1 The U.S. Business Environment

What Goes Up . . . Can Go Even Higher!

The sign in front of a Texas Mobil gasoline station summed it up nicely: The "prices" for the three grades of gasoline sold at the station were listed as "an arm," "a leg," and "your first born." While the sign no doubt led to a few smiles from motorists, its sentiments were far from a laughing matter. The stark reality is that gas prices have fluctuated dramatically in recent years, reaching an all-time high of over $4.00 per gallon in early 2008 before dropping back to less than $2.00 per gallon in 2009. By 2011, though, prices were surging again, and some experts suggested that they could hit $5.00 per gallon in the near future. Indeed, the dramatic price fluctuations that began in mid-2004 have left consumers, government officials, and business leaders struggling to cope with uncertainty about future prices.

After reading this chapter, you should be able to:

1. **Define the nature of U.S. business and identify its main goals and functions.**
2. **Describe the external environments of business and discuss how these environments affect the success or failure of any organization.**
3. **Describe the different types of global economic systems according to the means by which they control the factors of production.**
4. **Show how markets, demand, and supply affect resource distribution in the United States, identify the elements of private enterprise, and explain the various degrees of competition in the U.S. economic system.**
5. **Explain the importance of the economic environment to business and identify the factors used to evaluate the performance of an economic system.**

What makes this gas crisis unusual is that it began with an unusual mix of supply, demand, and global forces. In the past, gas prices generally increased only when the supply was reduced. But the circumstances underlying the increases that started in 2004 and continued through 2011 were much more complex. First, global supplies of gasoline have been increasing at a rate that has more than offset the steady decline in U.S. domestic production of gasoline since 1972. As a result, the United States has been relying more on foreign producers and is, therefore, subject to whatever prices those producers want to charge. Second, demand for gasoline in the United States has continued to rise as a result of a

growing population, the continued popularity of large gas-guzzling vehicles, and a strong demand for other petroleum-based products.

Another major piece of the puzzle has been a surging global economy that until recently caused a higher demand for oil and gasoline. China, in particular, has become a major consumer of petroleum, passing Japan in 2005 to trail only the United States in total consumption. The global recession that started in 2008, however, reduced demand in most industrialized countries. The recession, in fact, probably played a role in the dip in prices in 2009 just as the gradual recovery that started in 2010 has helped spur higher prices once again. Political turmoil in the Middle East in 2011 also played a major role.

The price fluctuations have also led to a wide array of related consequences. Automobile manufacturers stepped up their commitment to making more fuel-efficient cars even as automobile sales

Heather A. Craig/Shutterstock

WHAT'S IN IT FOR ME?

The forces that have caused jumps in gas prices reflect both the opportunities and challenges you'll find in today's business world. All businesses are subject to the influences of economic forces. But these same economic forces also provide astute managers and entrepreneurs with opportunities for profits and growth. By understanding these economic forces and how they interact, you'll be better able to (1) appreciate how managers must contend with the challenges and opportunities resulting from economic forces from the standpoint of an employee and a manager or business owner, and (2) understand why prices fluctuate from the perspective of a consumer.

In this chapter, we'll look at some basic elements of economic systems and describe the economics of market systems. We'll also introduce and discuss several indicators that are used to gauge the vitality of our domestic economic system. But first, let's start with some business basics.

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plummeted during the recent recession. Refiners posted record profits (indeed, some critics charged that the energy companies were guilty of price gouging). And even local police officers were kept busy combating a surge in gasoline theft, yet another indication that gas was becoming an increasingly valuable commodity![1]

Our opening story continues on page 24.

1 **Define the nature of U.S. business and identify its main goals and functions.**

The Concept of Business and the Concept of Profit

What do you think of when you hear the word *business*? Does it conjure up images of successful corporations, such as Apple and Google? Or of less successful companies, such as Borders Books and Kmart? Are you reminded of smaller firms, such as your local supermarket or favorite restaurant? Or do you think of even smaller family-owned operations, such as your neighborhood pizzeria or the florist down the street?

All these organizations are **businesses**—organizations that provide goods or services that are then sold to earn profits. Indeed, the prospect of earning **profits**—the difference between a business's revenues and its expenses—is what encourages people to open and expand businesses. After all, profits are the rewards owners get for risking their money and time. The right to pursue profits distinguishes a business from those organizations—such as most universities, hospitals, and government agencies—that run in much the same way but that generally don't seek profits.[2]

Consumer Choice and Demand In a capitalistic system, such as that in the United States, businesses exist to earn profits for owners; within certain broad constraints an owner is free to set up a new business, grow that business, sell it, or even shut it down. But consumers also have freedom of choice. In choosing how to pursue profits, businesses must take into account what consumers want and/or need. No matter how efficient a business is, it won't survive if there is no demand for its goods or services. Neither a snowblower shop in Florida nor a beach-umbrella store in Alaska is likely to do well.

Opportunity and Enterprise If enterprising businesspeople can spot a promising opportunity and then develop a good plan for capitalizing on it, they can succeed. For example, as large retailers like Circuit City and Linens-N-Things closed their doors in 2009, other firms profited by handling the inventory liquidations of those failed retailers. The opportunity always involves goods or services that consumers need and/or want—especially if no one else is supplying them or if existing businesses are doing so inefficiently or incompletely.

The Benefits of Business So what are the benefits of businesses? Businesses produce most of the goods and services we consume, and they employ most working people. They create most new innovations and provide a vast range of opportunities for new businesses, which serve as their suppliers. A healthy business climate also contributes to the quality of life and standard of living of people in a society. Business profits enhance the personal incomes of millions of owners and stockholders, and business taxes help to support governments at all levels. Many businesses support charities and provide community leadership. However, some businesses also harm the environment, and their decision makers sometimes resort to unacceptable practices for their own personal benefit.

In this chapter, we begin our introduction to business by examining the environment in which businesses operate. This provides a foundation for our subsequent discussions dealing with economic forces that play a major role in the success and failure of businesses everywhere.

Gain hands-on experience through an interactive, real-world scenario. This chapter's simulation entitled Supply and Demand is located at **www.mybizlab.com.**

Figure 1.1 Dimensions of the External Environment

The External Environments of Business

2 Describe the external environments of business and discuss how these environments affect the success or failure of any organization.

All businesses, regardless of their size, location, or mission, operate within a larger external environment. This **external environment** consists of everything outside an organization's boundaries that might affect it. (Businesses also have an *internal environment*, more commonly called *corporate culture*; we discuss this in Chapter 5.) Not surprisingly, the external environment plays a major role in determining the success or failure of any organization. Managers must, therefore, have a complete and accurate understanding of their environment and then strive to operate and compete within it. Businesses can also influence their environments.

Figure 1.1 shows the major dimensions and elements of the external environment as it affects businesses today. As you can see, these include the *domestic business environment*, the *global business environment*, the *technological environment*, the *political-legal environment*, the *sociocultural environment*, and the *economic environment*.

Business organization that provides goods or services to earn profits

Profits difference between a business's revenues and its expenses

External Environment everything outside an organization's boundaries that might affect it

LE Robshaw/Alamy

Urban Outfitters is affected by the external environment in many different ways.

Domestic Business Environment

The **domestic business environment** refers to the environment in which a firm conducts its operations and derives its revenues. In general, businesses seek to be close to their customers, to establish strong relationships with their suppliers, and to distinguish themselves from their competitors. Take Urban Outfitters, for example. The firm initially located its stores near urban college campuses; it now also locates stores in other, often more upscale, areas as well. The company also has a strong network of suppliers and is itself a wholesale supplier to other retailers through its Free People division. And it has established a clear identity for itself within the domestic business environment that enables it to compete alongside such competitors as Aeropostale and dELiA*s.

Global Business Environment

The **global business environment** refers to the international forces that affect a business. Factors affecting the global environment at a general level include international trade agreements, international economic conditions, political unrest, and so forth. For example, as political protests spread through much of the Middle East in 2011 oil prices began to surge and companies with operations in the region took emergency measures to protect their employees. At a more immediate level, any given business is likely to be affected by international market opportunities, suppliers, cultures, competitors, and currency values. For instance, Urban Outfitters currently has stores in several other countries, including Canada, the United Kingdom, and Ireland, and has plans for other international expansion. But as it expands into other parts of the world, it will have to contend with different languages, more diverse cultures, and so forth. Even now, many of its suppliers are foreign companies.

Technological Environment

The **technological environment** generally includes all the ways by which firms create value for their constituents. Technology includes human knowledge, work methods, physical equipment, electronics and telecommunications, and various processing systems that are used to perform business activities. For instance, Urban Outfitters relies on a sophisticated information system that tracks sales and inventory levels in order to be highly responsive to its customers. The firm also enjoys considerable success with its e-commerce websites. Urban Outfitters has developed a strong market presence in Japan, for example, even though it has no retail outlets in that country.

Political-Legal Environment

The **political-legal environment** reflects the relationship between business and government, usually in the form of government regulation of business. It is important for several reasons. First, the legal system defines in part what an organization can and can't do. For instance, Urban Outfitters is subject to a variety of political and legal forces, including product identification laws and local zoning requirements. Likewise, various government agencies regulate important areas, such as advertising practices, safety and health considerations, and acceptable standards of business conduct. Pro- or anti-business sentiment in government and political stability are also important considerations, especially for international firms. For instance, shortly after President Obama took office in 2009, a number of new regulations were imposed on businesses. And the president himself forced the resignation of General Motors' CEO in exchange for infusing new capital into the struggling automaker.

Sociocultural Environment

The **sociocultural environment** includes the customs, mores, values, and demographic characteristics of the society in which an organization functions. Sociocultural processes also determine the goods and services, as well as the standards of business conduct, that a society is likely to value and accept. For example, a few years ago, Urban Outfitters introduced a Monopoly-like game called Ghettopoly. The company received a lot of unfavorable publicity about the game, based on critics' charges that it made light of poverty and other social problems. In response, Urban Outfitters pulled it from shelves and discontinued its sale.

Economic Environment

The **economic environment** refers to relevant conditions that exist in the economic system in which a company operates. For example, if an economy is doing well enough that most people have jobs, a growing company may find it necessary to pay higher wages and offer more benefits in order to attract workers from other companies. But if many people in an economy are looking for jobs, as was the case during the 2009–2010 recession, a firm may be able to pay less and offer fewer benefits.

The rest of this chapter is devoted to the economic environment; the other environments of business are covered throughout the rest of the book.

Economic Systems

3 **Describe the different types of global economic systems according to the means by which they control the factors of production.**

A U.S. business operates differently from a business in France or the People's Republic of China, and businesses in these countries differ from those in Japan or Brazil. A key factor in these differences is the economic system of a firm's *home country*—the nation in which it does most of its business. An **economic system** is a nation's system for allocating its resources among its citizens, both individuals and organizations.

Factors of Production

A basic difference between economic systems is the way in which a system manages its **factors of production**—the resources that a country's businesses use to produce goods and services. Economists have long focused on four factors of production: *labor, capital, entrepreneurs*, and *physical resources*. In addition to these traditional four factors, *information resources* are now included as well. Note that the concept of factors of production can also be applied to the resources that an individual organization *manages* to produce goods and services.

Labor People who work for businesses provide labor. **Labor**, sometimes called **human resources**, includes the physical and intellectual contributions people make while engaged in economic production. Starbucks, for example, employs over 176,000 people.[3] The firm's workforce includes the baristas who prepare coffees for customers, store managers, regional managers, coffee tasters, quality control experts, coffee buyers, marketing experts, financial specialists, and other specialized workers and managers.

Capital Obtaining and using labor and other resources requires **capital**—the financial resources needed to operate a business. You need capital to start a new business and

Domestic Business Environment the environment in which a firm conducts its operations and derives its revenues

Global Business Environment the international forces that affect a business

Technological Environment all the ways by which firms create value for their constituents

Political-Legal Environment the relationship between business and government

Sociocultural Environment the customs, mores, values, and demographic characteristics of the society in which an organization functions

Economic Environment relevant conditions that exist in the economic system in which a company operates

Economic System a nation's system for allocating its resources among its citizens

Factors of Production resources used in the production of goods and services—labor, capital, entrepreneurs, physical resources, and information resources

Labor (Human Resources) physical and mental capabilities of people as they contribute to economic production

Capital funds needed to create and operate a business enterprise

(a) Xinhua/Photoshot

(b) UPPA/Photoshot

(c) foodfolio/Alamy

Starbucks uses various factors of production, including (a) labor, such as this Starbucks barrista; (b) entrepreneurs, such as CEO Howard Schultz; and (c) physical resources, including coffee beans.

then to keep it running and growing. For example, when Howard Schultz decided to buy the fledgling Starbucks coffee outfit back in 1987, he used personal savings and a loan to finance his acquisition. As Starbucks grew, he came to rely more on Starbucks' profits. Eventually, the firm sold stock to other investors to raise even more money. Starbucks continues to rely on a blend of current earnings and both short- and long-term debt to finance its operations and fuel its growth. Moreover, even when the firm decided to close several hundred coffee shops in 2008 and early 2009, it employed capital to pay off leases and provide severance pay to employees who lost their jobs.

Entrepreneurs An **entrepreneur** is a person who accepts the risks and opportunities entailed in creating and operating a new business. Three individuals founded Starbucks back in 1971 and planned to emphasize wholesale distribution of fresh coffee beans. However, they lacked either the interest or the vision to see the retail potential for coffee. But Howard Schultz was willing to accept the risks associated with retail growth and, after buying the company, he capitalized on the market opportunities for rapid growth. Had his original venture failed, Schultz would have lost most of his savings. Most economic systems encourage entrepreneurs, both to start new businesses and to make the decisions that allow them to create new jobs and make more profits for their owners.

Physical Resources **Physical resources** are the tangible things that organizations use to conduct their business. They include natural resources and raw materials, offices, storage and production facilities, parts and supplies, computers and peripherals, and a variety of other equipment. For example, Starbucks relies on coffee beans and other food products, the equipment it uses to make its coffee drinks, paper products for packaging, and other retail equipment, as well as office equipment and storage facilities for running its business at the corporate level.

MANAGING IN TURBULENT TIMES

What Goes Around . . .

It seems like just yesterday. In 2005 the global economy was booming. In the United States, for example, business profits were soaring, jobs were plentiful, and home ownership was at any all-time high. The stock market reached unprecedented highs, pension plans were burgeoning, and new business opportunities were plentiful.

Fast-forward just five short years to 2010, and things looked a lot different. Business profits were down, hundreds of thousands of jobs were lost and unemployment claims soared, and mortgage foreclosures were the order of the day. The stock market plummeted, pension plans went broke, and it seemed like no one wanted to start a new business (and even those who did had a hard time getting financing).

What happened in this short period of time? Economists call it the business cycle. Historically, our economy has followed long periods of growth and prosperity, with periods of cutbacks and retreats. And that's where we were in 2010. During extended periods of prosperity, people sometimes start to act as though good times will last forever. They continue to bid up stock prices, for instance, far beyond rational value. They also take on too much debt, save too little money, and spend beyond their means. But things have a way of correcting themselves, and that's what happened when our economy went into recession beginning in 2008.

So what does the future hold? Well, while no one has a real crystal ball, most experts agree that the bad times will run their course, and then things will start looking up again. Indeed, by mid-2011 the stock market was inching back up and many businesses were cautiously hiring again. It may take awhile longer for growth to really take off again, but one day soon profits will again start to surge, businesses will embark on ambitious hiring plans, the stock market will surpass all previous highs, and business opportunities will again be plentiful. Until then, though, managers have to focus on following core business principles and do their best to steer their organizations through today's turbulence.

Lilli Day/iStockphoto.com

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Information Resources The production of tangible goods once dominated most economic systems. Today, **information resources**—data and other information used by businesses—play a major role. Information resources that businesses rely on include market forecasts, the specialized knowledge of people, and economic data. In turn, much of what they do results either in the creation of new information or the repackaging of existing information for new users. For example, Starbucks uses various economic statistics to decide where to open new outlets. It also uses sophisticated forecasting models to predict the future prices of coffee beans. And consumer taste tests help the firm decide when to introduce new products.

Types of Economic Systems

Different types of economic systems manage these factors of production differently. In some systems, all ownership is private; in others, all factors of production are owned or controlled by the government. Most systems, however, fall between these extremes.

Economic systems also differ in the ways decisions are made about production and allocation. A **planned economy** relies on a centralized government to control all

Entrepreneur individual who accepts the risks and opportunities involved in creating and operating a new business venture

Physical Resources tangible items organizations use in the conduct of their businesses

Information Resources data and other information used by businesses

Planned Economy economy that relies on a centralized government to control all or most factors of production and to make all or most production and allocation decisions

or most factors of production and to make all or most production and allocation decisions. In a **market economy**, individual producers and consumers control production and allocation by creating combinations of supply and demand. Let's look at each of these types of economic systems as well as mixed market economies in more detail.

Planned Economies There are two basic forms of planned economies: *communism* (discussed here) and *socialism* (discussed as a mixed market economy). As envisioned by nineteenth-century German economist Karl Marx, **communism** is a system in which the government owns and operates all factors of production. Under such a system, the government would assign people to jobs; it would also own all business and control business decisions—what to make, how much to charge, and so forth. Marx proposed that individuals would contribute according to their abilities and receive benefits according to their needs. He also expected government ownership of production factors to be temporary: Once society had matured, government would wither away, and workers would take direct ownership of the factors of production.

The former Soviet Union and many Eastern European countries embraced communism until the end of the twentieth century. In the early 1990s, however, one country after another renounced communism as both an economic and a political system. Today, North Korea, Vietnam, and the People's Republic of China are among the few nations with openly communist systems. Even in these countries, however, planned economic systems are making room for features of the free enterprise system.

Market Economies A **market** is a mechanism for exchange between the buyers and sellers of a particular good or service. (Like *capital*, the term *market* can have multiple meanings.) Market economies rely on capitalism and free enterprise to create an environment in which producers and consumers are free to sell and buy what they choose (within certain limits). As a result, items produced and prices paid are largely determined by supply and demand. The underlying premise of a market economy is to create shared value—in theory, at least, effective businesses benefit because they earn profits on what they sell while customers also benefit by getting what they want for the best price available.[4]

To understand how a market economy works, consider what happens when you go to a fruit market to buy apples. While one vendor is selling apples for $1 per pound, another is charging $1.50. Both vendors are free to charge what they want, and you are free to buy what you choose. If both vendors' apples are of the same quality, you will buy the cheaper ones. If the $1.50 apples are fresher, you may buy them instead. In short, both buyers and sellers enjoy freedom of choice.

Taken to a more general level of discussion, individuals in a market system are free to not only buy what they want but also to work where they want and to invest, save, or spend their money in whatever manner they choose. Likewise, businesses are free to decide what products to make, where to sell them, and what prices to charge. This process contrasts markedly with that of a planned economy, in which individuals may be told where they can and cannot work, companies may be told what they can and cannot make, and consumers may have little or no choice in what they purchase or how much they pay. The political basis of market processes is called **capitalism**, which allows the private ownership of the factors of production and encourages entrepreneurship by offering profits as an incentive. The economic basis of market processes is the operation of demand and supply, which we discuss in the next section.

Mixed Market Economies In reality, there are really no "pure" planned or "pure" market economies. Most countries rely on some form of **mixed market economy** that features characteristics of both planned and market economies. Even a market economy that strives to be as free and open as possible, such as the U.S. economy, restricts certain activities. Some products can't be sold legally, others can be sold only to people of a certain age, advertising must be truthful, and so forth. And the People's Republic of China, the world's most important planned economy, is increasingly allowing certain forms of private ownership and entrepreneurship (although with government oversight).

When a government is making a change from a planned economy to a market economy, it usually begins to adopt market mechanisms through **privatization**—the process of converting government enterprises into privately owned companies. In Poland,

for example, the national airline was sold to a group of private investors. In recent years, this practice has spread to many other countries as well. For example, the postal system in many countries is government-owned and government-managed. The Netherlands, however, recently privatized its TNT Post Group N.V., already among the world's most efficient post-office operations. Canada has also privatized its air traffic control system. In each case, the new enterprise reduced its payroll, boosted efficiency and productivity, and quickly became profitable.

In the partially planned system called **socialism**, the government owns and operates selected major industries. In such mixed market economies, the government may control banking, transportation, or industries producing such basic goods as oil and steel. Smaller businesses, such as clothing stores and restaurants, are privately owned. Many Western European countries, including England and France, allow free market operations in most economic areas but keep government control of others, such as health care. And when the U.S. government took an ownership stake in General Motors and Chrysler as part of the recession-driven bail out in 2009 many critics of President Obama called the decision an act of socialism.

Geoff A Howard/Alamy

Many formerly planned economies have moved toward a more mixed economic model.

The Economics of Market Systems

Understanding the complex nature of the U.S. economic system is essential to understanding the environment in which U.S. businesses operate. In this section, we describe the workings of the U.S. market economy. Specifically, we examine the nature of *demand and supply*, *private enterprise*, and *degrees of competition*. We will then discuss private enterprise and forms of competition.

4 Show how markets, demand, and supply affect resource distribution in the United States, identify the elements of private enterprise, and explain the various degrees of competition in the U.S. economic system.

Demand and Supply in a Market Economy

A market economy consists of many different markets that function within that economy. As a consumer, for instance, the choices you have and the prices you pay for gas, food, clothing, and entertainment are all governed by different sets of market forces. Businesses also have many different choices about buying and selling their products. Dell Computer, for instance, can purchase keyboards from literally hundreds of different manufacturers. Its managers also have to decide what inventory levels should be, at what prices they should sell their goods, and how they will distribute these goods. Literally billions of exchanges take place every day between businesses and individuals; between businesses; and among individuals, businesses, and governments. Moreover, exchanges conducted in one area often affect exchanges elsewhere. For instance, the high cost of gas may also lead to prices going up for other products, ranging from food to clothing to delivery services. Why? Because each of these businesses relies heavily on gas to transport products.

Market Economy economy in which individuals control production and allocation decisions through supply and demand

Communism political system in which the government owns and operates all factors of production

Market mechanism for exchange between buyers and sellers of a particular good or service

Capitalism system that sanctions the private ownership of the factors of production and encourages entrepreneurship by offering profits as an incentive

Mixed Market Economy economic system featuring characteristics of both planned and market economies

Privatization process of converting government enterprises into privately owned companies

Socialism planned economic system in which the government owns and operates only selected major sources of production

The Laws of Demand and Supply On all economic levels, decisions about what to buy and what to sell are determined primarily by the forces of demand and supply.[5] **Demand** is the willingness and ability of buyers to purchase a product (a good or a service). **Supply** is the willingness and ability of producers to offer a good or service for sale. Generally speaking, demand and supply follow basic laws:

- The **law of demand**: Buyers will purchase (demand) *more* of a product as its price *drops* and *less* of a product as its price *increases*.
- The **law of supply**: Producers will offer (supply) *more* of a product for sale as its price *rises* and *less* of a product as its price *drops*.

The Demand and Supply Schedule To appreciate these laws in action, consider the market for pizza in your town (or neighborhood). If everyone is willing to pay $25 for a pizza (a relatively high price), the town's only pizzeria will produce a large supply. But if everyone is willing to pay only $5 (a relatively low price), it will make fewer pizzas. Through careful analysis, we can determine how many pizzas will be sold at different prices. These results, called a **demand and supply schedule**, are obtained from marketing research, historical data, and other studies of the market. Properly applied, they reveal the relationships among different levels of demand and supply at different price levels.

Demand and Supply Curves The demand and supply schedule can be used to construct demand and supply curves for pizza in your town. A **demand curve** shows how many products—in this case, pizzas—will be demanded (bought) at different prices. A **supply curve** shows how many pizzas will be supplied (baked or offered for sale) at different prices.

Figure 1.2 shows demand and supply curves for pizzas. As you can see, demand increases as price decreases; supply increases as price increases. When demand and supply curves are plotted on the same graph, the point at which they intersect is the **market price** (also called the **equilibrium price**)—the price at which the quantity of goods demanded and the quantity of goods supplied are equal. In Figure 1.2, the equilibrium price for pizzas in our example is $10. At this point, the quantity of pizzas demanded and the quantity of pizzas supplied are the same: 1,000 pizzas per week.

Surpluses and Shortages What if the pizzeria decides to make some other number of pizzas? For example, what would happen if the owner tried to increase profits by making *more* pizzas to sell? Or what if the owner wanted to lower overhead, cut back on store hours, and *reduce* the number of pizzas offered for sale? In either case, the result would be an inefficient use of resources and lower profits. For instance, if the pizzeria supplies 1,200 pizzas and tries to sell them for $10 each, 200 pizzas will not be bought. Our demand schedule shows that only 1,000 pizzas will be demanded at this price. The pizzeria will therefore have a **surplus**—a situation in which the quantity supplied exceeds the quantity demanded. It will lose the money that it spent making those extra 200 pizzas.

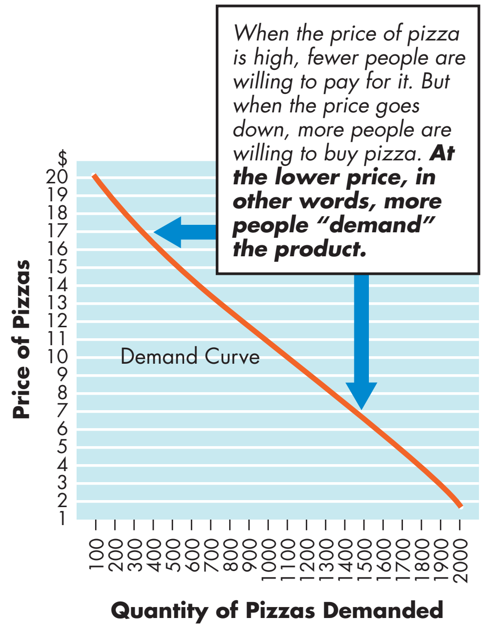
Conversely, if the pizzeria supplies only 800 pizzas, a **shortage** will result. The quantity demanded will be greater than the quantity supplied. The pizzeria will "lose" the extra profit that it could have made by producing 200 more pizzas. Even though consumers may pay more for pizzas because of the shortage, the pizzeria will still earn lower total profits than if it had made 1,000 pizzas. It will also risk angering customers who cannot buy pizzas and encourage other entrepreneurs to set up competing pizzerias to satisfy unmet demand. Businesses should seek the ideal combination of price charged and quantity supplied so as to maximize profits, maintain goodwill among customers, and discourage competition. This ideal combination is found at the equilibrium point.

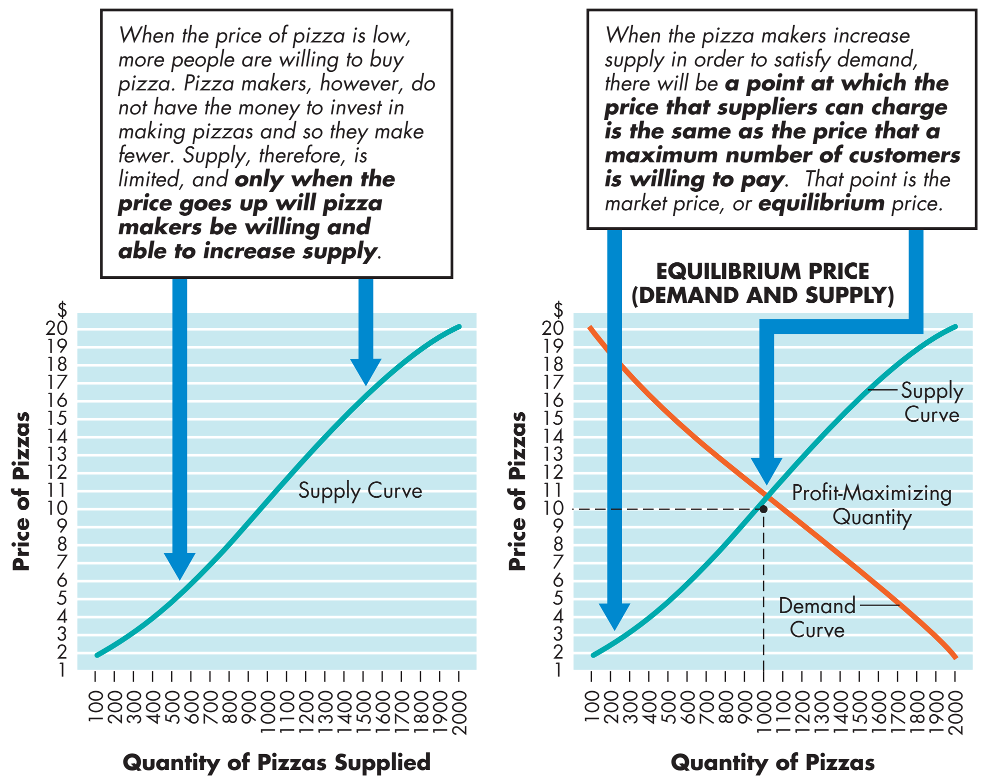
Our example involves only one company, one product, and a few buyers. The U.S. economy—indeed, any market economy—is far more complex. Thousands of companies sell hundreds of thousands of products to millions of buyers every day. In the end, however, the result is much the same: Companies try to supply the quantity and selection of goods that will earn them the largest profits.

Figure 1.2 **Demand and Supply**
Source: Adapted from Karl E. Case and Ray C. Fair, *Principles of Economics*, 8th ed., updated (Upper Saddle River, NJ: Prentice Hall, 2007).

DEMAND AND SUPPLY SCHEDULES

Price	Quantity of Pizzas Demanded	Quantity of Pizzas Supplied
$2	2000	100
$4	1900	400
$6	1600	600
$8	1200	800
$10	1000	1000
$12	800	1200
$14	600	1300
$16	400	1600
$18	200	1800
$20	100	2000





Demand the willingness and ability of buyers to purchase a good or service

Supply the willingness and ability of producers to offer a good or service for sale

Law of Demand principle that buyers will purchase (demand) more of a product as its price drops and less as its price increases

Law of Supply principle that producers will offer (supply) more of a product for sale as its price rises and less as its price drops

Demand and Supply Schedule assessment of the relationships among different levels of demand and supply at different price levels

Demand Curve graph showing how many units of a product will be demanded (bought) at different prices

Supply Curve graph showing how many units of a product will be supplied (offered for sale) at different prices

Market Price (Equilibrium Price) profit-maximizing price at which the quantity of goods demanded and the quantity of goods supplied are equal

Surplus situation in which quantity supplied exceeds quantity demanded

Shortage situation in which quantity demanded exceeds quantity supplied

Private Enterprise and Competition in a Market Economy

Market economies rely on a **private enterprise** system—one that allows individuals to pursue their own interests with minimal government restriction. In turn, private enterprise requires the presence of four elements: private property rights, freedom of choice, profits, and competition.

1. *Private property rights.* Ownership of the resources used to create wealth is in the hands of individuals.
2. *Freedom of choice.* You can sell your labor to any employer you choose. You can also choose which products to buy, and producers can usually choose whom to hire and what to produce.
3. *Profits.* The lure of profits (and freedom) leads some people to abandon the security of working for someone else and to assume the risks of entrepreneurship. Anticipated profits also influence individuals' choices of which goods or services to produce.
4. *Competition.* If profits motivate individuals to start businesses, competition motivates them to operate those businesses efficiently. **Competition** occurs when two or more businesses vie for the same resources or customers. To gain an advantage over competitors, a business must produce its goods or services efficiently and be able to sell at a reasonable profit. To achieve these goals, it must convince customers that its products are either better or less expensive than those of its competitors. Competition, therefore, forces all businesses to make products better or cheaper. A company that produces inferior, expensive products is likely to fail.

Degrees of Competition Even in a free enterprise system, not all industries are equally competitive. Economists have identified four degrees of competition in a private enterprise system: *perfect competition, monopolistic competition, oligopoly*, and *monopoly*. Note that these are not always truly distinct categories but actually tend to fall along a continuum; perfect competition and monopoly anchor the ends of the continuum, with monopolistic competition and oligopoly falling in between. Table 1.1 summarizes the features of these four degrees of competition.

Perfect Competition For **perfect competition** to exist, two conditions must prevail: (1) all firms in an industry must be small, and (2) the number of firms in the industry must be large. Under these conditions, no single firm is powerful enough to influence the price of its product. Prices are, therefore, determined by such market forces as supply and demand.

TABLE 1.1 Degrees of Competition

Characteristic	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Example	Local farmer	Stationery store	Steel industry	Public utility
Number of competitors	Many	Many, but fewer than in perfect competition	Few	None
Ease of entry into industry	Relatively easy	Fairly easy	Difficult	Regulated by government
Similarity of goods or services offered by competing firms	Identical	Similar	Can be similar or different	No directly competing goods or services
Level of control over price by individual firms	None	Some	Some	Considerable

In addition, these two conditions also reflect four principles:

1 The products of each firm are so similar that buyers view them as identical to those of other firms.

2 Both buyers and sellers know the prices that others are paying and receiving in the marketplace.

3 Because each firm is small, it is easy for firms to enter or leave the market.

4 Going prices are set exclusively by supply and demand and accepted by both sellers and buyers.

U.S. agriculture is a good example of perfect competition. The wheat produced on one farm is the same as that from another. Both producers and buyers are aware of prevailing market prices. It is relatively easy to start producing wheat and relatively easy to stop when it's no longer profitable.

Monopolistic Competition In **monopolistic competition**, there are numerous sellers trying to make their products at least seem to be different from those of competitors. While there are many sellers involved in monopolistic competition, there tend to be fewer than in pure competition. Differentiating strategies include brand names (Tide versus Cheer), design or styling (Diesel versus Lucky jeans), and advertising (Coke versus Pepsi). For example, in an effort to attract health-conscious consumers, Kraft Foods promotes such differentiated products as low-fat Cool Whip, low-calorie Jell-O, and sugar-free Kool-Aid.

Monopolistically competitive businesses may be large or small, but they can still enter or leave the market easily. For example, many small clothing stores compete successfully with large apparel retailers, such as Abercrombie & Fitch, Banana Republic, and J. Crew. A good case in point is bebe stores. The small clothing chain controls its own manufacturing facilities and can respond just as quickly as firms like the Gap to changes in fashion tastes. Likewise, many single-store clothing businesses in college towns compete by developing their own T-shirt and cap designs with copyrighted slogans and logos.

Product differentiation also gives sellers some control over prices. For instance, even though Target shirts may have similar styling and other features, Ralph Lauren Polo shirts can be priced with little regard for lower Target prices. But the large number of buyers relative to sellers applies potential limits to prices: Although Polo might be able to sell shirts for $20 more than a comparable Target shirt, it could not sell as many shirts if they were priced at $200 more.

Oligopoly When an industry has only a handful of sellers, an **oligopoly** exists. As a general rule, these sellers are quite large. The entry of new competitors is hard because large capital investment is needed. Thus, oligopolistic industries (the automobile, airline, and steel industries) tend to stay that way. Only two companies make large commercial aircraft: Boeing (a U.S. company) and Airbus (a European consortium). Furthermore, as the trend toward globalization continues, most experts believe that oligopolies will become increasingly prevalent.

Oligopolists have more control over their strategies than do monopolistically competitive firms, but the actions of one firm can significantly affect the sales of every other firm in the industry. For example, when one firm cuts prices or offers incentives to increase sales, the others usually protect sales by doing the same.

Private Enterprise economic system that allows individuals to pursue their own interests without undue governmental restriction

Competition vying among businesses for the same resources or customers

Perfect Competition market or industry characterized by numerous small firms producing an identical product

Monopolistic Competition market or industry characterized by numerous buyers and relatively numerous sellers trying to differentiate their products from those of competitors

Oligopoly market or industry characterized by a handful of (generally large) sellers with the power to influence the prices of their products

ENTREPRENEURSHIP AND NEW VENTURES

Business . . . and Pleasure

Americans are multitaskers. We sip lattes while driving, we walk the dog while checking stock quotes, and we pay our bills online while watching TV; it is no surprise that this trend has taken on bigger dimensions. In many sectors business and entertainment are no longer considered two separate entities. Entertainment used to be defined as amusement parks, miniature golf, baseball games, and movies. Business was business: work, dine, shop, etc. But now, in a recessionary market economy, industries feel even more pressure to mix business with entertainment. The brightly colored play structures in McDonald's and the first mall roller coaster paved the way for this upsurge of integration that is now almost impossible to avoid.

Apple and Starbucks recently announced a partnership that allows customers to preview Apple iTunes songs while waiting in line for their coffee. The customers also have the option to buy or download music onto their iPod touch, iPhone, PC, or Mac. JetBlue is partnering with XM Radio to offer passengers a sample of the new wave of satellite radio, and United offers DirecTV satellite television viewing on some of its flights. Select Wal-Mart stores host live broadcasts of concerts enticing shoppers to linger just a little longer. This growing trend is not likely to change anytime soon. But businesses should be wary of new business cycles created in the entertainment realm. Entertainment-driven corporations are always at a high risk of deflation when the economy falters. Those businesses that rely on partnerships with these high-risk firms may not be as grounded as they seem.

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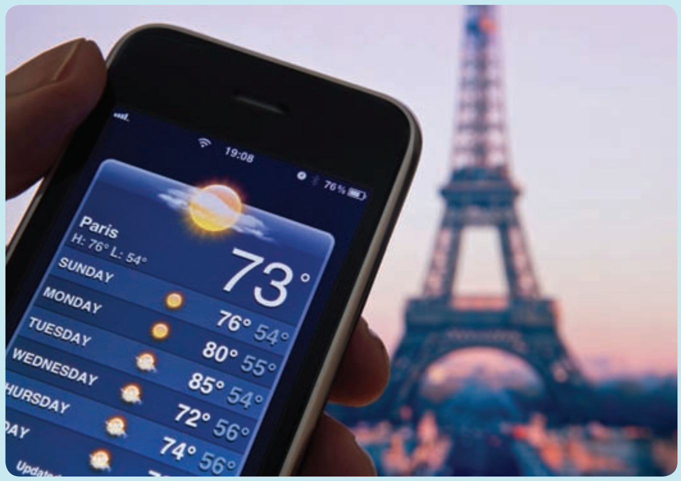


Ian Shaw/Alamy

Likewise, when one firm raises prices, others generally follow suit. Therefore, the prices of comparable products are usually similar. When an airline announces new fare discounts, others adopt the same strategy almost immediately. Just as quickly, when discounts end for one airline, they usually end for everyone else.

Monopoly A **monopoly** exists when an industry or market has only one producer (or else is so dominated by one producer that other firms cannot compete with it). A sole supplier enjoys complete control over the prices of its products. Its only constraint is a decrease in consumer demand due to increased prices. In the United States, laws, such as the Sherman Antitrust Act (1890) and the Clayton Act (1914), forbid many monopolies and regulate prices charged by **natural monopolies**—industries in which one company can most efficiently supply all needed goods or services.[3] Many electric companies are natural monopolies because they can supply all the power needed in a local area. Duplicate facilities—such as two power plants and two sets of power lines—would be wasteful.

5 Explain the importance of the economic environment to business and identify the factors used to evaluate the performance of an economic system.

Economic Indicators

Because economic forces are so volatile and can be affected by so many things, the performance of a country's economic system varies over time. Sometimes it gains strength and brings new prosperity to its members (this describes the U.S. economy during the early years of the 21st century); other times it weakens and damages their fortunes (as was the case during 2009–2010). Clearly, then, knowing how an economy is performing is useful for both business owners and investors alike.

Most experts look to various **economic indicators**—statistics that show whether an economic system is strengthening, weakening, or remaining stable—to help assess the performance of an economy.

Economic Growth, Aggregate Output, and Standard of Living

At one time, about half the U.S. population was involved in producing the food that we needed. Today, less than 2.5 percent of the U.S. population works in agriculture, and this number is expected to decrease slightly over the next decade.[6] But agricultural efficiency has improved because better ways of producing products have been devised, and better technology has been invented for getting the job done. We can say that agricultural productivity has increased because we have been able to increase total output in the agricultural sector.

We can apply the same concepts to a nation's economic system, although the computations are more complex. Fundamentally, how do we know whether an economic system is growing or not? Experts call the pattern of short-term ups and downs (or, better, expansions and contractions) in an economy the **business cycle**. The primary measure of growth in the business cycle is **aggregate output**—the total quantity of goods and services produced by an economic system during a given period.[7]

To put it simply, an increase in aggregate output is growth (or economic growth). When output grows more quickly than the population, two things usually follow:

- Output per capita—the quantity of goods and services per person—goes up.
- The system provides more of the goods and services that people want.

When these two things occur, people living in an economic system benefit from a higher **standard of living**, which refers to the total quantity and quality of goods and services that they can purchase with the currency used in their economic system. To know how much your standard of living is improving, you need to know how much your nation's economic system is growing (see Table 1.2). For instance, while the U.S. economy reflects overall growth in most years, in 2009 the economy actually shrank by 2.6 percent due to the recession.

Gross Domestic Product

Gross domestic product (GDP) refers to the total value of all goods and services produced within a given period by a national economy through domestic factors of production. GDP is a measure of aggregate output. Generally speaking, if GDP is going up, aggregate output is going up; if aggregate output is going up, the nation is experiencing *economic growth*.

TABLE 1.2 U.S. GDP and GDP per Capita

2009 Gross Domestic Product (GDP) ($ Trillion)	2009 GDP: Real Growth Rate (%)	2009 GDP per Capita: Purchasing Power Parity
$14.14	−2.6%	$46,000

Monopoly market or industry in which there is only one producer that can therefore set the prices of its products

Natural Monopoly industry in which one company can most efficiently supply all needed goods or services

Economic Indicator a statistic that helps assess the performance of an economy

Business Cycle short-term pattern of economic expansions and contractions

Aggregate Output the total quantity of goods and services produced by an economic system during a given period

Standard of Living the total quantity and quality of goods and services people can purchase with the currency used in their economic system

Gross Domestic Product (GDP) total value of all goods and services produced within a given period by a national economy through domestic factors of production

Sometimes, economists also use the term **gross national product (GNP)**, which refers to the total value of all goods and services produced by a national economy within a given period regardless of where the factors of production are located. What, precisely, is the difference between GDP and GNP? Consider a General Motors automobile plant in Brazil. The profits earned by the factory are included in U.S. GNP—but not in GDP—because its output is not produced domestically (that is, in the United States). Conversely, those profits are included in Brazil's GDP—but not GNP—because they are produced domestically (that is, in Brazil). Calculations quickly become complex because of different factors of production. The labor, for example, will be mostly Brazilian but the capital mostly American. Thus, wages paid to Brazilian workers are part of Brazil's GNP even though profits are not.

Real Growth Rate GDP and GNP usually differ by less than 1 percent, but economists argue that GDP is a more accurate indicator of domestic economic performance because it focuses only on domestic factors of production. With that in mind, let's look at the middle column in Table 1.2. Here we find that the real growth rate of U.S. GDP—the growth rate of GDP *adjusted for inflation and changes in the value of the country's currency*—was –2.6 percent in 2009. This is in contrast to growth of 2.20 percent in 2007 and 1.4 percent in 2008 (as the recession was taking hold). But what do these numbers actually mean? Remember that *growth depends on output increasing at a faster rate than population*. The U.S. population is growing at a rate of 0.97 percent per year.[8] The *real growth rate* of the U.S. economic system, therefore, has for the past few years been only modest.

GDP per Capita The number in the third column of Table 1.2 is a reflection of the standard of living: *GDP per capita* means GDP per person. We get this figure by dividing total GDP ($14.14 trillion) by total population, which happens to be a bit over about 301 million.[9] In a given period (usually calculated on an annual basis), the United States produces goods and services equal in value to $46,000 for every person in the country. Figure 1.3 shows both GDP and GDP per capita in the United States between 1950 and 2009. GDP per capita is a better measure than GDP itself of the economic well-being of the average person.

Real GDP **Real GDP** means that GDP has been adjusted to account for changes in currency values and price changes. To understand why adjustments are necessary, assume that pizza is the only product in a hypothetical economy. In 2010, a pizza cost $10; in 2011, a pizza cost $11. In both years, exactly 1,000 pizzas were produced. In 2010, the local GDP was $10,000 ($10 × 1,000); in 2011, the local GDP was $11,000 ($11 × 1,000). Has the economy grown? No. Because 1,000 pizzas were produced in both years, *aggregate output* remained the same. The point is to not be misled into believing that an economy is doing better than it is. If it is not adjusted, local GDP for 2011 is **nominal GDP**—GDP measured in current dollars or with all components valued at current prices.[10]

Purchasing Power Parity In the example, *current prices* would be 2011 prices. On the other hand, we calculate real GDP when we adjust GDP to account for changes in *currency values and price changes*. When we make this adjustment, we account for both GDP and **purchasing power parity**—the principle that exchange rates are set so that the prices of similar products in different countries are about the same. Purchasing power parity gives us a much better idea of *what people can actually buy with the financial resources allocated to them by their respective economic systems*. In other words, it gives us a better sense of standards of living across the globe. Figure 1.4 illustrates a popular approach to see how purchasing power parity works in relation to a Big Mac. For instance, the figure pegs the price of a Big Mac in the United States at $3.73. Based on currency exchange rates, a Big Mac would cost $7.20 in Norway and $4.91 in Brazil. But the same burger would cost only $1.90 in Hong Kong and $1.78 in Argentina.

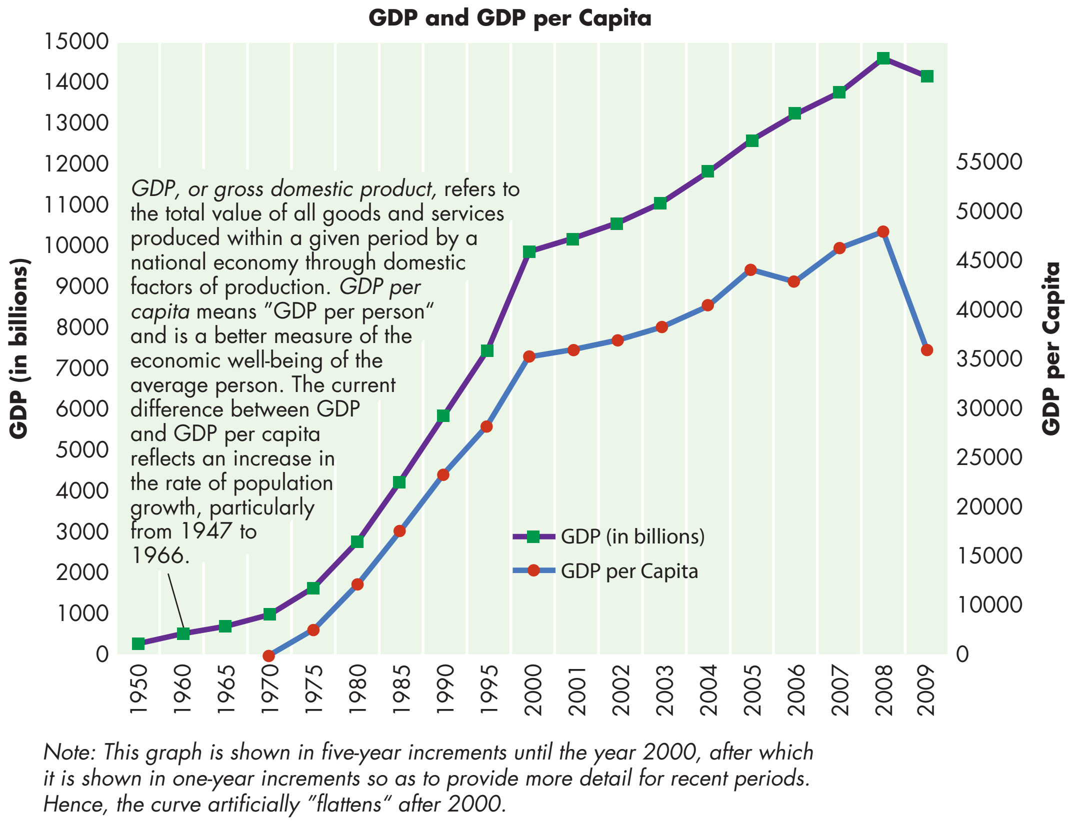


Figure 1.3 **GDP and GDP per Capita**
Source: Data obtained from U.S. Department of Commerce Bureau of Economic Analysis, **www.bea.gov/bea/dn/gdplev.xls**; U.S. Census Bureau, **www.census.gov/popest/states/tables/NST-EST2005–01.xls**; www.census.gov/popest/archives/1990s; National Economic Accounts, at **http://www.bea.gov/national/nipaweb/TableView.asp#Mid**; From World Bank Development Indicators 2007–Feb 2008: International Comparison Program (May 29, 2008), at http://www.finfacts.com/biz10/globalworldincomepercapita.htm.

Productivity A major factor in the growth of an economic system is **productivity**, which is a measure of economic growth that compares how much a system produces with the resources needed to produce it. Let's say that it takes 1 U.S. worker and 1 U.S. dollar to make 10 soccer balls in an 8-hour workday. Let's also say that it takes 1.2 Saudi workers and the equivalent of 1.2 riyals, the currency of Saudi Arabia, to make 10 soccer balls in the same 8-hour workday. We can say that the U.S. soccer-ball industry is more productive than the Saudi soccer-ball industry. The two factors of production in this extremely simple case are labor and capital.

If more products are being produced with fewer factors of production, the prices of these products will likely go down. As a consumer, therefore, you would need less of your currency to purchase the same quantity of these products. In short, your standard of living—at least with regard to these products—has improved. If your entire economic system increases its productivity, then your overall standard of living improves. In fact, *standard of living improves only through increases in productivity*.[11] Real growth in GDP reflects growth in productivity.

Gross National Product (GNP) total value of all goods and services produced by a national economy within a given period regardless of where the factors of production are located

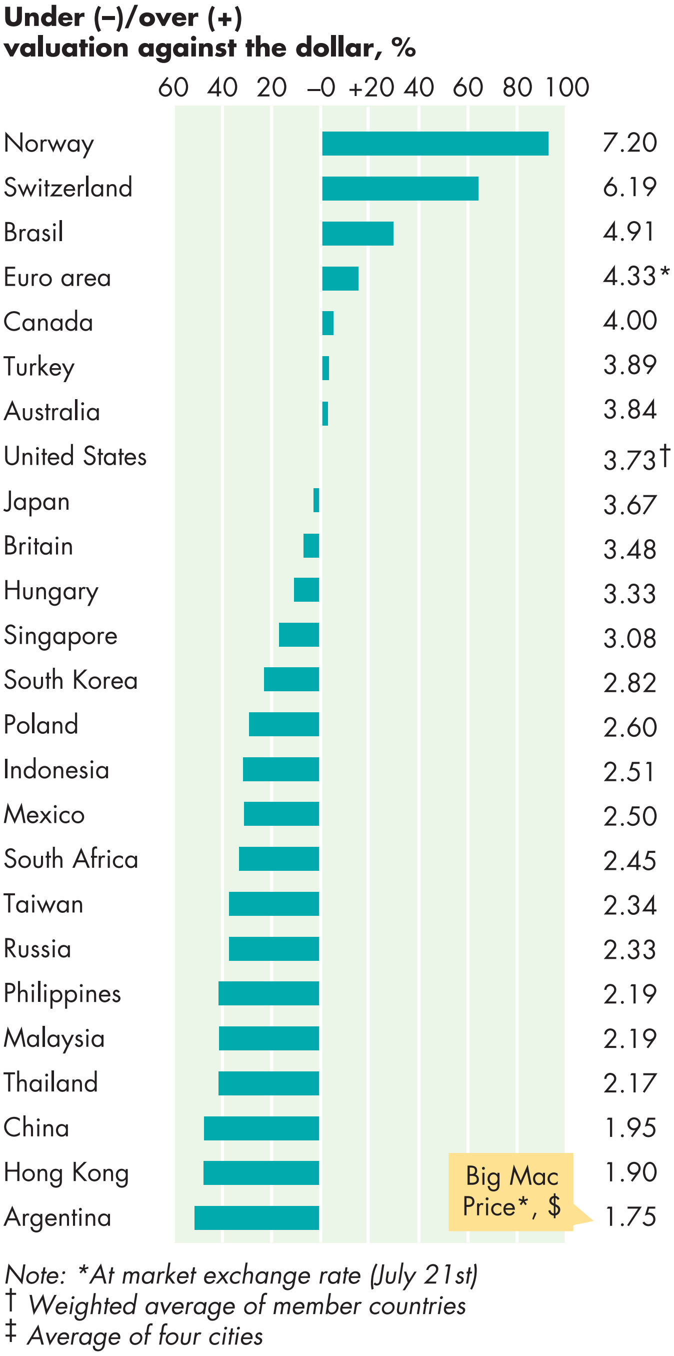
Real GDP gross domestic product (GDP) adjusted to account for changes in currency values and price changes

Nominal GDP gross domestic product (GDP) measured in current dollars or with all components valued at current prices

Purchasing Power Parity the principle that exchange rates are set so that the prices of similar products in different countries are about the same

Productivity a measure of economic growth that compares how much a system produces with the resources needed to produce it

Figure 1.4 **The Big Mac Index**
Source: Data obtained from Big Mac Index Review 2007 (May 29, 2008), at **http://www.woopidoo.com/reviews/news/big-mac-index.htm**



Productivity in the United States is generally increasing, and as a result, so are GDP and GDP per capita in most years (excluding the 2009–2010 recession). Ultimately, increases in these measures of growth mean an improvement in the standard of living. However, things don't always proceed so smoothly. Several factors can inhibit the growth of an economic system, including *balance of trade* and the *national debt*.

Balance of Trade A country's **balance of trade** is the economic value of all the products that it exports minus the economic value of its imported products. The principle here is quite simple:

- A *positive* balance of trade results when a country exports (sells to other countries) more than it imports (buys from other countries).
- A *negative* balance of trade results when a country imports more than it exports.

A negative balance of trade is commonly called a *trade deficit*. In 2008, the U.S. trade deficit was almost $400 billion. The United States is a *debtor nation* rather

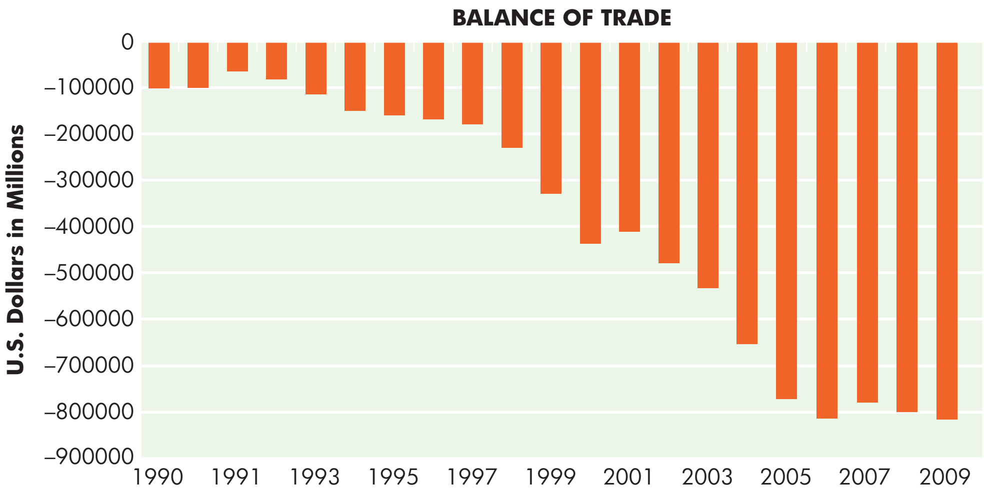


Figure 1.5 Balance of Trade
Source: Data obtained from U.S. Census Bureau (June 19, 2008), at **http://www.census.gov/foreign-trade/balance/c0004.html#2005**.

than a *creditor nation*. Recent trends in the U.S. balance of trade are shown in Figure 1.5.

Trade deficit affects economic growth because the amount of money spent on foreign products has not been paid in full. Therefore, it is, in effect, borrowed money, and borrowed money costs more in the form of interest. The money that flows out of the country to pay off the deficit can't be used to invest in productive enterprises, either at home or overseas.

National Debt Its **national debt** is the amount of money that the government owes its creditors. As of this writing, the U.S. national debt is over $13.6 trillion. You can find out the national debt on any given day by going to any one of several Internet sources, including the U.S. National Debt Clock at www.brillig.com/debt_clock.

How does the national debt affect economic growth? While taxes are the most obvious way the government raises money, it also sells *bonds*—securities through which it promises to pay buyers certain amounts of money by specified future dates. (In a sense, a bond is an IOU with interest.)[12] These bonds are attractive investments because they are extremely safe: The U.S. government is not going to default on them (that is, fail to make payments when due). Even so, they must also offer a decent return on the buyer's investment, and they do this by paying interest at a competitive rate. By selling bonds, therefore, the U.S. government competes with every other potential borrower for the available supply of loanable money. The more money the government borrows, the less money is available for the private borrowing and investment that increase productivity.

Economic Stability

Stability is a condition in which the amount of money available in an economic system and the quantity of goods and services produced in it are growing at about the same rate. A chief goal of an economic system, stability can be threatened by certain factors.

Inflation

Inflation occurs when an economic system experiences widespread price increases. Instability results when the amount of money injected into an

Balance of Trade the economic value of all the products that a country exports minus the economic value of all the products it imports

National Debt the amount of money the government owes its creditors

Stability condition in which the amount of money available in an economic system and the quantity of goods and services produced in it are growing at about the same rate

Inflation occurs when widespread price increases occur throughout an economic system

economy exceeds the increase in actual output, so people have more money to spend but the same quantity of products available to buy. As supply and demand principles tell us, as people compete with one another to buy available products, prices go up. These high prices will eventually bring the amount of money in the economy back down. However, these processes are imperfect—the additional money will not be distributed proportionately to all people, and price increases often continue beyond what is really necessary. As a result, purchasing power for many people declines.

Keeping in mind that our definition of inflation is the occurrence of widespread price increases throughout an economic system, it stands to reason that we can measure inflation by measuring price increases. Price indexes such as the **consumer price index (CPI)** measure the prices of typical products purchased by consumers living in urban areas.[13] The CPI is expressed as a percentage of prices as compared to a base period. The current base period used to measure inflation is 1982–1984, which is set at 100 (indicating a percentage). For comparison purposes, the CPI index was 172.2 in 2000, 195.3 in 2005, and 214.2 in 2010. So, prices in 2010 were slightly more than double the level in the 1982–1984 base period.

While we tend to view inflation as bad, however, in most ways it is better than *deflation*, which happens when there are widespread price cuts. While inflation creates instability, it also generally indicates the overall economy is growing (just in an erratic manner). But deflation generally means the overall economy is shrinking, a more serious problem by most measures.

Unemployment Finally, we need to consider the effect of unemployment on economic stability. **Unemployment** is the level of joblessness among people actively seeking work in an economic system. When unemployment is low, there is a shortage of labor available for businesses to hire. As businesses compete with one another for the available supply of labor, they raise the wages they are willing to pay. Then, because higher labor costs eat into profit margins, they raise the prices of their products. Although consumers have more money to inject into the economy, this increase is soon undone by higher prices, so purchasing power declines.

There are at least two related problems:

- If wage rates get too high, businesses will respond by hiring fewer workers and unemployment will go up.
- Businesses could raise prices to counter increased labor costs, but they won't be able to sell as many of their products at higher prices. Because of reduced sales, they will cut back on hiring and, once again, unemployment will go up.

What if the government tries to correct this situation by injecting more money into the economic system—say by cutting taxes or spending more money? Prices in general may go up because of increased consumer demand. Again, purchasing power declines and inflation may set in.[14] During the recession of 2008–2009 millions of workers lost their jobs as businesses like Circuit City closed their doors and others, such as General Motors and Kodak, cut thousands of jobs in an effort to stem losses. Indeed, in early 2010 unemployment in the United States reached a 25-year high of 10.2 percent. By January 2011, as the economy was gradually pulling out of recession unemployment had dropped to around 9.5 percent.

Recessions and Depressions Unemployment is sometimes a symptom of a system-wide disorder in the economy. During a downturn in the business cycle, people in different sectors may lose their jobs at the same time. As a result, overall income and spending may drop. Feeling the pinch of reduced revenues, businesses may cut spending on the factors of production—including labor. Yet more people will be put out of work, and unemployment will only increase further. Unemployment that results from this vicious cycle is called *cyclical unemployment.*

If we look at the relationship between unemployment and economic stability, we are reminded that when prices get high enough, consumer demand for goods

and services goes down. We are also reminded that when demand for products goes down, producers cut back on hiring and, not surprisingly, eventually start producing less. Consequently, aggregate output decreases. When we go through a period during which aggregate output declines, we have a recession. During a *recession*, producers need fewer employees—less labor—to produce products. Unemployment, therefore, goes up.

To determine whether an economy is going through a recession, we start by measuring aggregate output. Recall that this is the function of real GDP, which we find by making necessary adjustments to the total value of all goods and services produced within a given period by a national economy through domestic factors of production. A **recession** is more precisely defined as a period during which aggregate output, as measured by real GDP, declines. As noted earlier, most economists agree that the U.S. economy went into recession in 2008; most also predicted that we were gradually emerging from recession in early 2011. A prolonged and deep recession is a **depression**. The last major depression in the United States started in 1929 and lasted over 10 years. Most economists believe that the 2008–2010 recession, while the worst in decades, was not really a depression.

Managing the U.S. Economy

The government acts to manage the U.S. economic system through two sets of policies: fiscal and monetary. It manages the collection and spending of its revenues through **fiscal policies**. Tax rates, for example, can play an important role in fiscal policies helping to manage the economy. One key element of President Barack Obama's presidential platform was an overhaul of the U.S. tax system. Among other things, he proposed cutting taxes for the middle class while simultaneously raising taxes for both higher-income people and businesses.

Monetary policies focus on controlling the size of the nation's money supply. Working primarily through the Federal Reserve System (the nation's central bank, often referred to simply as "the Fed"), the government can influence the ability and willingness of banks throughout the country to lend money.[15] For example, to help offset the 2008–2009 recession, the government injected more money into the economy through various stimulus packages. On the one hand, officials hoped that these funds would stimulate business growth and the creation of new jobs. On the other hand, though, some experts feared that increasing the money supply might also lead to inflation.

Taken together, fiscal policy and monetary policy make up **stabilization policy**—government economic policy whose goal is to smooth out fluctuations in output and unemployment and to stabilize prices. In effect, the economic recession that started in 2008 was a significant departure from stabilization as business valuations dropped and jobs were eliminated. The various government interventions, such as financial bailouts, represented strategies to restore economic stability.

Consumer Price Index (CPI) a measure of the prices of typical products purchased by consumers living in urban areas

Unemployment the level of joblessness among people actively seeking work in an economic system

Recession a period during which aggregate output, as measured by GDP, declines

Depression a prolonged and deep recession

Fiscal Policies policies used by a government regarding how it collects and spends revenue

Monetary Policies policies used by a government to control the size of its money supply

Stabilization Policy government economic policy intended to smooth out fluctuations in output and unemployment and to stabilize prices

Heather A. Craig/Shutterstock

Continued from page 4

Hitting the Peak?

While surging oil and gas prices occupied the thoughts of consumers in 2011, government officials began to worry about the bigger picture. The surging global demand for gasoline has been forcing experts to face a stark reality—the global supply of petroleum will soon peak and then slowly begin to decline. While no one can pinpoint when this will happen, virtually all the experts agree that it will happen well before the middle of this century.

So then what? The laws of supply and demand will continue to work, but in perhaps different ways. First, just because the supply of oil will decline doesn't mean that it will disappear immediately. While there may be gradual reductions in supply, oil and gas will remain available for at least another century—but at prices that may make those of today seem like a bargain. New technology may also allow businesses to extract petroleum from locations that are not currently accessible, such as from the deepest areas under the oceans.

Second, and more significantly, there will be market incentives for businesses everywhere to figure out how to replace today's dependence on oil and gas with alternatives. For instance, automobile manufacturers are already seeing increased demand for their hybrid products—cars and trucks that use a combination of gasoline and electrical power. Hence, firms that can produce alternative sources of energy will spring up, and those who find viable answers will prosper. And companies that can figure out how to replace today's plastic products with new products that don't rely on petroleum will also find willing buyers.

QUESTIONS FOR DISCUSSION

1. What were the basic factors of production in the petroleum industry? What do you think the factors of production might be in the future?
2. Explain how the concepts of the demand and supply of petroleum combine to determine market prices.
3. What are the economic indicators most directly affected by energy prices?
4. Does the global energy situation increase or decrease your confidence in a capitalistic system based on private enterprise?
5. Should there be more government intervention in the exploration for and pricing of petroleum products? Why or why not?

SUMMARY OF LEARNING OBJECTIVES

MyBizLab

1. Define the nature of U.S. business and identify its main goals and functions. (p. 4)

A *business* is an organization that provides goods or services to earn profits. The prospect of earning *profits*—the difference between a business's revenues and expenses—encourages people to open and expand businesses. Businesses produce most of the goods and services that Americans consume and employ most working people. New forms of technology, service businesses, and international opportunities promise to keep production, consumption, and employment growing indefinitely.

2. Describe the external environments of business and discuss how these environments affect the success or failure of any organization. (pp. 5–7)

The *external environment* of business refers to everything outside its boundaries that might affect it. Both the *domestic* and the *global business environment* affect virtually all businesses. The *technological*, *political-legal*, *sociocultural*, and *economic environments* are also important.

3. Describe the different types of global economic systems according to the means by which they control the factors of production. (pp. 7–11)

Economic systems differ in the ways in which they manage the five *factors of production* (1) *labor*, or *human resources*, (2) *capital*, (3) *entrepreneurship*, (4) *physical resources*, and (5) *information resources*. A *planned economy* relies on a centralized government to control factors of production and make decisions. Under *communism*, the government owns and operates all sources of production. In a *market economy*, individuals—producers and consumers—control production and allocation decisions through supply and demand. A *market* is a mechanism for exchange between the buyers and sellers of a particular product or service. Sellers can charge what they want, and customers can buy what they choose. The political basis of market processes is *capitalism*, which fosters private ownership of the factors of production and encourages entrepreneurship by offering profits as an incentive. Most countries rely on some form of *mixed market economy*—a system featuring characteristics of both planned and market economies.

4. Show how markets, demand, and supply affect resource distribution in the United States, identify the elements of private enterprise, and explain the various degrees of competition in the U.S. economic system. (pp. 11–16)

Decisions about what to buy and what to sell are determined by the forces of demand and supply. *Demand* is the willingness and ability of buyers to purchase a product or service. *Supply* is the willingness and ability of producers to offer a product or service for sale. A *demand and supply schedule* reveals the relationships among different levels of demand and supply at different price levels.

Market economies reflect the operation of a *private enterprise system*—a system that allows individuals to pursue their own interests without government restriction. Private enterprise works according to four principles: (1) private property rights, (2) freedom of choice, (3) profits, and (4) competition. Economists have identified four degrees of competition in a private enterprise system: (1) *perfect competition*, (2) *monopolistic competition*, (3) *oligopoly*, and (4) *monopoly*.

5. Explain the importance of the economic environment to business and identify the factors used to evaluate the performance of an economic system. (pp. 16–23)

Economic indicators are statistics that show whether an economic system is strengthening, weakening, or remaining stable. The overall health of the economic environment—the economic system in which they operate—affects organizations. The two key goals of the U.S. system are *economic growth* and *economic stability*. Growth is assessed by *aggregate output*. Among the factors that can inhibit growth, two of the most important are *balance of trade* and the *national debt*. *Economic stability* means that the amount of money available in an economic system and the quantity of goods and services produced in it are growing at about the same rate. There are two key threats to stability: *inflation* and *unemployment*. The government manages the economy through two sets of policies: *fiscal policies* (such as tax increases) and *monetary policies* that focus on controlling the size of the nation's money supply.

KEY TERMS

MyBizLab

aggregate output (p. 17)
balance of trade (p. 20)
business (p. 4)
business cycle (p. 17)
capital (p. 7)
capitalism (p. 10)
communism (p. 10)
competition (p. 14)
consumer price index (CPI) (p. 22)
demand (p. 12)
demand and supply schedule (p. 12)
demand curve (p. 12)
depression (p. 23)
domestic business environment (p. 6)
economic environment (p. 7)
economic indicators (p. 17)
economic system (p. 7)
entrepreneur (p. 8)
external environment (p. 5)
factors of production (p. 7)
fiscal policies (p. 23)
global business environment (p. 6)
gross domestic product (GDP) (p. 17)
gross national product (GNP) (p. 18)
inflation (p. 21)
information resources (p. 9)
labor (human resources) (p. 7)
law of demand (p. 12)
law of supply (p. 12)
market (p. 10)

QUESTIONS AND EXERCISES

QUESTIONS FOR REVIEW

1. What are the factors of production? Is one factor more important than the others? If so, which one? Why?
2. What is a demand curve? A supply curve? What is the term for the point at which they intersect?
3. What is GDP? Real GDP? What does each measure?
4. Why is inflation both good and bad? How does the government try to control it?

QUESTIONS FOR ANALYSIS

5. In recent years, many countries that previously used planned economies have moved to market economies. Why do you think this has occurred? Can you envision a situation that would cause a resurgence of planned economies?
6. Cite an instance in which a surplus of a product led to decreased prices. Cite an instance in which a shortage led to increased prices. What eventually happened in each case? Why?
7. Explain how current economic indicators, such as inflation and unemployment, affect you personally. Explain how they may affect you as a manager.
8. At first glance, it might seem as though the goals of economic growth and stability are inconsistent with one another. How can you reconcile this apparent inconsistency?

APPLICATION EXERCISES

9. Visit a local shopping mall or shopping area. List each store that you see and determine what degree of competition it faces in its immediate environment. For example, if there is only one store in the mall that sells shoes, that store represents a monopoly. Note those businesses with direct competitors (two jewelry stores) and show how they compete with one another.
10. Interview a business owner or senior manager. Ask this individual to describe for you the following things: (1) how demand and supply affect the business, (2) what essential factors of production are most central to the firm's operations, and (3) how fluctuations in economic indicators affect his or her business.

BUILDING YOUR BUSINESS SKILLS

Paying the Price of Doing E-Business

Goal

To help you understand how the economic environment affects a product's price.

Background Information

Assume that you own a local business that provides Internet access to individuals and businesses. Yours is one of four such businesses in the local market. Each one charges the same price: $12 per month for standard DSL service. You also provide e-mail service, as do two of your competitors. Two competitors give users free personal web pages. One competitor just dropped its price to $10 per month, and the other two have announced that they'll follow suit. Your break-even price is $7 per customer—that is, you must charge $7 for your service package in order to cover your costs. You are concerned about getting into a price war that may destroy your business.

Method

Step 1

Divide into groups of four or five people. Each group should develop a general strategy for responding to competitors' price changes. Be sure to consider the following factors:

- How demand for your product is affected by price changes
- The number of competitors selling the same or a similar product
- The methods you can use—other than price—to attract new customers and retain current customers

Step 2

Develop specific pricing strategies based on each of the following situations:

- A month after dropping the price to $10, one of your competitors raises it back to $12.

- Two of your competitors drop their prices even further—to $8 a month. As a result, your business falls off by 25 percent.
- One of the competitors who offers free web pages announces that the service will become optional for an extra $2 a month.
- Two competitors announce that they will charge individual users $8 a month but will charge a higher price (not yet announced) for businesses.
- All four providers (including you) are charging $8 a month. One goes out of business, and you know that another is in poor financial health.

FOLLOW-UP QUESTIONS

1. Discuss the role that various inducements other than price might play in affecting demand and supply in this market.
2. Is it always in a company's best interest to feature the lowest prices?
3. Eventually, what form of competition is likely to characterize this market?

EXERCISING YOUR ETHICS: INDIVIDUAL EXERCISE

Prescribing a Dose of Competitive Medicine

The Situation

You are a businessperson in a small town, where you run one of two local pharmacies. The population and economic base are fairly stable. Each pharmacy controls about 50 percent of the market. Each is reasonably profitable, generating solid if unspectacular revenues.

The Dilemma

You have just been approached by the owner of the other pharmacy. He has indicated an interest either in buying your pharmacy or in selling his to you. He argues that neither of you can substantially increase your profits and complains that if one pharmacy raises its prices, customers will simply go to the other one. He tells you outright that if you sell to him, he plans to raise prices by 10 percent. He believes that the local market will have to accept the increase for two reasons: (1) The town is too small to attract national competitors, such as Walgreens or CVS, and (2) local customers can't go elsewhere to shop because the nearest town with a pharmacy is 40 miles away.

QUESTIONS TO ADDRESS

1 What are the roles of supply and demand in this scenario?
2 What are the underlying ethical issues?
3 What would you do if you were actually faced with this situation?

EXERCISING YOUR ETHICS: TEAM EXERCISE

Making the Right Decision

The Situation

Hotel S is a large hotel in the heart of a southern city. The hotel is a franchise operation run by an international hotel chain. The primary source of revenue for the hotel is convention business. A major tropical storm is about to hit the city, which in the past has been prone to heavy flooding.

The Dilemma

Because Hotel S is a licensed operation, it must maintain numerous quality standards in order to keep its license. This license is important because the international management company handles advertising, reservations, and so on. If it were to lose its license, it is almost certain that the hotel would have to reduce its staff.

For the past few years, members of the Hotel S team have been lobbying the investors who own the hotel to undertake a major renovation. They fear that without such a renovation, the hotel will lose its license when it comes up for renewal in a few months. The owners, however, have balked at investing more of their funds in the hotel itself but have indicated that hotel management can use revenues earned above a specified level for upgrades.

The tropical storm approaching the city has cut off most major transportation avenues, and telephone service is also down. The Hotel S staff is unable to reach the general manager, who has been traveling on business. Because the city is full of conventioneers, hotel rooms are in high demand. Unfortunately, because of the disrepair at the hotel, it only has about 50 percent occupancy. Hotel S staff have been discussing what to do and have identified three basic options:

1 The hotel can reduce room rates in order to help both local citizens as well as out-of-town visitors. The hotel can also provide meals at reduced rates. A few other hotels are also doing this.
2 The hotel can maintain its present pricing policies. Most of the city's hotels are adopting this course of action.
3 The hotel can raise its rates by approximately 15 percent without attracting too much attention. It can also start charging for certain things it has been providing for free, such as local telephone calls, parking, and morning coffee. None of the staff members favors this option out of greed, but instead see it as a way to generate extra profits for renovation and to protect jobs.

Team Activity

Assemble a group of four students and assign each group member to one of the following roles:

- A member of the hotel staff
- The Hotel S manager
- A customer at the hotel
- A Hotel S investor

ACTION STEPS

1 Before hearing any of your group's comments on this situation, and from the perspective of your assigned role, which of the three options do you think is the best choice? Write down the reasons for your position.
2 Before hearing any of your group's comments on this situation, and from the perspective of your assigned role, what are the underlying ethical issues, if any, in this situation? Write down the issues.
3 Gather your group together and reveal, in turn, each member's comments on the best choice of the three options. Next, reveal the ethical issues listed by each member.
4 Appoint someone to record main points of agreement and disagreement within the group. How do you explain the results? What accounts for any disagreement?
5 From an ethical standpoint, what does your group conclude is the most appropriate action that should have been taken by the hotel in this situation?
6 Develop a group response to the following question: Can your team identify other solutions that might help satisfy both extreme views?

VIDEO EXERCISE MyBizLab

Bancfirst

Learning Objectives

The purpose of this video is to help you:

1 Describe the impact of the external environment on a business.
2 Identify factors that influence demand and supply curves and the equilibrium price.
3 Understand the impact of the business cycle.

Synopsis

BancFirst is a multi-branch bank located in Oklahoma. While many banks faced serious crises during the past few years, BancFirst has remained strong. A relaxed regulatory environment allowed banks to make mortgage loans to buyers who were unlikely to be able to repay the loans. When these buyers began to default on their loans, banks foreclosed on the loans and became the owners of these homes. In the past, banks were typically able to resell foreclosed homes and recover the amount of the loan. However, with a large number of homes for sale and a shrinking pool of buyers, banks found themselves unable to sell the foreclosed homes and began to face serious challenges. While the number of bank failures was less than ten for most of the last decade, rates began to skyrocket in 2009. BancFirst avoided much of this crisis by sticking to well-established lending guidelines.

DISCUSSION QUESTIONS

1 What are the major elements of the external environment? Of these, which is most important to BancFirst?
2 What are the factors that caused the demand curve for houses to shift to the right? How did this affect the equilibrium price?
3 Which factors created a shift in the supply curve? How did this affect the equilibrium price for houses?
4 There are four stages in the business cycle: prosperity, recession, depression, and recovery. Where was the U.S. economy when the housing crisis began? Where are we today?
5 The U.S. government "bailed out" a number of banks during this crisis. Do you think that this prevented a depression? Do you think that this is the proper role of government?

Online Exploration

Visit the BancFirst website (www.bancfirst.com) and click on Investor Relations. From this page, you will be able to access the bank's latest annual report (Latest 10-K). Although the report is very long, you can read through the first few pages to learn more about the bank. Beginning on page 13, BancFirst identifies a number of risk factors. What are the primary concerns that BancFirst has identified? What plans have they made to address each concern?

END NOTES

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[15] See "The New Fed," *BusinessWeek*, November 7, 2005, pp. 30–34.