

Chapter Two

Economics: The Framework for Business

Review Questions

1. How did the global economic crisis unfold?

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

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

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Global Economic Crisis: How Did this Happen?

Difficulty Level: Easy

Learning Objective: 2-1

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

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

BUSPROG: Analytic

Bloom's: Knowledge

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Easy

Learning Objective: 2-2

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

Macroeconomics is the study of a country's overall economic issues, such as the unemployment rate, the gross domestic product, and taxation policies. Microeconomics, on the other hand, focuses on smaller economic units such as individual consumers,

families, and individual businesses. The two dimensions of economics clearly interrelate. For instance, if income taxes were to decrease by 50% (a macroeconomic shift), you might decide to go to Starbucks every day, rather than making your coffee at home (a microeconomic decision).

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Economics: Navigating a Crisis

Difficulty Level: Moderate

Learning Objective: 2-1

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

Fiscal policy refers to government efforts to influence the economy through taxation and spending decisions that are designed to encourage growth, boost employment, and curb inflation. Monetary policy, managed by the Federal Reserve System (the Fed), refers to efforts to shape the economy by influencing interest rates and the supply of money. Politics plays a much stronger role in fiscal policy, since the president proposes a taxation and spending plan that Congress must approve, implement, and oversee. Both the president and Congress are elected, of course, and must answer directly to their constituents. The governors of the Fed, on the other hand, are appointed by the president and approved by Congress, but they serve single 14-year terms. Since their terms are staggered, no single president can appoint all of the members. This structure helps ensure that the governors act in the best long-term interests of the economy, and do not simply respond to the political pressures of the moment.

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Easy

Learning Objective 2-2

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

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

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Capitalism: The Free Market System
Difficulty Level: Easy
Learning Objective: 2-3

6. Describe the difference between a monopolistic competition and a monopoly.

A monopolistic competition is a market structure with many competitors selling differentiated products. Producers have some control over prices, and new producers can enter and leave the market fairly easily. A monopoly is a market structure with just a single producer completely dominating the industry. With a few exceptions, monopolies are illegal in the United States because they stifle competition.

BUSPROG: Analytic
Bloom's: Knowledge
Topic: Four Degrees of Competition
Difficulty Level: Easy
Learning Objective: 2-3

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

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

BUSPROG: Analytic
Bloom's: Comprehension
Topic: Supply and Demand: Fundamental Principles of a Free Market System
Difficulty Level: Moderate
Learning Objective: 2-3

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

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

Communism is an economic and political system that calls for public ownership of virtually all enterprises, under the planning and direction of a strong central government.

The goal is to dramatically improve the lot of the worker at the expense of the super rich. But in practice, communist economies have produced crippling shortages and excessive corruption, leading to a lower standard of living for everyone.

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

BUSPROG: Analytic

Bloom's: Comprehension

Topic: Planned Economies: Socialism and Communism

Difficulty Level: Moderate

Learning Objective: 2-4

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

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

BUSPROG: Analytic

Bloom's: Analysis

Topic: Mixed Economies: The Story of the Future

Difficulty Level: Easy

Learning Objective: 2-5

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

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

BUSPROG: Analytic

Bloom's: Analysis

Topic: Evaluating Economic Performance: What's Working

Difficulty Level: Moderate

Learning Objective: 2-6

Application Questions

1. Research four industries—past or present—that represent the four degrees of competition (pure competition, monopolistic competition, oligopoly, and monopoly). For each example, describe the industry, explain how it came to embody that type of competition, and describe how difficult it would be for an entrepreneur to enter the industry. Finally, provide your opinion regarding whether certain industries are better suited to certain degrees of competition, or if all industries should strive toward one single type of competition in particular.

This exercise will serve to contrast the four degrees of competition for students. Students will come up with plenty of creative examples for the four degrees of competition. For the opinion section, students' answers should explore the complexity of competition. Students may gravitate toward one option or the other, but they are more likely to fall somewhere along the spectrum.

BUSPROG: Analytic
Bloom's: Application
Topic: Four Degrees of Competition
Difficulty Level: Easy
Learning Objective: 2-3

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

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

BUSPROG: Analytic
Bloom's: Synthesis
Topic: Evaluating Economic Performance: What's Working
Difficulty Level: Challenging
Learning Objective: 2-6

3. How does America's economic system affect your day-to-day life? How would your life be different if you lived under socialism or communism? How would it be different if you lived under a purely free market system?

Students should synthesize the information presented in the text into clear, logical responses. They should consider the effects of monetary and fiscal policy changes, the current economic climate, and the economy's effect on their own work and spending habits. When discussing life under alternate economic systems, students should demonstrate an understanding of these system's major concepts through creative vignettes.

BUSPROG: Reflective Thinking

Bloom's: Application

Topic: Economics

Difficulty Level: Easy

Learning Objective: 2-3, 2-4

4. Major events in our country tend to have significant economic consequences. Consider the following events, and determine the likely impact of each on the five measures of economic performance discussed in the book (gross domestic product, employment, the business cycle, price levels, and productivity):
 - The Hurricane Sandy aftermath
 - The influx of illegal immigrants in the U.S.
 - The subprime mortgage crisis

	<i>The Hurricane Sandy aftermath</i>	<i>The influx of illegal immigrants in the U.S.</i>	<i>The subprime mortgage crisis</i>
<i>Gross Domestic Product</i>	<i>Many companies suspended business (or shut down altogether), harming GDP slightly.</i>	<i>Illegal immigrants' willingness to work hard for little pay likely increased GDP.</i>	<i>The economic crisis and resulting recession had a starkly negative effect on GDP.</i>
<i>Employment</i>	<i>Some businesses had to shut down, decreasing employment levels.</i>	<i>Employment among United States citizens likely decreased.</i>	<i>Unemployment increased to almost 10 percent during the recession.</i>
<i>The Business Cycle</i>	<i>Though devastating, the storm did not likely affect the overall business cycle.</i>	<i>It could be argued that illegal immigrants encourage either expansion or contraction.</i>	<i>The United States experienced contraction because of upside-down loans, leading to deep recession.</i>

Price Levels	<i>Gasoline and other prices likely spiked in the short term, but eventually stabilized.</i>	<i>Illegal immigrants' cheap labor likely reduces the price of common goods and services.</i>	<i>Price levels declined sharply in some industries and remained constant in others.</i>
Productivity	<i>The storm shut down parts for the East coast for days or weeks, harming productivity.</i>	<i>A willingness to work hard for less pay likely increased productivity.</i>	<i>Productivity increased, as fewer workers had to output more goods.</i>

BUSPROG: Analytic

Bloom's: Application

Topic: Evaluating Economic Performance: What's Working?

Difficulty Level: Moderate

Learning Objective: 2-6

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

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

BUSPROG: Analytic

Bloom's: Evaluation

Topic: Managing the Economy Through Fiscal and Monetary Policy

Difficulty Level: Challenging

Learning Objective: 2-2

Team Project

You are the governing council of a small but happy nation. Your country has a stable economy, a sustainable soybean industry, and a sizable army. You are on good terms with your four neighbors to the north, east, west, and south, but if you asked any favors of them, they would certainly want something in return.

Without warning, your neighbor to the west (and closest trading partner) collapsed under the weight of an economic crisis and fell into a state of anarchy. Its government has disappeared, its money is worthless, and its people are starving. If you can no longer trade with this neighbor, there's a chance that your country will face an economic crisis of its own. If you provide too much aid, however, your own people will starve and your neighbor will come to rely on you. If you do nothing, you face the ire of a failed state with nothing to lose. Your people don't have much to give, and they fear that economic ruin is just around the corner.

As a group, determine a creative path forward—what fiscal and/or monetary policies will you enact to sustain your own economy while dealing with your former trading partner? Create a list of action items, and write a brief narrative detailing how you expect your plan to play out. Share your decisions with the class, and discuss the similarities and differences in your action plans.

Students will quickly learn that the effects of economic policy can be difficult to predict, and that there is often no clear path forward during a crisis. To enhance the effect of the project, prepare a list of real-time events to announce while students are working. "Your neighbor to the north has invaded your neighbor to the west," "locusts have destroyed your soybean crop," and "your neighbor to the east has proposed to unite the five nations into a new communist union" are examples—feel free to get creative and throw students curveballs. When students gather to share their plans, assess their economic strategies and judge whether they would navigate the crisis effectively.

BUSPROG: Reflective Thinking
Bloom's: Analysis, and Evaluation
Topic: Navigating a Crisis
Difficulty Level: Challenging
Learning Objective: 2-1

Case Connection

The Consumer Financial Protection Bureau: Too Far, or Not Far Enough?

Recall from the chapter that during the economic crisis of the late 2000s, subprime mortgages were sliced up and resold as specialized securities. As more and more households went upside-down, an estimated \$2 trillion worth of these assets became toxic. The banks and investment houses that held these toxic assets could not sell them for even a fraction of their original worth,

pushing those companies further into economic turmoil. As the crisis worsened and panic set in, some institutions took advantage of the lack of regulation and governmental oversight in the industry, selling these toxic assets to unsuspecting buyers as if they still held value.

Many of the participants in these schemes were eventually exposed, leading to a number of high profile, high stakes lawsuits. In October 2012, for example, federal prosecutors filed a \$1 billion suit against Bank of America for knowingly committing mortgage fraud from 2007 to 2009. The discovery of rampant fraud in the financial sector also led to the creation of the Consumer Financial Protection Bureau (CFPB), a new federal agency tasked with regulating banks, payday lenders, and other financial services companies.

First proposed by Massachusetts Senator Elizabeth Warren in 2007 and signed into law in 2010, the CFPB proved a hot-button political issue from the moment it was announced. Lauded by consumer advocates eager for protection and loathed by Wall Street bankers who felt they were being unfairly punished, the CFPB captivated media attention as politicians debated the agency's organizational structure. A congressional blockade forced President Barack Obama to skip over Warren as the agency's first director, instead choosing Ohio Attorney General Richard Cordray in a controversial pro-forma recess appointment.

The CFPB's core functions include writing and enforcing federal regulatory laws, restricting practices that it deems unfair or abusive, promoting financial education, and processing consumer complaints. Much of the controversy surrounding the agency revolves around its power to regulate business practices. In the first three months of 2013, for example, the CFPB issued 10 new regulations regarding credit card fees, automated teller machine (ATM) fee disclosures, and more. While some believe the CFPB is crucial to avoiding another economic crisis, others believe that the agency oversteps its bounds and stifles innovation.

Those who believe the CFPB should be allowed to maintain—even extend—its regulatory powers make the following points:

- Weighing the positive aspects of the agency, the Economist's Schumpeter blog suggests that the financial sector has long eluded regulation thanks to weak, ineffective legislation. The CFPB is agile, powerful, and aggressive enough to contend with a deceitful industry that has operated under its own rules for too long.
- When you buy a new car, fresh produce, or ibuprofen, you can safely assume that the product has undergone rigorous testing to ensure that it is safe. When it comes to buying a mortgage or a credit card, however, you must rely solely on the word of the company trying to sell you the product. The CFPB serves as an independent advocate for the safety of individual consumers, says TIME's Michael Grunwald.
- The CFPB can restrict the practices that led to the Great Recession, and perhaps even prevent the next economic crisis. To this end, consumer advocacy group Consumer Action contends, "To prevent another bailout, we need to extend the government's resolution authority – currently limited to FDIC-insured banks – to cover non-bank financial companies, as well."

However, those who want to abolish the CFPB (or at least substantially limit its power) make several compelling counterpoints:

- Weighing the negative aspects of the agency, the Economist's Schumpeter blog suggests that the CFPB is far too large. A financial firm might be sued by one wing of the agency

for providing a financial product to a segment of the population, and sued by another wing for not providing that same product to the same segment of the population. Thus, the column argues, the CFPB is destined to devolve into a prosecutorial bureaucracy.

- According to CBS's Marlys Harris, the CFPB will threaten the health of banks that provide financing for businesses, stifling job creation and innovation. By regulating the banking sector's most profitable products and services, the CFPB will force banks to be more conservative with their money, making them less likely to grant loans to entrepreneurs and small businesses.
- The United States Congress has a constitutional right to oversee agency budgets. However, the CFPB's funding comes directly from the Federal Reserve, sidestepping congressional approval. Without a congressional check on CFPB spending, economist George Will argues that the agency is answerable to no one—and may even be unconstitutional.

You Decide:

- In your opinion, is the Consumer Financial Protection Bureau necessary? Should its powers be extended, abridged, maintained, or abolished? Explain, citing the arguments you think are the most relevant to support your position.

Students' answers will vary depending on their positions. Students who oppose the Consumer Financial Protection Bureau may cite the government's lawsuit against Bank of America as an example of existing legal structures in action. They may provide examples of stifled innovation, job loss, economic stagnation, and other negative results of regulation. Students who support the Consumer Financial Protection Bureau may point to the damage done by financial institutions and the need to curb risky investment. They may cite the burgeoning recovery as evidence that regulation does not hamper economic growth.

Students' positions on the CFPB should demonstrate comprehension of and reflection on the role of the agency. They may incorporate chapter text regarding the free market and capitalism. Students may posit that the agency will evolve over time—for better or worse—and that its role will need to shift as the financial sector rebounds from the crisis. Students should use arguments mentioned in the text or of their own formation to bolster their positions.

BUSPROG: Reflective Thinking

Bloom's: Evaluation

Topic: The Consumer Financial Protection Bureau

Difficulty Level: Challenging

Learning Objective: 2-1

- In Chapter 1, you learned that business moves at breakneck speeds. On balance, do you believe that the Consumer Financial Protection Bureau will have an effect on change in the financial industry? Will it affect the U.S. economy as a whole? Explain.

Change is inevitable in business. Because of its sheer size, however, it is likely that the CFPB will have some effect on the rate of change in the financial sector, and to some degree, the U.S. economy as a whole. The extent of the effect is up for debate, but it could be argued that the CFPB has already had a significant impact on how the financial industry operates. The CFPB will not likely have a momentous impact on the U.S. economy as a whole, however, since the economy encompasses much more than just the financial sector. Students should incorporate material they learned in both Chapter 1 and Chapter 2. They may cite the 10 regulations approved in early 2013 as evidence of the CFPB's ability to affect immediate change.

BUSPROG: Analytic

Bloom's: Application

Topic: The Consumer Financial Protection Bureau

Difficulty Level: Moderate

Learning Objective: 1-1, 2-1

- How did the economic crisis of the late 2000s affect the United States' overall economic environment? How does the Consumer Financial Protection Bureau fit into that environment? Use the chapter text to support your answer.

The economic crisis, worsened by the creation and selling of toxic assets, had a devastating effect on America's economic environment. Unemployment skyrocketed, and the U.S. lost jobs it would never see return. While the U.S. continued to stagger, the government took proactive steps (TARP and the \$825 billion stimulus) to encourage an economic turnaround, and by 2011 the U.S. economy was positioned for stability and growth in the decades to come.

Students should incorporate key chapter concepts into their analysis of the CFPB's economic position. The CFBP was created to promote a stable economy by overseeing the sector that caused the economic crisis. By bringing some amount of regulation to a free market-based industry that spiraled out of control, the CFBP will ideally encourage long-term expansion and discourage rapid contraction, such as that seen during the Great Recession. This exemplifies a mixed economy, whereby markets are controlled by regulations that discourage unfair business practices and protect consumers.

BUSPROG: Analytic

Bloom's: Application

Topic: The Consumer Financial Protection Bureau

Difficulty Level: Easy

Learning Objective: 2-1

Sources: "U.S. Accuses Bank of America of a 'Brazen' Mortgage Fraud," by Ben Protess, New York Times website: <http://dealbook.nytimes.com/2012/10/24/federal-prosecutors-sue-bank-of->

[america-over-mortgage-program](#); “Interview: Richard Cordray: Consumer Finance Protection Bureau,” PBS website: <http://www.pbs.org/wnet/need-to-know/economy/interview-richard-cordray-consumer-finance-protection-bureau/16774>; “Treasury Unveils Plan to Buy Troubled Assets,” NBC News website: http://www.nbcnews.com/id/29817617/ns/business-stocks_and_economy/t/treasury-unveils-plan-buy-troubled-assets; “About Us,” Consumer Finance Protection Bureau website: <http://www.consumerfinance.gov/the-bureau>; “Regulations,” Consumer Finance Protection Bureau website: <http://www.consumerfinance.gov/regulations>; “Blessing or Bureaucracy,” Economist website: <http://www.economist.com/blogs/schumpeter/2012/01/consumer-financial-protection-bureau>; “The Case Against the Consumer Financial Protection Bureau,” by Marlys Harris, CBS News website: http://www.cbsnews.com/8301-505145_162-38141193/the-case-against-the-consumer-financial-protection-bureau. “Answerable to No One,” by George F. Will, Washington Post website: http://www.washingtonpost.com/opinions/george-will-a-government-agency-answerable-to-no-one/2012/11/16/27a4f604-2f53-11e2-9f50-0308e1e75445_story.html