in 2006 through the market trough in 2009. Increasing numbers of subprime borrowers found themselves "upside down"—they owed their lenders more than the value of their homes. Once this happened, they couldn't refinance to lower their payments. Foreclosure rates climbed at an increasing pace. RealtyTrac, a leading online marketplace for foreclosure properties, reported that foreclosure rates were 33% higher in 2010 than they were in all of 2009. In 2011, the foreclosure rate dropped to the lowest level since 2007, when the recession began. And by January 2014, the inventory of foreclosed homes had experienced 16 consecutive months of year-to-year double-digit declines, signaling that the fragile economic recovery had finally taken hold.[3]

As mortgage values dropped, financial institutions began to feel the pressure—especially firms such as Bear Stearns that specialized in trading mortgage-backed securities, and firms such as Washington Mutual that focused on selling subprime mortgages. When financial institutions actually began to face collapse, a wave of fear washed over the entire banking industry. Banks became unwilling to lend money to each other or to clients, which meant that funds were not available for businesses to finance either day-to-day operations or longer-term growth. Company after company—from General Motors to Yahoo!, to American Express, to countless small employers— began to announce layoffs. The December 2008 unemployment rate hit 7.2%. About 2.6 million Americans lost their jobs in 2008, making 2008 the worst year for jobs since 1945. And the unemployment rate continued to rise, hitting 9.3% in 2009 and 9.6% in 2010, leading to total Great Recession job losses of nearly 8 million, many of which will never come back as the economy continues to change and old skills become obsolete.[4] The national average unemployment rate began to drop in late 2011 until it reached a near historic low of 3.5% in February 2020.

Exhibit 2.1

House Price Index



Source: Housing's Rise and Fall in 20 Cities, December 27, 2011, The *New York Times* website, http://www.nytimes.com/interactive/2011/05/31/business/economy/case-shiller-index.html#city/IND20, accessed January 25, 2012.

2-2b Moving in a Better Direction

Although the benefits were not immediately obvious in the face of a downward trend, the federal government and the Federal Reserve—known as "the Fed"—intervened in the economy at an unprecedented level to prevent total financial disaster. In March 2008, the Fed staved off bankruptcy at Bear Stearns. In early September 2008, the U.S. Department of the Treasury seized Fannie Mae and Freddie Mac, which owned about half of the U.S. mortgage market. A week later, the Fed bailed out tottering global insurance giant AIG with an $85 billion loan. But the bleeding continued.

The negative spiral spurred Congress to pass a controversial $700 billion economic bailout plan in early October 2008, called TARP (the Troubled Assets Relief Program). By the end of the year, the Treasury had spent the first half of that money investing in banks, although early results were imperceptible for the economy. Just as the Treasury began to release funds to the banks, GM and Chrysler, two of the Big Three U.S. automakers, announced they also desperately needed a bailout. Both firms suggested that bankruptcy was imminent without government assistance. (Ford, the other member of the Big Three, also admitted to financial problems but claimed that it was not in the dire straits faced by its domestic competitors.) Facing the loss of more than 2.5 million jobs related to the auto industry, the Treasury agreed to spend a portion of what remained of the $700 billion in a partial auto industry bailout.[5] Although much of the public railed against the expensive government bailout program, by 2010 it appeared likely that TARP could end up costing taxpayers far less than anticipated, or even nothing, as insurance companies and banks began to break even, or in many cases earn profits, and pay back their government loans.[6]

As the new administration began, President Obama proposed, and Congress passed, an $825 billion economic stimulus package called the American Recovery and Reinvestment Act, designed to turn the economy around over the next two years. The plan included cutting taxes, building infrastructure, and investing $150 billion in green energy. In late 2011, the economy began to turn around at a very slow pace. Employment grew slowly for 49 months in a row—the best run since at least World War II. Although employment numbers improved, many people traded good-paying jobs for part-time work and/or lower-paying positions. This has constrained incomes and restrained consumer spending in the years since.[7]

All of these moves by the federal government and the Federal Reserve are part of fiscal and monetary policy.

fiscal policy Government efforts to influence the economy through taxation and spending.

2-3 Managing the Economy Through Fiscal and Monetary Policy

While the free market drives performance in the American economy, the federal government and the Federal Reserve can help *shape* performance. During the recent crisis, both the government and the Fed have taken proactive—some say heavy-handed—roles to mitigate this economic contraction. The overarching goal is controlled, sustained growth, and both fiscal and monetary policy can help achieve this objective.

2-3a Fiscal Policy

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. Clearly, fiscal strategies are closely tied to political philosophy. But regardless of politics, most economists agree that lower taxes can boost the economy by leaving more money in people's pockets for them to spend or invest. Most also agree that government spending can boost the economy in the short term by providing jobs, such as mail carrier, bridge repairer, or park ranger; and in the long term by investing in critical public assets, such as a national renewable energy grid. Done well, both taxation and spending can offer economic benefits. The tricky part is finding the right balance between the two approaches. As American economist Henry Hazlitt pointed out, it's important to keep in mind that "[e]ither immediately or ultimately, every dollar of government spending must be raised through a dollar of taxation; once we look at the matter in this way, the supposed miracles of government spending will appear in another light."

2-3b Debt Ceiling/Fiscal Cliff

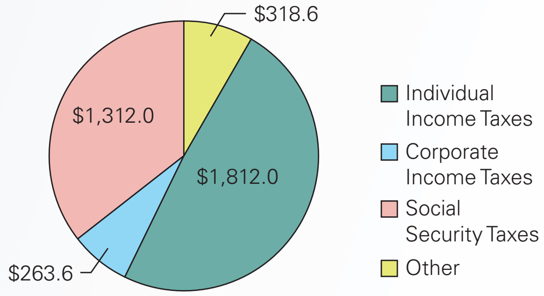
In mid-2011, the U.S. economy shuddered again as the news headlines screamed with dire warnings about a national or even international economic meltdown when we hit the federal *debt ceiling*. What did this mean? The debt ceiling is the maximum amount Congress lets the government borrow. In theory, this is meant to limit the amount that the government can borrow, but in practice, voting on

> "Government does not solve problems; it subsidizes them."
> —U.S. President Ronald Reagan

Exhibit 2.2

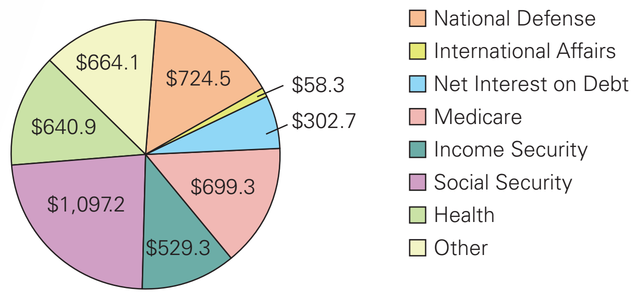
Federal Government Revenue and Expenses

Federal Government Revenue
Fiscal 2020 Estimated (billions of dollars)



TOTAL = $3,706.3

Federal Government Expenses
Fiscal 2020 Estimated (billions of dollars)



TOTAL = $4,789.7

Source: Economic Report of the President, 2020, Table B – 47 Federal Receipts and Outlays, by major category, and surplus or deficit, fiscal years 1950- 2021, https://www.govinfo.gov/content/pkg/ERP-2020/pdf/ERP-2020-table47.pdf, accessed January 10, 2021.

the debt ceiling happens separately from voting on taxes and spending, so the debt ceiling ends up being mostly about whether the federal government can pay for debts that it has already incurred. Typically, debt ceiling hikes are fairly routine; in fact, Congress has raised the debt ceiling 74 times since 1962, and ten times since 2001, all with little or no notice. But as federal debt began to nudge the ceiling in 2011, it garnered unprecedented political and journalistic attention because various political groups saw the issue as an opportunity to further their political agenda. Those who wanted to raise the debt ceiling portrayed others as irresponsible buffoons who were willing to shut down the government simply to make a point without any real long-term change in spending. Those who did not want to raise the debt ceiling argued that the others are spendthrift bureaucrats who must learn to live within their means like the Americans who elected them.

After weeks of high-profile wrangling, Congress finally agreed to raise the debt ceiling, which temporarily averted a shutdown crisis, but the deal they reached to do so created the fiscal cliff. The *fiscal cliff* was a package of draconian across-the-board spending cuts and sharp tax hikes scheduled to hit at the same time that could dramatically decrease the U.S. budget deficit. Going over the *fiscal cliff* could potentially cripple the U.S. economy, and possibly even cause the United States to default on some of its debt, which could send world markets into a tailspin. But once again, Congress could not reach a reasonable long-term agreement, so they simply passed last-minute legislation that pushed the really tough tax and spending decisions farther down the road. The federal government actually did shut down for 16 days in October 2013 after much congressional squabbling failed to produce a budget agreement. The government reopened with passage of another temporary agreement that again delayed the tough fiscal choices. If the country continues to fracture along political lines, it may become increasingly difficult to reach a federal budget agreement, leading to more regular government shutdowns, such as the two very brief shutdowns at the start of 2018. In the middle of December 2020, Congress averted a government shutdown by passing yet another temporary funding bill.[8]

Every year, the government must create a budget, or a financial plan, that outlines expected revenue from taxes and fees, and expected spending. If revenue is higher than spending, the government incurs a **budget surplus** (rare in recent years, but usually quite welcome!). If spending is higher than revenue, the government incurs a **budget deficit** and must borrow money to cover the shortfall. The sum of all the money borrowed over the years and not yet repaid is the total **federal debt**. Exhibit 2.2 shows an estimate of key sources of revenue and key expenses

budget surplus Overage that occurs when revenue is higher than expenses over a given period of time.

budget deficit Shortfall that occurs when expenses are higher than revenue over a given period of time.

federal debt The sum of all the money that the federal government has borrowed over the years and not yet repaid.

What Does It Really Mean to Call an Uber?

If you're like most people, the first thing that comes to mind when you think about "calling an Uber" is hailing a car for a local trip or maybe arranging a food delivery to satisfy a craving via UberEATS. But if you are a member of the entertainment elite, calling an Uber may well mean hailing a helicopter via Uber Copter to get to the Cannes Film Festival or to avoid the bumper-to-bumper traffic between Manhattan and the Hamptons on a steamy New York weekend. Airbus expanded its private helicopter service into all-new markets by joining forces with Uber in 2016. The partnership was launched as demand from some of Airbus's traditional customers—oil and gas companies—dropped in the wake of falling commodity prices. But Uber has expanded beyond just helicopter rides. In India, Uber's services include on-demand rickshaws, and in Turkey, it offers on-demand boats. Although the cost of the Uber Copter is sky high (the price of a flight from Manhattan's Wall Street to JFK airport was roughly $220 in 2019, depending on demand), the price of hailing a rickshaw is more reasonable in India and Pakistan, starting at a minimum fare of roughly $0.74. Motorcycle hailing is even more reasonable with a base fare of roughly $0.37 U.S., and the driver shows up with the helmet for the rider. It's fun to imagine what calling an Uber might mean in the future—on-demand drones? On-demand robots? Time will tell.[9]

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for the federal government in 2018. Note that spending significantly outstrips receipts, creating a one-year budget deficit of more than a trillion dollars. Clearly, any additional spending without corresponding tax increases could dramatically increase the shortfall. Also note that these numbers changed dramatically with the onset of the pandemic in 2020, although that data was not available at the time of writing.

By the end of 2020 , the total U.S. federal debt stood at $26.95 trillion and growing, a staggering $82,000 for every U.S. citizen.[10]

The debt has only grown bigger every year since 1957, and the pace of growth will likely increase further in the wake of the COVID-19 pandemic. This matters to each taxpayer because as the government repays the debt—not to mention paying the skyrocketing interest to finance this debt—less and less money will be available for other uses; services may be eliminated (e.g., student loans, veterans' benefits, housing subsidies), or taxes will soar, or perhaps even both.

Analysts agree that the federal tax reform that Congress passed in late 2017 will add an estimated $1.5 trillion to the deficit over ten years due to a decrease in corporate taxes from 35% to 21% and a decrease in individual income taxes.[11]

monetary policy Federal Reserve decisions that shape the economy by influencing interest rates and the supply of money.

commercial banks Privately owned financial institutions that accept demand deposits and make loans and provide other services for the public.

2-3c Monetary Policy

Monetary policy refers to actions that shape the economy by influencing interest rates and the supply of money. The Federal Reserve—essentially the central bank of the United States—manages U.S. monetary policy. For the first time in its history, the Fed has also taken an activist role in bailing out and propping up shaky financial firms during the economic crisis. Other Fed functions include banking services for member banks and the federal government.

The Fed is headed by a seven-member Board of Governors. The president appoints each member of the Board to serve a single 14-year term—though a member can also complete a former member's unexpired term and still be appointed to a full term of their own. These terms are staggered, with one expiring every two years, so that no single president can appoint all of the members. This structure helps ensure that the Fed can act independently of political pressure.

In addition to setting monetary policy, the Board of Governors oversees the operation of the 12 Federal Reserve Banks that carry out Fed policies and perform banking services for **commercial banks** in their districts. Interestingly, the federal government does not own these Federal Reserve Banks. Instead, they're owned by the member commercial banks in their individual districts.

The president appoints one of the seven members of the Board of Governors to serve as its chair—a position so powerful that many consider him or her

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the second most powerful person on earth. For nearly 19 years, the chair was Alan Greenspan. When Greenspan retired in early 2006, President Bush appointed economist Ben Bernanke to the chair role. Bernanke led the Fed's proactive efforts to turn the ailing economy around. In early 2014, the Senate confirmed economist Janet Yellen as new chair of the Fed. Yellen was the first female chair, and she focused primarily on fighting unemployment by encouraging economic expansion. In late 2017, President Trump appointed Jerome Powell to succeed Janet Yellen as new chair of the Fed. Although analysts anticipated that Powell would continue Yellen's policies, he was quite different from recent Fed Chairs because he has a business background, rather than an academic background.

The core purpose of the Fed is to influence the size of the **money supply**—or the total amount of money within the overall economy. Clearly, you know what money is. But the formal definition of **money** is anything generally accepted as a medium of exchange, a measure of value, or a means of payment. The two most commonly used definitions of the money supply are M1 and M2:

- **M1:** All currency—paper bills and metal coins—plus checking accounts and traveler's checks.
- **M2:** All of M1 plus most savings accounts, money market accounts, and certificates of deposit (low-risk savings vehicles with a fixed term, typically less than one year).

By the end of 2020, the M1 money supply totaled more than $6.5 trillion, and the M2 version of the money supply totaled about $19.1 trillion. In practice, the term "money supply" most often refers to M2. (Note that credit cards are not part of the money supply, although they do have an unmistakable impact on the flow of money through the economy.)[12]

When the economy contracts, the Fed typically increases the money supply. If more money is available, interest rates usually drop, encouraging businesses to expand and consumers to spend. But when prices begin to rise, the Fed attempts to reduce the money supply. Ideally, if less money is available, interest rates will rise. This will reduce spending, which should bring inflation under control. Specifically, the Fed uses three key tools to expand and contract the money supply: open market operations, discount rate changes, and reserve requirement changes.

Open Market Operations This is the Fed's most frequently used tool. **Open market operations** involve buying and selling government securities, which include treasury bonds, notes, and bills. These securities are the IOUs the government issues to finance its deficit spending.

How do open market operations work? When the economy is weak, the Fed *buys* government securities on the open market. When the Fed pays the sellers of these securities, money previously held by the Fed is put into circulation. This directly stimulates spending. In addition, any of the additional funds supplied by the Fed that are deposited in banks will allow banks to make more loans, making credit more readily available. This encourages even more spending and further stimulates the economy.

When inflation is a concern, the Fed *sells* securities. Buyers of the securities write checks to the Fed to pay for securities they bought, and the Fed withdraws these funds from banks. With fewer funds, banks must cut back on the loans they make, credit becomes tighter, and the money supply shrinks. This reduces spending and cools off the inflationary pressures in the economy.

Open market operations are set by the aptly named Federal Open Market Committee, which consists of the seven members of the Board of Governors and 5 of the 12 presidents of the Federal Reserve district banks. Each year, the Federal Open Market Committee holds eight regularly scheduled meetings to make decisions about open market operations, although they do hold additional meetings when the need arises. Both businesses and markets closely watch Open Market Committee rate setting and outlook statements in order to guide decision making.

Discount Rate Changes

Just as you can borrow money from your bank, your bank can borrow funds from the Fed. And just as you must pay interest on your loan, your bank must pay interest on loans from the Fed. The **discount rate** is the interest rate the Fed charges on its loans to commercial banks. When the Fed reduces the discount rate, banks can obtain funds at a lower cost and use these funds to make more loans to their

money supply The total amount of money within the overall economy.

money Anything generally accepted as a medium of exchange, a measure of value, or a means of payment.

M1 money supply Includes all currency plus checking accounts and traveler's checks.

M2 money supply Includes all of M1 money supply plus most savings accounts, money market accounts, and certificates of deposit.

open market operations The Federal Reserve function of buying and selling government securities, which include treasury bonds, notes, and bills.

discount rate The rate of interest that the Federal Reserve charges when it loans funds to banks.

Looking to Multiply Your Money? Look No Further Than Your Local Bank!

Everyone knows that banks help people save money, but most people don't realize that banks actually create money. While the process is complex, a simplified example illustrates the point. Say you deposit $5,000 in the bank. How much money do you have? Obviously, $5,000. Now imagine that your neighbor Anne goes to the bank for a loan. In line with Federal Reserve requirements, the bank must hold onto about 10% of its funds, so it loans Anne $4,500. She uses the money to buy a used car from your neighbor Jake, who deposits the $4,500 in the bank. How much money does Jake have? Clearly, $4,500. How much money do you have? Still, $5,000. Thanks to the banking system, our "money supply" has increased from $5,000 to $9,500. Multiply this phenomenon times millions of banking transactions, and you can see why cold, hard cash accounts for only about 10% of the total U.S. M2 money supply. But what happens if everyone goes to the bank at once to withdraw their money? The banking system would clearly collapse. And in fact, in 1930 and 1931, a run on the banks caused wave after wave of devastating bank failures. Panicked customers lost all their savings, ushering in the worst years of the Great Depression. To restore public confidence in the banking system, in 1933 Congress established the Federal Deposit Insurance Corporation (FDIC). The FDIC insures deposits in banks and thrift institutions for up to $100,000 per customer, per bank. In the wake of the banking crisis, the FDIC temporarily increased its coverage to $250,000 per depositor at the end of 2008. Since the FDIC began operations on January 1, 1934, no depositor has lost a single cent of insured funds as a result of a bank failure.

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own customers. With the cost of acquiring funds from the Fed lower, interest rates on bank loans also tend to fall. The result: businesses and individuals are more likely to borrow money and spend it, which stimulates the economy. Clearly, the Fed is most likely to reduce the discount rate during recessions. In fact, during the early months of the Great Recession, the Fed cut the rate to less than 1%. The Fed kept the rate well below 1% throughout the recovery, eventually nudging it up at the end of 2015 and again at the end of 2016. As the recovery continued, the Fed continued raising rates slowly—*very* slowly. But in response to the COVID-19-pandemic-driven economic crash in March 2020, the Fed decreased the discount rate back down to .25%.[13]

Reserve Requirement Changes The Fed requires that all of its member banks hold funds, called "reserves," equal to a stated percentage of the deposits held by their customers. This percentage is called the **reserve requirement** (or required reserve ratio). The reserve requirement helps protect depositors who may want to withdraw their money without notice. Currently, the reserve requirement stands at about 10%, depending on the size and type of a bank's deposits. If the Fed increases the reserve requirement, banks must hold more funds, meaning they will have fewer funds available to make loans. This makes credit tighter and causes interest rates to rise. If the Fed decreases the reserve requirement, some of the funds that banks were required to hold become available for loans. This increases the availability of credit and causes interest rates to drop. Since changes in the reserve requirement can have a dramatic impact on both the economy and the financial health of individual banks, the Fed uses this tool quite infrequently.

Other Fed Functions In addition to monetary policy, the Fed has several other core functions, including regulating financial institutions and providing banking services both for the government and for banks. In its role as a regulator, the Fed sets and enforces rules of conduct for banks and oversees mergers and acquisitions to ensure fairness and compliance with government policy. In its role as a banker for banks, the Fed coordinates the

Federal Deposit Insurance Corporation (FDIC) A federal agency that insures deposits in banks and thrift institutions for up to $250,000 per customer, per bank.

reserve requirement A rule set by the Fed, which specifies the minimum amount of reserves (or funds) a bank must hold, expressed as a percentage of the bank's deposits.

> "The U.S. economy is 70% based on consumer spending."
>
> —Time Magazine

check-clearing process for checks on behalf of any banks that are willing to pay its fees. And as the government's bank, the Fed maintains the federal government's checking account and keeps the U.S. currency supply in good condition.

2-4 Capitalism: The Free Market System

It's a simple fact—more clear now than ever before—no one can get everything they want all of the time. We live in a world of finite resources, which means that societies must determine how to distribute resources among their members. An **economic system** is a structure for allocating limited resources. Over time and around the globe, nations have instituted different economic systems. But a careful analysis suggests that no system is perfect, which may explain why there isn't one standard approach. The next sections of this chapter examine each basic type of economic system and explore the trend toward mixed economies.

The economic system of the United States is called **capitalism**, also known as a "private enterprise system" or a "free market system." Brought to prominence by Adam Smith in the 1700s, capitalism is based on private ownership, economic freedom, and fair competition. One core capitalist principle is the paramount importance of individuals, innovation, and hard work. In a capitalist economy, individuals, businesses, or nonprofit organizations privately own the vast majority of enterprises (with only a small fraction owned by the government). These private-sector businesses are free to make their own choices regarding everything from what they will produce to how much they will charge, to whom they will hire and fire. Correspondingly, individuals are free to choose what they will buy, how much they are willing to pay, and where they will work.

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Adam Smith (1723–1790) has often been called the "father of modern economics."

To thrive in a free enterprise 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. As companies compete to attract the best resources and offer the best values, quality goes up, prices remain reasonable, and choices proliferate, raising the standard of living in the economy as a whole.

2-4a The Fundamental Rights of Capitalism

For capitalism to succeed, the system must ensure some fundamental rights—or freedoms—to all of the people who live within the economy.

- *The right to own a business and keep after-tax profits:* Remember that capitalism doesn't guarantee that anyone will actually *earn* profits. Nor does it promise that there won't be taxes. But if you do earn profits, you get to keep your after-tax income and spend it however you see fit (within the limits of the law, of course). This right acts as a powerful motivator for business owners in a capitalist economy; the lower the tax rate, the higher the motivation. The U.S. government strives to maintain low tax rates to preserve the after-tax profit incentive that plays such a pivotal role in the free enterprise system.

economic system A structure for allocating limited resources.

capitalism An economic system—also known as the private enterprise or free market system—based on private ownership, economic freedom, and fair competition.

- *The right to private property:* This means that individuals and private businesses can buy, sell, and use property—which includes land, machines, and buildings—in any way that makes sense to them. This right also includes the right to will property to family members. The only exceptions to private property rights are minimal government restrictions designed to protect the greater good. You can't, for instance, use your home or business to produce cocaine, abuse children, or spew toxic smoke into the air.
- *The right to free choice:* Capitalism relies on economic freedom. People and businesses must be free to buy (or not buy) according to their wishes. They must be free to choose where to work (or not work) and where to live (or not live). Freedom of choice directly feeds competition, creating a compelling incentive for business owners to offer the best goods and services at the lowest prices. U.S. government trade policies boost freedom of choice by encouraging a wide array of both domestic and foreign producers to compete freely for our dollars.
- *The right to fair competition:* A capitalist system depends on fair competition among businesses to drive higher quality, lower prices, and more choices. Capitalism can't achieve its potential if unfair practices—such as deceptive advertising, predatory pricing, and broken contracts—mar the free competitive environment. The government's role is to create a level playing field by establishing regulations and monitoring the competition to ensure compliance.

2-4b Four Degrees of Competition

Although competition is essential for the free market system to function, not all competition works the same. Different industries experience different degrees of competition, ranging from pure competition to monopolies.

- **Pure competition** is a market structure with many competitors selling virtually identical products. Since customers can't (or won't) distinguish one product from another, no single producer has any control over the price. And new producers can easily enter and leave purely competitive markets. In today's U.S. economy, examples of pure competition have virtually disappeared. Agriculture probably comes closest—corn is basically corn, for example—but with the dramatic growth of huge corporate farms and the success of major agricultural cooperatives such as Sunkist, Sun-Maid, and Land O'Lakes, the number of competitors in agriculture has dwindled, and new farmers have trouble entering the market. Not only that, segments of the agriculture market—such as organic farms and hormone-free dairies—have emerged with hit products that command much higher prices than the competition.
- **Monopolistic competition** is a market structure with many competitors selling differentiated products. (Caution! Monopolistic competition is quite different from a *monopoly*, which we will cover shortly.) Producers have some control over the price of their wares, depending on the value that they offer their customers. And new producers can fairly easily enter categories marked by monopolistic competition. In fact, in monopolistic competition, a successful product usually attracts new suppliers quite quickly. Examples of monopolistic competition include the clothing industry and the restaurant business.

Think about the clothing business, for a moment, in local terms. How many firms do you know that sell T-shirts? You could probably think of at least 50 without too much trouble. And the quality and price are all over the board: designer T-shirts can sell for well over $100, but plenty of options go for less than $10. How hard would it be

Roman Tiraspolsky/Shutterstock.com

Which of the four degrees of competition does the soft drink market represent?

to start your own T-shirt business? Probably not hard at all. In fact, chances are strong that you know at least one person who sells T-shirts on the side. In terms of product and price variation, number of firms, and ease of entry, the T-shirt business clearly demonstrates the characteristics of monopolistic competition.

- **Oligopoly** is a market structure with only a handful of competitors selling products that can be similar or different. The retail gasoline business and the car manufacturing industry, for instance, are both oligopolies, even though gas stations offer very similar products, and car companies offer quite different models and features. Other examples of oligopoly include the soft drink industry, the computer business, and network television. Breaking into a market characterized by oligopoly can be tough because it typically requires a huge upfront investment.

You could start making T-shirts in your kitchen, for instance, but you'd need a pretty expensive facility to start manufacturing cars. Oligopolies typically avoid intense price competition, since they have nothing to gain—every competitor simply makes less money. When price wars do flare up, the results can be devastating for entire industries.

Monopoly is a market structure with just a single producer completely dominating the industry, leaving no room for any significant competitors. Monopolies usually aren't good for anyone but the company that has control, since without competition there isn't any incentive to hold down prices or increase quality and choices.

JHVEPhoto/Shutterstock.com

The EU slapped Google with a $1.7 billion fine for preventing rivals from competing fairly in the online ad market.

Because monopolies can harm the economy, most are illegal according to federal legislation such as the Sherman Antitrust Act of 1890 and the Clayton Antitrust Act of 1914. In the mid-1990s, Microsoft ran afoul of antimonopoly laws due to its position and policies in the software business. Even though Microsoft is not an actual monopoly, it was convicted of "monopolistic practices" that undermined fair competition. In 2020, the Justice Department accused Google of illegally protecting its monopoly over search and search advertising markets, which may ultimately reshape how consumers use the internet.[14]

However, in a few instances, the government not only allows monopolies but actually encourages them. This usually occurs when it would be too inefficient for each competitor to build its own infrastructure to serve the public. A **natural monopoly** arises. Public utilities offer a clear example. Would it really make sense for even a handful of competitors to pipe neighborhoods separately for water? Clearly, that's not practical. Just imagine the chaos! Instead, the government has granted exclusive rights—or monopolies—to individual companies for limited geographic areas and then regulated them (with mixed results) to ensure that they don't abuse the privilege. In addition to natural monopolies, the government grants patents and copyrights, which create artificial monopoly situations (at least temporarily) to encourage innovation.

2-4c Supply and Demand: Fundamental Principles of a Free Market System

In a free market system, the continual interplay between buyers and sellers determines the selection of products and prices available in the economy. If a business makes something that few people

pure competition A market structure with many competitors selling virtually identical products. Barriers to entry are quite low.

monopolistic competition A market structure with many competitors selling differentiated products. Barriers to entry are low.

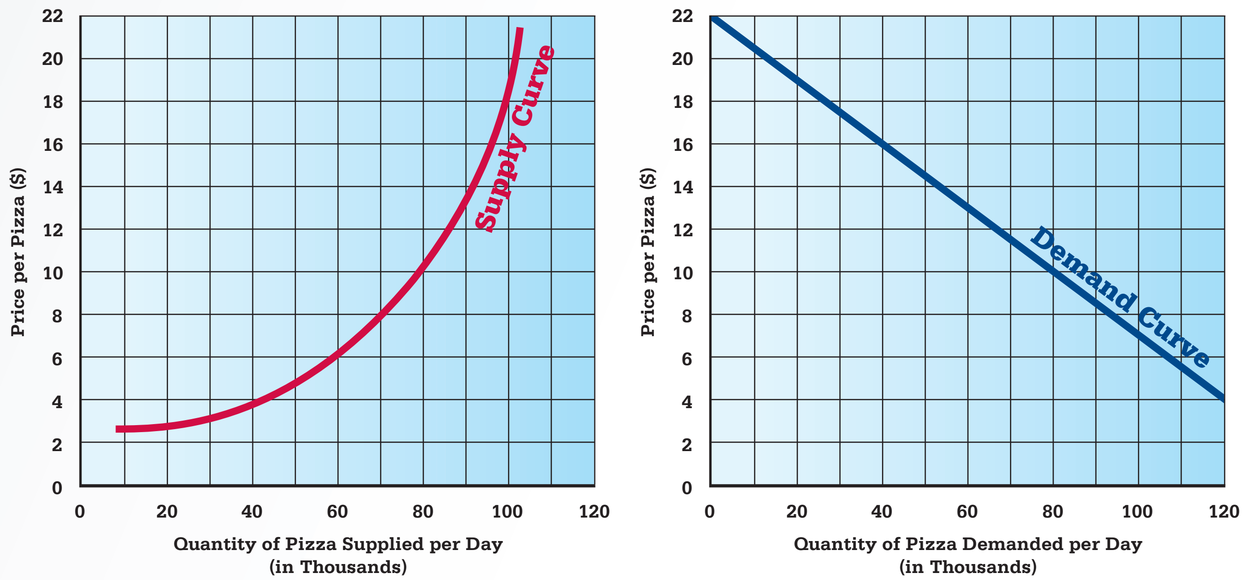
oligopoly A market structure with only a handful of competitors selling products that can be similar or different. Barriers to entry are typically high.

monopoly A market structure with one producer completely dominating the industry, leaving no room for any significant competitors. Barriers to entry tend to be virtually insurmountable.

natural monopoly A market structure with one company as the supplier of a product because the nature of that product makes a single supplier more efficient than multiple, competing ones. Most natural monopolies are government sanctioned and regulated.

Exhibit 2.3

The Supply Curve and Demand Curve



actually want, sales will be low, and the firm will typically yank the product from the market. Similarly, if the price of a product is too high, low sales will dictate a price cut. But if a new good or service becomes a hit, you can bet that similar offerings from other firms will pop up almost immediately (unless barriers—such as government-granted patents—prevent new entrants). The concepts of supply and demand explain how the dynamic interaction between buyers and sellers directly affects the range of products and prices in the free market.

supply The quantity of products that producers are willing to offer for sale at different market prices.

supply curve The graphed relationship between price and quantity from a supplier standpoint.

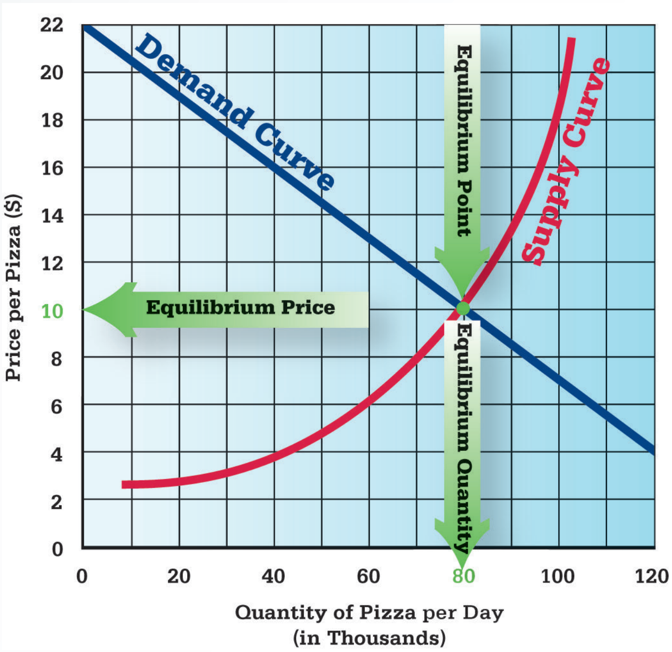
demand The quantity of products that consumers are willing to buy at different market prices.

Supply **Supply** refers to the quantity of products that producers are willing to offer for sale at different market prices. 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. Think about it in terms of pizza. Assume it costs a local restaurant about $5 to make a pizza. If the market price for pizza hits, say, $20, you can bet that restaurant will start cranking out pizza. But if the price drops to $6, the restaurant has much less incentive to focus on pizza and will probably invest its limited resources in cooking other, pricier dishes.

The relationship between price and quantity from a supplier standpoint can be shown on a graph called the **supply curve**. The supply curve maps quantity on the *x*-axis (or horizontal axis) and price on the *y*-axis (or vertical axis). In most categories, as the price rises, the quantity produced rises correspondingly, yielding a graph that curves up as it moves to the right. Exhibit 2.3 shows a possible supply curve for pizza.

Demand **Demand** refers to the quantity of products that consumers are willing to buy at different market prices. Since consumers generally seek to get the products they need (or want) at the lowest possible prices, they tend to buy more products with lower prices and fewer products with higher prices. Pizza and tacos, for instance, are both popular meals. But if pizza costs a lot less than tacos, most people will get pizza more often than tacos. Likewise, if the price of pizza were out

Exhibit 2.4
Equilibrium



of hand, people would probably order tacos (or some other option) more often, reserving their pizza-eating for special occasions.

The relationship between price and quantity from a demand standpoint can be shown on a graph called the **demand curve**. Like the supply curve, the demand curve maps quantity on the *x*-axis and price on the *y*-axis. But different from the supply curve, the demand curve for most goods and services slopes downward as it moves to the right, since the quantity demanded tends to drop as prices rise. Exhibit 2.3 shows how a demand curve for pizza could look.

Equilibrium Price It's important to remember that supply and demand don't operate in a vacuum. The constant interaction between the two forces helps determine the market price in any given category. In theory, market prices adjust toward the point where the supply curve and the demand curve intersect (refer to Exhibit 2.4). The price associated with this point of intersection—the point where the quantity demanded equals the quantity supplied—is called the **equilibrium price**, and the quantity associated with this point is called the "equilibrium quantity."

2-5 Planned Economies: Socialism and Communism

In capitalist economies, private ownership is paramount. Individuals own businesses, and their personal fortunes depend on their success in the free market. But in planned economies, the government plays a more heavy-handed role in controlling the economy. The two key categories of planned economies are socialism and communism.

2-5a Socialism

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 utilities, telecommunications, and healthcare. Although the official government goal is to run these enterprises in the best interest of the overall public, inefficiencies and corruption often interfere with effectiveness. Socialist economies also tend to have higher taxes, which are designed to distribute wealth more evenly through society. Tax revenues typically fund services that citizens in free enterprise systems would have to pay for themselves in countries with lower tax rates. Examples range from free childcare to free university education, to free public healthcare systems. Critics of the recent government intervention in the U.S. economy believe that the new moves have pushed us too far in a socialist direction.

Most Western European countries—from Sweden to Germany, to the United Kingdom—developed powerful socialist economies in the decades after World War II. But more recently, growth in these countries has languished. Although many factors have contributed to the slowdown, the impact of high taxes on the profit incentive and lavish social programs on the work incentive has clearly played a role. Potential entrepreneurs may migrate to countries that let them keep more of their profits, and workers with abundant benefits may find

demand curve The graphed relationship between price and quantity from a customer demand standpoint.

equilibrium price The price associated with the point at which the quantity demanded of a product equals the quantity supplied.

socialism An economic system based on the principle that the government should own and operate key enterprises that directly affect public welfare.

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Competitive Carbon

Achieving sustainability begins with measuring sustainability. We all know that the more we consume, the worse it is for the planet. But wouldn't it be nice if we could make better choices based on a good understanding of the environmental impact of each of the goods and services that we buy? A growing number of brands are differentiating themselves by labeling the "carbon footprint" or" carbon cost" of each item they sell. This includes Swedish pop-up shop, the "klimatbutik," where items are priced according to their carbon footprint—each customer has a weekly budget of 18.6 kg. In September 2020, Just Salad was the first U.S. restaurant chain to put carbon labels on its entire menu. Similarly, Allbirds footwear brand prints the carbon emissions on the sole of its popular sneakers. According to Allbirds' sustainability lead Hana Kajimura, they believe that printing carbon omissions on their products is an important step in helping their customers develop an understanding of carbon footprints in the same way that they already have for calories or other nutrition facts on food. As an overall consumer focus on sustainability continues to develop, companies that better educate consumers about the true cost of their products will gain a substantial competitive edge.[15]

pics of my life/Shutterstock.com

themselves losing motivation. Over the last decade, many of these economies have imposed stiff austerity measures to control government spending, eliminating some public benefits many took for granted.

2-5b Communism

Communism is an economic and political system that calls for public ownership of virtually all enterprises, under the direction of a strong central government. The communist concept was the brainchild of political philosopher Karl Marx, who outlined its core principles in his 1848 *Communist Manifesto*. The communism that Marx envisioned was supposed to dramatically improve the lot of the worker at the expense of the super-rich.

But countries that adopted communism in the 1900s—most notably the former Soviet Union, China, Cuba, North Korea, and Vietnam—did not thrive. Most imposed authoritarian governments that suspended individual rights and choices. People were unable to make even basic choices such as where to work or what to buy. Without the free market to establish what to produce, crippling shortages and surpluses developed. Corruption infected every level of government. Under enormous pressure from their own people and the rest of the world, communism began to collapse across the Soviet Union and its satellite nations. At the end of the 1980s, it was replaced with democracy and the free market. Over the past two decades, China has also introduced significant free market reforms across much of the country, fueling a torrid growth rate that has only recently begun to slow. And in the 1990s, Vietnam launched free market reforms, stimulating rapid, sustained growth. The remaining communist economic systems—North Korea and Cuba—continue to falter, their people facing drastic shortages and even starvation.

communism An economic and political system that calls for public ownership of virtually all enterprises, under the direction of a strong central government.

2-6 Mixed Economies: The Story of the Future

In today's world, pure economies—market or planned—are practically nonexistent, since each would fall far short of meeting the needs of its 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. Instead, most of today's nations have

Big Brother Is Watching . . . or Is He?

One of the underlying principles of communism and socialism is that most people are willing to sacrifice self-interest for the good of the overall society. That may be true, but a new study suggests that may *only* be true if other people are watching. Researchers at the psychology department of a major university recently ran an experiment whereby they changed the price list at an honor system–based coffee bar in the faculty and staff break room. The prices themselves remained unchanged, but each week the photocopied picture above the prices varied between flowers and the eyes of real faces. The faces changed, but the eyes on the faces always looked directly at the observer. During the weeks with faces on the list, staff members paid nearly three times as much for their drinks as during the weeks with flowers. These results suggest that self-interest may be more natural and comfortable than fairness for most people. We're happy to be generous, but only when we think someone is watching—even if that someone is just a cutout picture of a face with observant eyes. Our deep-seated interest in our own well-being over everyone else's may be one reason why socialism and communism haven't created as much wealth over the long term as free enterprise has.[16]

Rangizzz/Shutterstock.com

mixed economies, falling somewhere along a spectrum that ranges from pure planned at one extreme to pure market at the other.

Even the United States—one of the most market-oriented economies in the world—does not have a *pure* market economy. The various departments of the government own a number of major enterprises, including the postal service, schools, parks, libraries, entire systems of universities, and the military. In fact, the federal government is the nation's largest employer, providing jobs for more than 4 million Americans. And—although the government does not directly *operate* firms in the financial sector—the federal government has become part owner in a number of financial institutions as part of the recent bailouts. The government also intervenes extensively in the free market by creating regulations that stimulate competition and protect both consumers and workers. Regulations are likely to become stronger in the wake of the economic crisis.[17]

Over the past 30 years, most economies of the world have begun moving toward the market end of the spectrum. Government-owned businesses have converted to private ownership via a process called **privatization**. Socialist governments have reduced red tape, cracked down on corruption, and created new laws to protect economic rights. Extravagant human services—from free healthcare to education subsidies—have shrunk. And far-reaching tax reform has created new incentives for both domestic and foreign investment in once-stagnant planned economies.[18]

Unfortunately, the price of economic restructuring has been a fair amount of social turmoil in many nations undergoing market reforms. Countries from France to China have experienced sometimes violent demonstrations in response to social and employment program cutbacks. Change is challenging, especially when it redefines economic winners and losers. But countries that have taken strides toward the market end of the spectrum—from small players such as the Czech Republic, to large players such as China—have seen the payoff in rejuvenated growth rates that have raised the standard of living for millions of people.

Ekaterina Bykova/Shutterstock.com

Karl Marx (1818–1883) was a Prussian-born theorist who helped develop the political ideology of communism.

mixed economies Economies that embody elements of both planned and market-based economic systems.

privatization The process of converting government-owned businesses to private ownership.

Has the American Dream Become a Nightmare?

In the late 1800s and early 1900s, millions of peasants from around the world set sail for the United States in search of the American Dream. Sometime between then and now, however, the American Dream lost its shine. According to a recent poll, only 25% of those surveyed agreed that "capitalism works for the ordinary American." Capitalism is charged with being fixated on shareholder returns, myopically short term, inherently monopolistic, antidemocratic, amoral, rootless, and bad for the planet. But according to experts writing for *Fortune* magazine, these indictments confuse the concept of capitalism with its implementation. They also point out that "capitalism is simply a tool—one that channels savings into investment and rewards risk-takers. Blaming capitalism for its misapplication is like blaming sex for overpopulation, teenage pregnancies, and sexually transmitted diseases. We can address these problems without all becoming celibate."

Maybe the lack of enthusiasm for capitalism should not be surprising, given the swell of support for Democratic Socialist Bernie Sanders during the 2016 and 2020 presidential elections. But as the text highlights, every economic system has advantages and disadvantages. Perhaps Winston Churchill had it right when he said, "Capitalism is the worst economic system, except for all the others."[19]

2-7 Evaluating Economic Performance: What's Working?

Clearly, economic systems are complex—very complex. So you probably won't be surprised to learn that no single measure captures all the dimensions of economic performance. To get the full picture, you need to understand a range of terms and measures, including gross domestic product, employment level, the business cycle, inflation rate, and productivity.

2-7a Gross Domestic Product

Real **gross domestic product (GDP)** measures the total value of all final goods and services produced within a nation's physical boundaries over a given period of time, adjusted for inflation. (Nominal GDP does not include an inflation adjustment.) All domestic production is included in the GDP, even when the producer is foreign owned. The U.S. GDP, for instance, includes the value of Hyundai Sonatas built in Alabama, even though Hyundai is a Korean firm. Likewise, the Indonesian GDP includes the value of Gap clothing manufactured in Indonesian factories, even though Gap is an American firm.

gross domestic product (GDP) The total value of all final goods and services produced within a nation's physical boundaries over a given period of time.

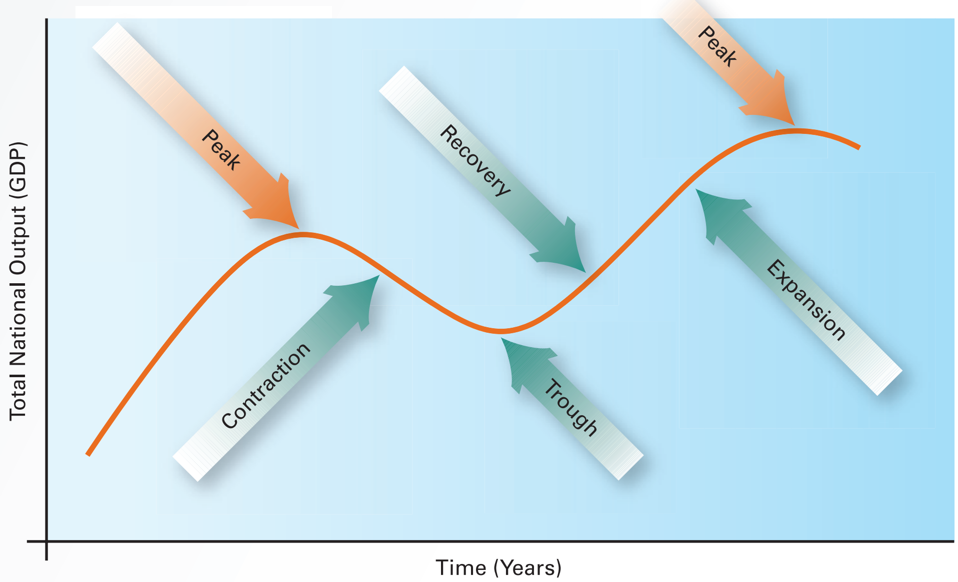
unemployment rate The percentage of people in the labor force over age 16 who do not have jobs and are actively seeking employment.

GDP is a vital measure of economic health. Businesspeople, economists, and political leaders use GDP to measure the economic performance of individual nations and to compare the growth among nations. Interestingly, GDP levels tend to be somewhat understated since they don't include any activities such as volunteer work, bartering, and homemakers—which can represent a significant portion of some countries' production. The GDP also ignores legal goods that are not reported to avoid taxation, plus output produced within households.[20] Check out Chapter 3 for a survey of the world's key economies according to total GDP and GDP growth rate.

2-7b Employment Level

The overall level of employment is another key element of economic health. When people have jobs, they have money, which allows them to spend and invest, fueling economic growth. Most nations track employment levels largely through the **unemployment rate**, which includes everyone age 16 and older who doesn't have a job and is actively seeking one. The U.S. unemployment rate climbed precipitously through the Great Recession, rising from 5.8% in 2008 to 9.3% in 2009, then dropping to 8.1% in 2012 as the economy began its glacially slow turnaround. Unemployment didn't move below 8% until September of 2012, and then it dropped slowly throughout 2013 to end the year at an annual average of 7.4% as the recovery began to take hold. Unemployment continued dropping, hitting 4.7% in December 2016. The unemployment rate dropped throughout 2017, ending the year at 4.1%, remaining at 4.1% through mid-2018, ultimately falling to 3.5% in February, 2020, before shooting up to 14.8% by April 2020 in response to COVID-19-pandemic-related lockdowns.[21] But unfortunately, about

Exhibit 2.5
The Business Cycle



half of the 8 million jobs lost during the recession were middle-income jobs, and about half of the new jobs created since have been in low-wage sectors of the economy, leading to stagnant household incomes.[22]

Interestingly, some unemployment is actually good—it reflects your freedom to change jobs. If you have an awful boss, for instance, you may just quit. If you quit, are you unemployed? Of course, you are. Are you glad? You probably are, and in normal times, the chances are good that you'll find another position that's a better fit for you. This type of job loss is called *frictional unemployment,* and it tends to be ultimately positive. *Structural unemployment*, on the other hand, is usually longer term. This category encompasses people who don't have jobs because the economy no longer needs their skills. In the United States, growing numbers of workers in the past decade have found themselves victims of structural unemployment as manufacturing jobs have moved overseas. Often their only option is expensive retraining. Two other categories of unemployment are *cyclical*, which involves layoffs during recessions, and *seasonal*, which involves job loss related to the time of year. In some areas of the country, construction and agricultural workers are seasonally unemployed, but the best example may be the department-store Santa who has a job only during the holiday season!

> Raising a child born in 2015 from birth to age 17 costs about $233,610 (not including college!)—almost $14,000 every year.
>
> —U.S. Department of Agriculture

2-7c The Business Cycle

The **business cycle** is the periodic contraction and expansion that occur over time in virtually every economy. But the word "cycle" may be a little misleading, since it implies that the economy contracts and expands in a predictable pattern. In reality, the phases of the cycle are different each time they happen, and—despite the efforts of countless experts—no one can accurately predict when changes will occur or how long they will last. Those who make the best guesses stand to make fortunes, but bad bets can be financially devastating. The two key phases of the business cycle are contraction and expansion, shown in Exhibit 2.5.

business cycle The periodic contraction and expansion that occur over time in virtually every economy.

- **Contraction** is a period of economic downturn, marked by rising unemployment. Businesses cut back on production, and consumers shift their buying patterns to more basic products and fewer luxuries. The economic "feel-good factor" simply disappears. Economists declare an official **recession** when GDP decreases for two consecutive quarters. A **depression** is an especially deep and long-lasting recession. Fortunately, economies seldom spiral into severe depressions, thanks in large part to proactive intervention from the government.

  The last depression in the United States was the Great Depression of the 1930s. Whether a downturn is mild or severe, the very bottom of the contraction is called the "trough," as shown in Exhibit 2.5.
- **Recovery** is a period of rising economic growth and increasing employment following a contraction. Businesses begin to expand. Consumers start to regain confidence, and spending begins to rise. The recovery is essentially the transition period between contraction and expansion.
- **Expansion** is a period of robust economic growth and high employment. Businesses expand to capitalize on emerging opportunities. Consumers are optimistic and confident, which fuels purchasing, which fuels production, which fuels further hiring. As Exhibit 2.5 demonstrates, the height of economic growth is called the peak of the expansion. The U.S. economy had the longest growth spurt on record during the ten-year period from 1991 to 2001. After a relatively mild slowdown in 2001–2002, the U.S. economy again expanded for several years before it plunged into a full-blown recession in 2008, leading to another expansion, until the COVID-19 pandemic in 2020.[23]

contraction A period of economic downturn, marked by rising unemployment and falling business production.

recession An economic downturn marked by a decrease in the GDP for two consecutive quarters.

depression An especially deep and long-lasting recession.

recovery A period of rising economic growth and employment.

expansion A period of robust economic growth and high employment.

inflation A period of rising average prices across the economy.

hyperinflation An average monthly inflation rate of more than 50%.

disinflation A period of slowing average price increases across the economy.

deflation A period of falling average prices across the economy.

consumer price index (CPI) A measure of inflation that evaluates the change in the weighted-average price of goods and services that the average consumer buys each month.

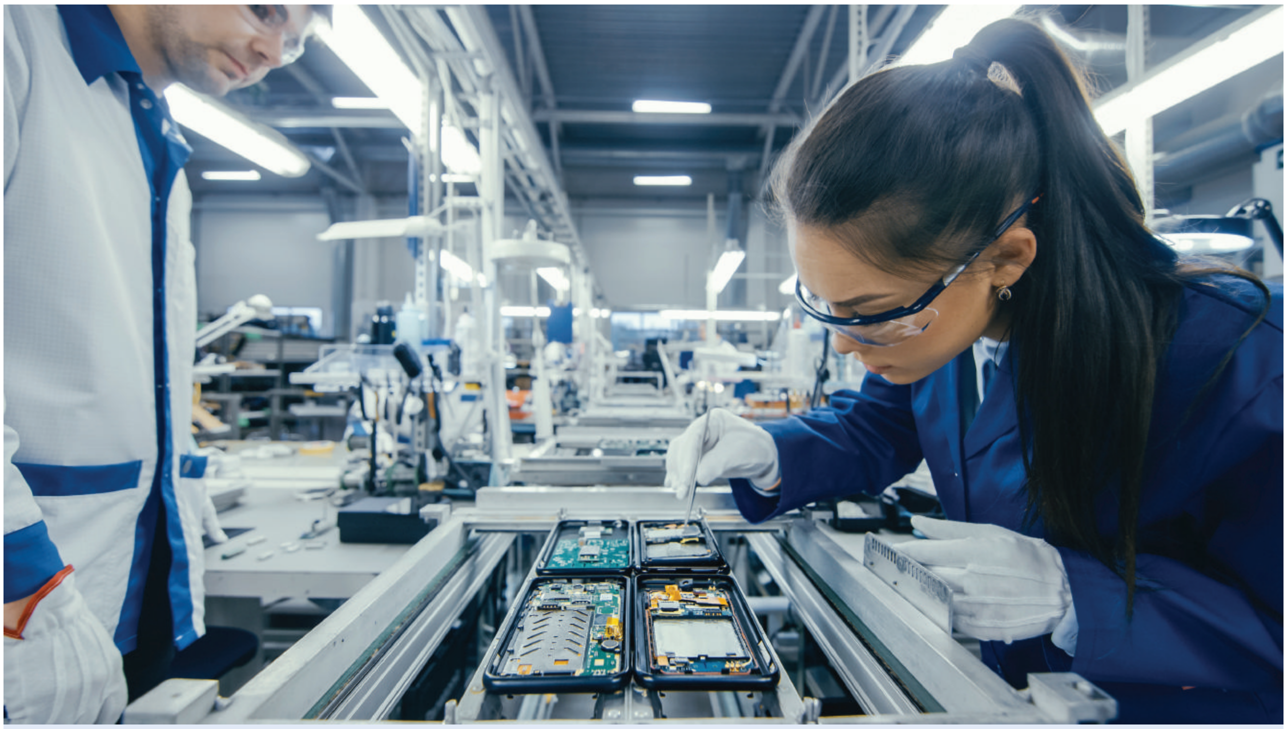
producer price index (PPI) A measure of inflation that evaluates the change over time in the prices that business pay each other for goods and services on a weighted average.

2-7d Price Levels

The rate of price changes across the economy is another basic measure of economic well-being. **Inflation** means that prices, on average, are rising. Similar to unemployment, a low level of inflation is not so bad. It reflects a healthy economy—people have money, and they are willing to spend it. But when the Federal Reserve—the nation's central bank—manages the economy poorly, inflation can spiral out of control, which can lead to **hyperinflation**, when average prices increase more than 50% per month. In Hungary, for example, inflation in its unstable, post–World War II economy climbed so quickly that prices doubled every 15 hours in 1946. More recently, prices in the war-torn former Yugoslavia doubled every 16 hours between October 1993 and January 1994.

When the rate of price increases slows down, the economy is experiencing **disinflation**, which was the situation in the United States in the mid-1990s and more recently in the second half of 2008. But when prices actually decrease, the economy is experiencing **deflation**, typically a sign of economic trouble that goes hand-in-hand with very high unemployment. People don't have money and simply won't spend unless prices drop. During the Great Depression in the 1930s, the U.S. economy experienced deflation, with prices dropping 9% in 1931 and nearly 10% in 1932. Despite some economic turmoil, inflation in the United States was relatively low from 2000 to 2007, hovering at around 3%. But inflation picked up in the first half of 2008, only to fall during the first months of the Great Recession. Inflation has remained low throughout the last decade, hovering in the neighborhood of 2%–despite very low interest rates, set by the Federal Reserve. In 2020, inflation fell to 1.2%.[24]

The government uses two major price indexes to evaluate inflation: the **consumer price index (CPI)** and the **producer price index (PPI)**. The CPI measures the change in weighted-average price over time in



Productivity is calculated by dividing the output by the input. Everything else being equal, the more circuit boards (output) assembled per hour of work (input), the higher the productivity.

a consumer "market basket" of goods and services that the average person buys each month. The U.S. Bureau of Labor Statistics creates the basket—which includes hundreds of items such as housing, transportation, haircuts, wine, and pet care—using data from more than 30,000 consumers. Although the market basket is meant to represent the average consumer, keep in mind that the "average" includes a lot of variation, so the CPI may not reflect your personal experience. For example, as a college student, you may be painfully sensitive to increases in tuition and the price of textbooks—a fact the authors of this particular textbook fully realize! But tuition and textbook prices aren't a big part of the "average" consumer's budget, so increases in these prices have a relatively small impact on the CPI.

The PPI measures the change over time in the prices that businesses pay each other for goods and services on a weighted average. Changes in the PPI can sometimes predict changes in the CPI because producers tend to pass on price increases (and sometimes also price decreases) to consumers within a month or two of the changes.

2-7e Productivity

Productivity refers to the relationship between the goods and services that an economy produces and the resources needed to produce them. The amount of output—goods and services—divided by the amount of input (e.g., hours worked) equals productivity. The goal, of course, is to produce more goods and services, using fewer hours and other inputs. A high level of productivity typically correlates with healthy GDP growth, while low productivity tends to correlate with a more stagnant economy.

Over the past couple of decades, the United States has experienced strong productivity growth, due largely to infusions of technology that help workers produce more output, more quickly. But keep in mind that productivity doesn't measure quality. That's why it's so important to examine multiple measures of economic health rather than relying on simply one or two dimensions.

productivity The basic relationship between the production of goods and services (output) and the resources needed to produce them (input) calculated via the following equation: output/input = productivity.

The Big Picture

From a business standpoint, one key goal of economics is to guide your decision making by offering a deeper understanding of the broad forces that affect both your business and your personal life. Knowing even basic economic principles can help you make better business decisions in virtually every area—from production, to marketing, to accounting, to name just a few—regardless of your specific function or level within an organization.

But you won't find an economics department within many (if any) businesses—rather, you'll find people across the organization applying economic theories and trends to their work, even in the face of continual economic flux. As you read through the other chapters in this book, take a moment to consider both the macroeconomic and microeconomic forces that affect each area you study. You're likely to find a surprising number of examples.

Careers in Business

Business Economist

Collect, analyze, and distribute data to explain economic phenomena and forecast economic trends, particularly with regard to supply and demand. Create and present clear, concise reports on economic trends to senior management on a monthly basis. Manage and motivate a small team of financial analysts and statisticians.

3 The World Marketplace: Business without Borders

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Learning Objectives

After studying this chapter, you will be able to:

- **3-1** Discuss dramatic changes in U.S. trade policy over the last decade
- **3-2** Describe business opportunities in the world economy
- **3-3** Explain the key reasons for international trade
- **3-4** Describe the tools for measuring international trade
- **3-5** Analyze strategies for reaching global markets
- **3-6** Discuss barriers to international trade and strategies to surmount them
- **3-7** Describe the free-trade movement, and discuss key benefits and criticisms

3-1 A Dramatic Change

For the second half of the 20th century and through the start of the 21st century, official U.S. trade policy moved the country, and indeed the world, toward increased free-trade and globalization. The result was a dramatic increase in the average standard of living (the amount of stuff each person can buy)—although many would argue that the price was a significant decrease in the average quality-of-life (sense of well-being). At the beginning of his administration, President Donald Trump linked American trade policy directly to national security. American trade policy—a cornerstone of his foreign policy—became a zero-sum game; if America had a trade deficit with any nation, that nation was violating the rules in his view. And in his opinion, the biggest violator was China.

Early in his administration, President Trump slapped huge tariffs (import taxes) on aluminum and steel. While these tariffs were ostensibly aimed at China, the United States imports most of its steel and aluminum from its allies such as Europe, Canada, and Mexico, and very little from China. The unfortunate result was higher prices for American

consumers. President Trump imposed further tariffs on about $360 billion in Chinese goods—well over half of what Beijing ships to the United States every year. Retaliatory tariffs from China and the EU were aimed at quintessentially American products such as Kentucky whiskey, Mack trucks, Florida boats, and American farm products. But the upshot of the Trump trade deal was a great deal of uproar with little result. In early 2020, Trump had negotiated and signed the "first phase" of the trade agreement with China that requires the Chinese to purchase $40 billion worth of U.S. agricultural products over two years. Unfortunately, as of September 2020, China's agricultural purchases were barely half of what they'd need to be to reach the agreed target for 2020. Meanwhile, heavy tariffs remained in place on both sides. The second phase of the agreement seems unlikely to happen as China sails out of the COVID-19 pandemic with a robust economy, the United States struggles to recover, and the U.S. trade deficit with China remains higher than ever.

Looking forward, the United States continues to face major "structural issues" in its relationship with China, as pointed out by President Trump, who accused China of showing strong favoritism to state-owned industries, of intellectual property theft, and of forcing U.S. companies to "transfer technology" to the Chinese government when they were operating in China. President Trump was unable to resolve these issues before the end of his administration, so they were left in the hands of the incoming Biden administration at the beginning of 2021—the results could determine the global economic structure for generations to come.[1]

> "The world is more malleable than you think and it's waiting for you to hammer it into shape."
>
> —Bono, Musician and Humanitarian

3-2 The Global Marketplace: A Huge Business Opportunity

Individual economies around the world have become more interdependent than ever before. The result is a tightly woven global economy marked by intense

Exhibit 3.1 **Selected Population and GDP Figures**

Nation	Population*	Per Capita GDP (PPP basis) **	GDP Growth Rate***
China	1,394,015,977	$8,014	+6.1%
India	1,351,209,574	$2,100	+4.5%
European Union	453,007,803	$40,900	+2.3%
United States	332,639,102	$55,761	+2.2%
Indonesia	267,026,366	$4,455	+5.0%
Pakistan	233,500,636	$1,404	+5.4%

Source: CIA World Factbook, https://www.cia.gov/the-world-factbook/countries/, accessed January 16, 2021.
*CIA World FactBook Population July 2021 Estimates
**CIA World FactBook 2019 GDP Estimates
***CIA World FactBook 2020 GDP Growth Estimates

competition and huge, shifting opportunities. Overall, during the last decade, global economic growth has been slow but relatively steady. The long-term potential for U.S. business is enormous.[2] Refer to Exhibit 3.1 for a sampling of some specific higher- and lower-growth countries.

A quick look at population trends validates the global business opportunity, especially in developing nations. In mid-2020, the world's population stands at about 7.8 billion people. With more than 332 million people, the United States accounts for less than 4.5% of the world's total population. More than 7.4 billion people live beyond our borders, representing more than 95% of potential customers for U.S. firms. But most of these nations remain behind the United States in terms of development and prosperity, posing considerable challenges for foreign firms. (In other words, most of their populations may not have the resources to buy even basic goods and services and their infrastructure and technology may not be developed enough to support contemporary business.) Exhibit 3.1, a comparison of population, gross domestic product (GDP) growth rate, and per capita GDP for the world's six largest nations, highlights some of the discrepancies. Note that even though U.S. and EU consumers clearly have money, China and India represent a much bigger opportunity in terms of both sheer size and economic growth.

3-2a So Where Exactly Will the Opportunity Be?

Projections for the future: Looking forward, economists see reasons for optimism in world markets. The International Monetary Fund (IMF) projects solid growth of 5.4% in 2021, led by emerging and developing countries, and followed by opening economies in the United States and Europe. Investment bank Morgan Stanley projects even stronger growth—also led by emerging markets—saying, "We maintain that consumers have driven the recovery, and investment growth—a reflection of the private corporate sector's risk tolerance and a key feature of any self-sustaining recovery—is bouncing back as well."

Growth projections for China—the world's largest developing economy—in 2021 range from +8.2% to +9.0%, with all economists urging caution regarding growth forecasts as they depend on the rollout of COVID-19 vaccinations, *and* effective, progrowth government policies. Growth projections across the rest of Asia are somewhat uneven, but all positive: the forecast for India ranges from +8.0% to +9.8%, and the forecast for Southeast Asia (which includes Indonesia, Malaysia, and the Philippines) is +5.2%.

Africa, home to 1.3 billion people, is another important part of the emerging-market picture. However, recent analysis suggests that the conventional narrative of Africa's rising middle class may be somewhat flawed. Collecting statistics in Africa is notoriously difficult. One challenge is simply how to define the middle class. One economist distinguishes the middle class from the poor by the ability to earn a steady income. And poverty itself is an enormous problem, growing rampantly. Nigeria, for example, recently overtook India as the country with the largest number of people living in extreme poverty, with an estimated 87 million Nigerians, or around half of the country's population, thought to be living on less than $1.90 per day. Nevertheless, the IMF projects respectable 3.5% growth for sub-Saharan Africa in 2021.[3]

3-2b The Cell Phone Connection

The growing number of people with cell phones offers an interesting indicator of economic growth. Several recent studies have found that if a country increases cell phone penetration by 10 percentage points, GDP will likely increase by anywhere from +0.5% to +1.2%. That may

Kicking Over a Really Big Anthill

The Chinese government recently pulled the plug on what would've been a record-setting IPO ($34 billion) of the Ant Group. The government apparently perceived that founder Jack Ma was thumbing his nose at regulators. The Ant Group was founded in 2004 as Alipay, the financial services arm of Alibaba—conceived to build trust between buyers and sellers doing business on the e-commerce giant. Alipay, which continued to grow and innovate over the years, was rebranded as Ant Financial Services in 2014. As of 2020, its mobile payment app, Alipay, had over 1 billion users, making it the world's most popular app outside social media networks. Ant is continuously cross-selling and upselling higher-value financial products to users of its payments network and expects engagement with its customers to grow tenfold in the coming five years. Its platform takes just three minutes to process a loan and 1 second to disburse the loan, with zero human intervention.

Just as Ant's massive stock debut was coming together in late 2020, Jack Ma gave a speech at a Shanghai finance conference, criticizing the risk-averse Chinese banking system and its tight financial regulatory structure. Shortly later, government regulators shut down the IPO. One social media commentator correctly observed that Ma's remarks comprised "the most expensive speech ever."

So why is such a huge company named for such a tiny insect? According to former CEO Eric Jing, the company named itself after the small insect because it "serves the little guys," just like they do.[4]

THINK A/Shutterstock.com

seem small, but it equates to somewhere between $49 and $118 billion for an economy the size of China. In other words, when the percentage of the population with cell phones goes up, the entire economy benefits.

Not surprisingly, cell phone penetration in India and China is skyrocketing. China currently boasts the world's largest base of cell phone users—more than 1 billion—and the growth will likely continue. India's subscriber base just crossed the 1 billion mark; it has grown explosively over the past five years and seems likely to follow suit in the next decade. Most of those phones are "feature phones," which are cell phones that typically don't support apps, have limited storage, and limited Internet connectivity. Clearly, smartphones and smartphone penetration are more directly applicable to business opportunity. Mobile smartphone usage skyrocketed between 2016 and 2020, and by 2021 experts predict that nearly half the people on the planet will own a smartphone. Smartphone penetration around the world varies dramatically. In 2020, penetration in China hit nearly 60%, and in India, only 25%. Meanwhile, smartphone penetration in Brazil was less than 50%, and up near 80% for most developed countries. In the United States, Europe, and Japan, cell phones followed landlines, but large swaths of developing nations aren't bothering to build conventional phone service. Rather, they're moving directly to cell phone networks. This trend is particularly marked across Africa, where cell phone penetration rates continue to grow explosively. Most of the penetration growth involves feature phones, but smartphone penetration is growing as well, providing access to the Internet for the first time ever to huge swaths of the population. David Knapp, general director of Motorola Vietnam, points out that many developing nations "can leapfrog technology." And Vietnamese microentrepreneur Nguyen Huu Truc says, "It's no longer something that only the rich can afford. Now, it's a basic means

Reddees/Shutterstock.com

As penetration increases, smartphones weave into every aspect of Indian culture.

of communication." As more people get the chance to get connected, better communication will likely feed economic growth. According to Muhammad Yunus, founder of Grameen Bank in Bangladesh, "A mobile phone is almost like having a card to get you out of poverty in a couple of years." The upshot is that millions of people worldwide will have a higher standard of living.[5]

3-3 Key Reasons for International Trade

Companies engage in global trade for a range of reasons beyond the obvious opportunity to tap into huge and growing new markets. The benefits include better access to factors of production, reduced risk, and an inflow of new ideas.

- *Access to factors of production:* International trade offers a valuable opportunity for individual firms to capitalize on factors of production that simply aren't present in the right amount for the right price in each individual country. India, China, and the Philippines, for example, attract multibillion-dollar investments because of their large cohort of technically skilled university graduates who work for about one-fifth the pay of comparable American workers. Russia and the Organization of the Petroleum Exporting Countries (OPEC) nations offer a rich supply of oil, and Canada, like other forested nations, boasts an abundant supply of timber. The United States offers plentiful capital, which is less available in other parts of the world. International trade helps even out some of the resource imbalances among nations.
- *Reduced risk:* Global trade reduces dependence on one economy, lowering the economic risk for multinational firms. When the Japanese economy entered a deep, sustained slump in the 1990s, for instance, Sony and Toyota thrived through their focus on other, healthier markets around the world. But a word of caution is key: as national economies continue to integrate, an economic meltdown in one part of the world can have far-reaching impact. Major foreign banks, for example, were badly burned by the U.S. subprime market mess, due to heavy investments in U.S. mortgage markets.

opportunity cost The opportunity of giving up the second-best choice when making a decision.

absolute advantage The benefit a country has in a given industry when it can produce more of a product than other nations using the same amount of resources.

comparative advantage The benefit a country has in a given industry if it can make products at a lower opportunity cost than other countries.

> Although Africans represent more than 70% of the world's poorest people, the continent is also home to 30% of the world's mineral reserves, 8% of its natural gas, 12% of its oil reserves, 40% of its gold, and up to 90%of its chromium and platinum.
>
> —United Nations and The Brookings Institute

- *Inflow of innovation:* International trade can also offer companies an invaluable source of new ideas. Japan, for instance, is far ahead of the curve regarding cell phone service. Japanese cell phone "extras," including games, ringtones, videos, and stylish new accessories, set the standard for cell service around the world. In Europe, meanwhile, consumers are showing a growing interest in traditional and regional foods, which allow them to picture where their ingredients come from. Companies with a presence in foreign markets experience budding trends like these firsthand, giving them a jump in other markets around the world.[6]

3-3a Competitive Advantage

Beyond individual companies, industries tend to succeed on a worldwide basis in countries that enjoy a competitive advantage. But to understand competitive advantage, you need to first understand how **opportunity cost** relates to international trade. When a country produces more of one good, it must produce less of another good (assuming that resources are finite). The value of the second-best choice—the value of the production that a country gives up in order to produce the first product—represents the opportunity cost of producing the first product.

A country has an **absolute advantage** when it can produce more of a good than other nations, using the same amount of resources. China, for example, has an absolute advantage in terms of clothing production, relative to the United States. But having an absolute advantage isn't always enough. Unless they face major trade barriers, the industries in any country tend to produce products for which they have a **comparative advantage**—meaning that they tend to turn out those goods that have

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the lowest opportunity cost compared to other countries. The United States, for instance, boasts a comparative advantage versus most countries in movie and television program production; Germany has a comparative advantage in the production of high-performance cars; and South Korea enjoys a comparative advantage in electronics.

But keep in mind that comparative advantage seldom remains static. As technology changes and the workforce evolves (through factors such as education and experience), nations may gain or lose comparative advantage in various industries. China and India, for example, are both seeking to build a comparative advantage versus other nations in technology production by investing in their infrastructure and their institutions of higher education.

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3-4 Global Trade: Taking Measure

Global trade dropped dramatically in the wake of COVID-19 pandemic-related lockdowns and travel restrictions in 2020. Correspondingly, global GDP dropped as the financial impact was felt worldwide. In 2021, experts anticipate that both global GDP and global trade will rebound, but the recovery depends of course on the decreasing number of COVID-19 cases, the vaccine rollout, and on the easing of trade tensions.[7]

Measuring the impact of international trade on individual nations requires a clear understanding of balance of trade, balance of payments, and exchange rates.[8]

3-4a Balance of Trade

The **balance of trade** is a basic measure of the difference between a nation's exports and imports. If the total value of exports is higher than the total value of imports, the country has a **trade surplus**. If the total value of imports is higher than the total value of exports, the country has a **trade deficit**. Balance of trade includes the value of both goods and services, and it incorporates trade with all foreign nations. Although a trade deficit signals the wealth of an economy that can afford to buy huge amounts of foreign products, a large deficit can be destabilizing. It indicates, after all, that as goods and services flow into a nation, money flows out—a challenge with regard to long-term economic health. The United States has had an overall trade deficit since 1976, and as the American appetite for foreign goods has grown, the trade deficit has ballooned.

3-4b Balance of Payments

Balance of payments is a measure of the total flow of money into or out of a country. Clearly, the balance of trade plays a central role in determining the balance of payments. But the balance of payments also includes other financial flows such as foreign borrowing and lending, foreign aid payments and receipts, and foreign investments. A **balance of payments surplus** means that more money flows in than out, while a **balance of payments deficit** means that more money flows out than in. Keep in mind that the balance of payments typically corresponds to the balance of trade because trade is, in general, the largest component.

3-4c Exchange Rates

Exchange rates measure the value of one nation's currency relative to the currency of other nations. While the exchange rate does not directly measure global commerce, it certainly has a powerful influence on how global trade affects individual nations and their trading partners. The exchange rate of

balance of trade A basic measure of the difference in value between a nation's exports and imports, including both goods and services.

trade surplus Overage that occurs when the total value of a nation's exports is higher than the total value of its imports.

trade deficit Shortfall that occurs when the total value of a nation's imports is higher than the total value of its exports.

balance of payments A measure of the total flow of money into or out of a country.

balance of payments surplus Overage that occurs when more money flows into a nation than out of that nation.

balance of payments deficit Shortfall that occurs when more money flows out of a nation than into that nation.

exchange rate A measurement of the value of one nation's currency relative to the currency of other nations.

a given currency must be expressed in terms of another currency. The table below shows some examples of how the exchange rate can influence the economy, using the dollar and the euro. In recent years, for example, a number of currencies underwent value swings versus the U.S. dollar (e.g., the EU euro, the Japanese yen, the Indian rupee, the Canadian dollar, and the British pound). One result was multibillion-dollar earnings hits against U.S. corporations with a strong international presence, including Johnson & Johnson and Philip Morris International. Many firms opt to present their earnings reports stripped of the effects of currency translations, but in today's global economy, that clearly offers a misleading picture of performance.[9]

Strong Dollar versus Euro: Who Benefits? (Example: $1.00 = 1.20 euros)	Weak Dollar versus Euro: Who Benefits? (Example: $1.00 = 0.60 euros)
U.S. travelers to Europe: Their dollars can buy more European goods and services.	*European travelers to the United States:* Their dollars buy more American goods and services.
American firms with European operations: Operating costs—from buying products to paying workers—are lower.	*European firms with American operations:* Operating costs—from buying products to paying workers—are lower.
European exporters: Their products are less expensive in the United States, so Europe exports more, and we import more.	*American exporters:* Their products are less expensive in Europe, so we export more, and Europe imports more.

3-4d Countertrade

A complete evaluation of global trade must also consider exchanges that don't actually involve money. A surprisingly large chunk of international commerce—possibly as much as 25%—involves the barter of products for products rather than for currency. Companies typically engage in **countertrade** to meet the needs of customers who don't have access to hard currency or credit, usually in developing countries. Individual countertrade agreements range from simple barter to a complex web of exchanges that end up meeting the needs of multiple parties. Done poorly, countertrading can be a confusing nightmare for everyone involved. But done well, countertrading is a powerful tool for gaining customers and products that would not otherwise be available.[10] Not surprisingly, barter opportunities tend to increase during economic downturns.

countertrade International trade that involves the barter of products for products rather than for currency.

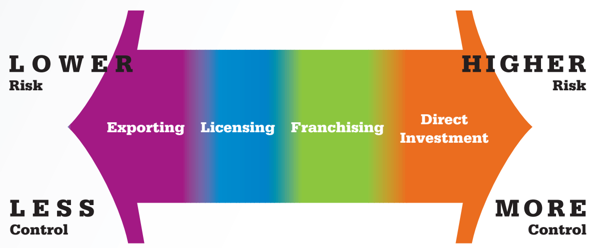
3-5 Seizing the Opportunity: Strategies for Reaching Global Markets

There is no one "right way" to seize the opportunity in global markets. In fact, the opportunity may not even make sense for every firm. While international trade can offer new profit streams and lower costs, it also introduces a higher level of risk and complexity to running a business. Being ready to take on the challenge can mean the difference between success and failure.

Firms ready to tap the opportunity have a number of options for how to move forward. One way is to seek foreign suppliers through outsourcing and importing. Another possibility is to seek foreign customers through exporting, licensing, franchising, and direct investment. These market development options fall in a spectrum from low cost–low control to high cost–high control, as shown in Exhibit 3.2. In other words, companies that choose to export products to a foreign country spend less to enter that market than companies that choose to build their own factories. But companies that build their own factories have a lot more control than exporters over how their business unfolds. Keep in mind that profit opportunity and risk—which vary along with cost and control—also play a critical role in how firms approach international markets.

Smaller firms tend to begin with exporting and move along the spectrum as the business develops. But larger firms may jump straight to the strategies that give them more control over their operations. Large firms are also likely to use a number of different approaches in different countries, depending on the goals of the firm and the structure of the foreign market. Regardless of the specific strategy, most large companies—such as General Electric, Nike, and Disney—both outsource

Exhibit 3.2
Market Development Options



with foreign suppliers and sell their products to foreign markets.

3-5a Foreign Outsourcing and Importing

Foreign outsourcing means contracting with foreign suppliers to produce products, usually at a fraction of the cost of domestic production. H&M, for instance, relies on a network for manufacturers around the globe, mostly in less developed parts of the world, including Kenya, Cambodia, Indonesia, Myanmar, Sri Lanka, and Bangladesh. Apple depends on firms in China and Taiwan to produce the iPhone. And countless small companies contract with foreign manufacturers as well. The key benefit, of course, is dramatically lower wages, which drive down the cost of production.

But while foreign outsourcing lowers costs, it also involves significant risk. Quality control typically requires very detailed specifications to ensure that a company gets what it actually needs. Another key risk of foreign outsourcing involves social responsibility. A firm that contracts with foreign producers has an obligation to ensure that those factories adhere to ethical standards. Deciding what those standards should be is often quite tricky, given different cultures, expectations, and laws in different countries. And policing the factories on an ongoing basis can be even harder than determining the standards. But companies that don't get it right face the threat of significant consumer backlash in the United States and Europe. This has been a particular issue with products produced in China. In the recent past, for instance, product defects forced U.S. firms to recall a host of Chinese-produced toys, including Thomas the Tank Engine trains that were coated with toxic lead paint, ghoulish fake eyeballs that were filled with kerosene, and Polly Pocket dolls that posed a swallowing hazard. In 2019, the European Environmental Bureau sounded the alarm that the EU was facing a "flood" of dangerously contaminated Chinese toys, most of them infused with illegal levels of toxic chemicals.[11]

Many Americans have become personally familiar with the quality/cost tradeoff as a growing number of companies have outsourced customer service to foreign call centers. Research suggests that the approximate cost of offering a live, American- or Canadian-based customer service agent averages about $0.75–$0.90 per minute, while outsourcing those calls to live agents in another country drops the average cost down to about $0.35–$0.45 per minute. But customers end up paying the difference in terms of satisfaction, reporting high levels of misunderstanding, frustration, and inefficiency.[12]

A number of firms—such as JetBlue and Amazon .com—have enjoyed the best of both worlds by outsourcing customer service calls to U.S. agents who work from their own homes.[13]

Importing means buying products from overseas that have already been produced, rather than contracting with overseas manufacturers to produce special orders. Imported products, of course, don't carry the brand name of the importer, but they also don't carry as much risk. Pier 1 Imports, a large, now exclusively online retail chain, has built a powerful brand around the importing concept, curating a range of merchandise that gives the customer the sense of a global shopping trip without the cost or hassle of actually leaving the country.

3-5b Exporting

Exporting is the most basic level of international market development. It simply means producing products domestically and selling them abroad. Exporting represents an especially strong opportunity for small and mid-sized companies. Planetary Design, for instance, in Missoula, Montana, sells a stellar line of stainless-steel coffee, tea, and other kitchen products around the world. Exports to countries such as Canada, Ecuador, Iceland, and Korea account for more than 15% of its total sales and support 10% of its workforce.[14]

3-5c Foreign Licensing and Foreign Franchising

Foreign licensing and foreign franchising, the next level of commitment to international markets, are quite similar. **Foreign licensing** involves a

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foreign outsourcing (also contract manufacturing) Contracting with foreign suppliers to produce products, usually at a fraction of the cost of domestic production.

importing Buying products domestically that have been produced or grown in foreign nations.

exporting Selling products in foreign nations that have been produced or grown domestically.

foreign licensing Authority granted by a domestic firm to a foreign firm for the rights to produce and market its product or to use its trademark/patent rights in a defined geographical area.