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ECONOMICS

When people hear the word “economics” they automatically tense up and pretend to not understand what is being talked about. Let me tell you first off that, to your surprise, you know more about economics than you think. Everyday we use economics. Sure, you’re thinking “Yeah, whenever I go to the mall or the store and spend money I’m using economics.” How can I deny that? Of course that’s economics. However, economics reaches farther than your wallet or purse. We use economic principles every time we have to make a decision or a choice. This semester I hope to ease your mind about economics and help you to understand that economics is not something to fear but instead is a tool that helps us all the time. (Unfortunately, most of the time “economics” is mentioned people are referring to money.)

CHAPTER 1. WHAT IS ECONOMICS?

- According to your textbook: *the study of how individuals and nations make choices about ways to use scarce resources to fulfill their needs and wants*
- A more general definition might be: *a way of breaking down situations where people have to make a choice from a number of options.*

A. 2 Parts of Economics:

- 1) **Macroeconomics:** the study of the economy as a whole (all the things you hear about in the news when they talk about the government’s economy): inflation, unemployment, economic growth, etc.
- 2) **Microeconomics:** the study of the individual parts of the economy (this is where we come in): households, business firms, government agencies, and the things that effect how they make decisions.

B. Other Basic Definitions:

1) **Goods and Services:** anything that satisfies human needs, wants, or desires.

- a) **Goods:** tangible items, such as food, cars, and clothing.
 - i) *Consumer Goods:* a good intended for final use by individuals.
 - ii) *Capital Goods:* a manufactured used to produce other goods and services.
 - iii) *Durable Goods:* any good that will generally last more than 3 years.
 - iv) *Non-durable Goods:* any good that will generally last less than 3 years.

b) **Services:** intangible items such as education, health care, a haircut, etc.

2) **Resources (factors of production):** anything that can be used to produce goods and services.

a) **Types of Resources, or the FACTORS OF PRODUCTION:**

- i) **Natural Resources:** these are things that are used to create a good or service. They are found on the land, under the land, in the water, or in the air.
- ii) **Labor:** The actual work of human beings.
- iii) **Capital:** Objects made by human beings for the use of production.
 - **financial capital:** the money used to buy the tools and equipment in production.
- iv) **Entrepreneurship:** This is a special type of labor, it is creative labor. It refers to the human ability to think and develop new ideas and business opportunities, as well as managing the other factors of production.

3) **Consumers:** people who use goods and services.

a) **consumption:** The process of buying up goods and services in order to satisfy needs and wants.

b) **conspicuous consumption:** Whenever a person buys something to impress others.

4) **Value:**

a) **Who determines value?** Value refers to how much something is worth. We generally like to define it using dollars and cents. However different people will place a higher value on certain items than other people because it may be more or less important to them.

b) **utility:** In order for something to have value it has to be useful (it must have utility). If a person has no use for an item, then it has no value to that person.

5) **Wealth**: This is the sum of all goods that have value and are transferable from one person to another.

6) **Production**: The process of creating goods and services.

a) **productivity**: Whenever the factors of production are used efficiently to create a good or service, it is called productivity.

b) **specialization**: This is when people, or perhaps capital, are used at whatever task they do best. This will be their “specialty.”

- Specialization increases productivity because more can be produced using the same amount of inputs (resources).

c) **Human Capital**: A difficult thing to measure, this is the skills, abilities, health, and motivation of employees.

- A business can increase this by spending money on things such as health care, training, paid vacations, etc.

CHAPTER 2. FUNDAMENTAL ECONOMIC PROBLEM

A. Scarcity

- Scarcity is based on one simple fact: **PEOPLE'S WANTS AND NEEDS ARE ALWAYS MORE THAN OUR RESOURCES CAN SUPPLY.**
- **Important fact:** If there were enough resources to supply everybody with everything they needed and wanted, then there wouldn't be a need for the study of economics. In other words, without scarcity there wouldn't be a need to study economics.

ALL SOCIETIES, RICH OR POOR, FACE THE PROBLEM OF SCARCITY!

1) Universal Problems Caused By Scarcity (3 basic questions of economics):

- a) What goods and services should be produced, and how much of them?
- b) How should these goods and services be produced? (What combination of resources and production techniques should be used?)
- c) For whom are these goods and services being produced? (How should these goods and services be distributed among the people?)

2) Rational Thinking

- need to know how to identify the problem
- in order to make an informed decision, a person must have an ample amount of information about the choices
- consider the costs and benefits of each choice

3) The Cost of Decisions

- costs: When making a choice there is always some price to pay (not necessarily in money).
 - a) Rational Choices: A rational choice is choosing the option that benefits us the most.
 - b) Trade-offs: The options we have to choose from are different tradeoffs.
 - c) Opportunity Costs: When we make a rational choice we must give up the other options. The value we place on the thing(s) we didn't chose are opportunity costs.

B. Models

- A general definition might be: *a representation of an object or idea of how it should look or work in an ideal world.*

Models are used by economists (or anybody else in a particular field) to view trends and make predictions.

1). Production Possibilities Frontier (PPF)

a) What is a frontier?

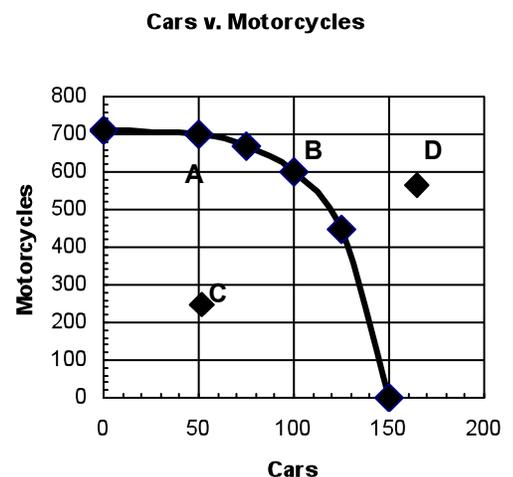
- A frontier is the furthest *limit*.

b) What is a PPF?

- a model: A PPF is a model that shows the different combinations of two things that can be produced from a set amount of factors of production.
- a limit: It shows the **MAXIMUM** combination of two goods or services that can be produced assuming that **ALL** of the resources are used in the most efficient and productive way possible (that is, with as little waste as possible).

c) Important Properties of PPFs

- i) Boundary: A PPF is a boundary. It shows the **LIMIT** of what can be produced with the factors of production that are available.



ii) **Combinations:** The PPF shows all of the possible combinations for the production of 2 items given a limited amount of resources.

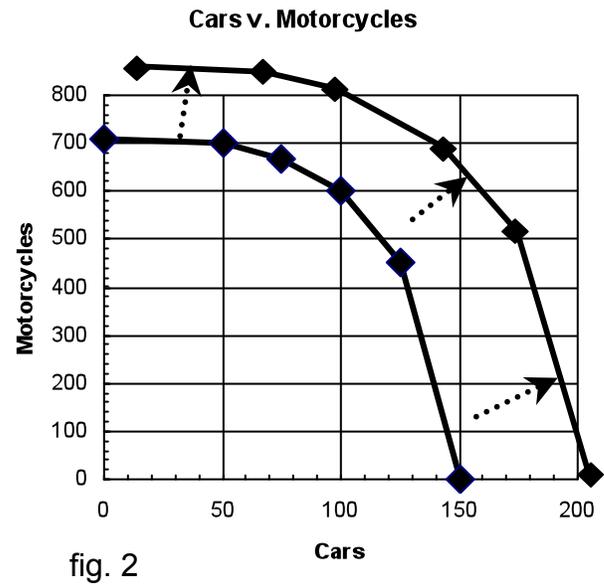
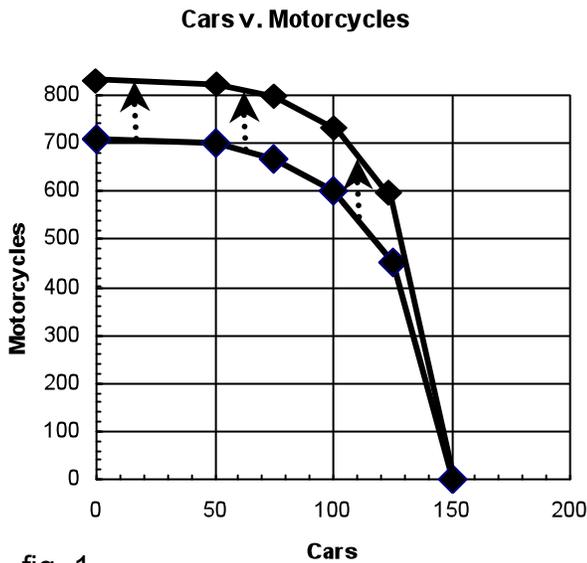
- **maximum efficiency:** When a company or person is using their resources in the best way possible, the result is a point ON the line. (Such as points A and B.)
- **inefficiency:** When a company or person is not using their resources in the best way possible, the result is a point INSIDE or BELOW the line. (Such as point C.) This means they are wasting some of their resources.
- **impossible combinations:** If a company is producing at a point that is OUTSIDE or ABOVE the line, then an error has occurred in the creation of the graph. The company or person may have underestimated the amount of resources they had. (Such as point D) If the PPF is correct then a company can NEVER be producing at a point outside of the line.

iii) **Negative Slope:** A PPF ALWAYS goes from the top left to the bottom right! That means that as one item increases, the other decreases.

- In this case, as we move from point A to point B the number of motorcycles we can produce decreases while the number of cars we can produce increases.

iv) **Shifts in the PPF:** There are many factors that may cause a PPF to shift. Here are some general rules, but each case has to be taken individually.

- A PPF shifts when there is a change in either technology or in the availability of resources.
 - An improvement in car manufacturing technology or an increase in a resource used for only cars will shift the PPF outward on the cars-axis ONLY (fig. 1).
 - An improvement in a technology used in producing both cars and motorcycles or an increase in resources used in the production of both cars and motorcycles will cause the PPF to shift outward on BOTH axes (fig. 2).

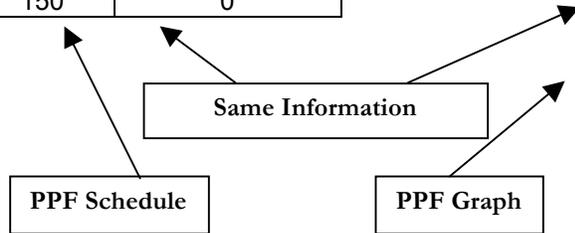


d) PPF Schedules:

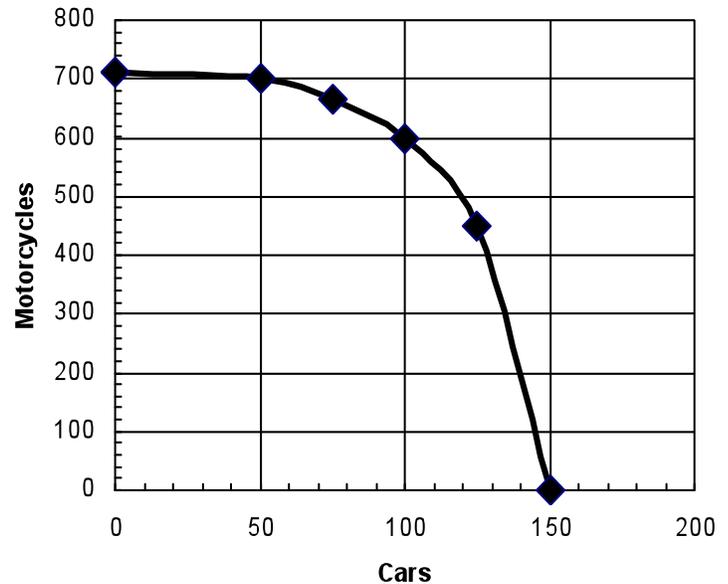
i) What is a schedule?

- A chart that shows the same information as a graph. It lists some of the possible combinations that can be produced at the current level of resources and technology.

Cars	Motorcycles
0	710
50	700
75	667
100	600
125	450
150	0



Cars v. Motorcycles



e) Calculating Opportunity Cost From A PPF:

i) measuring in units: When reading we can state our opportunity cost by referring to how many units of the item we give up.

- For example, using the graph and schedule above, we could say that by increasing our car production from 50 to 75 we must give up making 33 motorcycles.

ii) measuring in dollars: When we are given the value of the trade-offs, we can determine the value of the opportunity cost by figuring out how much money we are losing by making the choice.

- Below is a simpler example:

QUESTION: Using the PPF to the right, what is the opportunity cost of producing 10 more televisions?

[since we know that the opportunity cost is the value of the goods given up, we must determine how many radios we must give up to produce 10 more televisions]

a) Pick a point on the *televisions* axis. (Let's choose 30 televisions)

b) Find the point on the PPF that corresponds with 30 televisions. This is done by drawing a line straight up from the 30 until it reaches the PPF (marked as point A).

c) Move along the televisions axis to the right 10 units. (We get to 40 televisions)

d) Find the point on the PPF that corresponds with 40 televisions. (marked by point B)

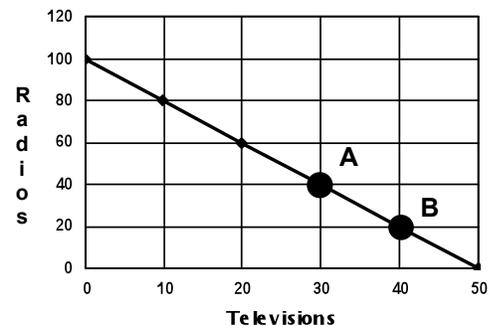
e) From each of these points on the PPF (Point A and Point B) find the amount of Radios being produced at that level of production.

(Point A=40 Radios, Point B=20 Radios)

f) Find the difference between the number of radios at Point A and the number of Radios at Point B. (40-20= 20 Radios)

Now try this one yourself: Using the same PPF, what is the opportunity cost of producing 60 more Radios?

Televisions v. Radios



ANSWER: 30 Televisions

Let's assume we are given the following dollar values for these televisions and radios:

Television: \$225

Radio: \$85

What is the dollar value of the opportunity cost of producing 60 more radios?

Since we have already discovered how many televisions we will have to stop making in the example above, half of the work is done for us.

a) Since we are increasing the number of radios by 60, multiply 60 radios times \$85:
 $60 \times \$85 = \5100

b) Since we are *decreasing* the number of televisions by 30, multiply 30 televisions times \$225:
 $30 \times \$225 = \6750

c) Our opportunity cost in dollars is the increase in the dollars we earn making more radios minus dollars we are losing by making fewer televisions:

$$\$5100 - \$6750 = -\$1650$$

Therefore, the choice of making 60 more radios would cost us \$1650. But this might not be the wrong decision, which we will see later when we look at *Supply & Demand*.

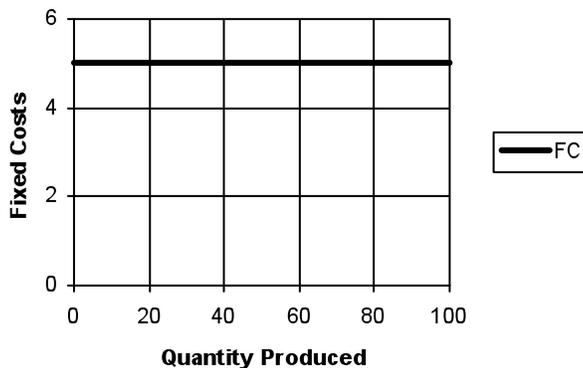
CHAPTER 3. COSTS OF PRODUCTION

A. Total Costs

- Every firm, regardless of what type of firm it is, has costs.
- These costs can be broken down into 2 categories:

1) Fixed Costs (FC):

- These are the costs that do not change if you produce more or less products.
- This amount is constant and cannot be reduced.
- To illustrate this, the graph below shows that no matter how many items are produced, the fixed costs will remain the same.



2) Variable Costs (VC):

- These are costs that are determined by the number of items you produce.
- Therefore, the more items you produce the more your variable costs will be.
- Variable costs include paying for the resources to produce the item.
- Therefore, the more items you produce the more resources you need to buy.



3) Total Costs (TC):

- Therefore, a firm's total costs are equal to their fixed costs plus their variable costs.

$$TC = FC + VC$$

- This value is useful to a firm in order to determine the company's monthly bills.
- However, it does not let the firm know how much each item they produce should cost.

B. Average Costs

1) Average Total Costs (ATC):

- If a firm wants to know how much it is costing them to produce an item they must find out the average total cost (ATC).
- The average total cost is determined by dividing the total cost by the number of items produced (Q).

$$\text{Average Total Cost (ATC)} = \frac{\text{TC}}{\text{Q}}$$

C. Cost-Benefit Analysis

- knowing total costs and average total costs tells how much it is costing to produce each item
- this information is not enough to determine when to stop producing additional items
- a firm will continually ask itself, “Should I produce more items?”
- the best way to answer that question is to weigh the benefit of the additional item against its cost

1) Marginal Benefit

- if one more item is produced, how much benefit will we gain?
- in a business sense, how much more does the business have to gain by making one more item?

2) Marginal Cost

- how much will be lost if an additional item is produced?
- in a business sense, how much will it cost the business to make one more item?

3) Cost-Benefit Analysis

- business will continue to make more items so long as the marginal benefit of each item is greater than the marginal cost
- Rule: if Marginal Benefit > Marginal Cost = produce more

CHAPTER 4. MARKETS

A. Factors of Production

- things needed to manufacture goods and services
- sometime called inputs
- resources can fit into one of four categories

1) *Land*

- “gifts of nature”
- natural resources not created by human effort

a) examples

- deserts, fertile fields, forests mineral deposits, cattle, whales, sunshine, and the climate

2) *Capital*

- tools, equipment, and factories used in the production of goods and services

a) financial capital

- the money used to buy the tools and equipment in production

3) *Labor*

- people with all their efforts, abilities, and skills

4) *Entrepreneurs*

- a risk-taker in search of profit
- the innovators responsible for much of the change in our economy
- the minds behind the economy
- they combine land, labor, and capital into new products

B. Circular Flow Model

- This is a model that shows how a market items flow through in a market economy like the one we have in the United States.

1) Economic Interdependence: This is based on cause and effect. If something happens in one place in the United States or the world it will affect us even though we could be thousands of miles away.

- *e.g.:* Gas prices.

2) Parts of a Basic Capitalist Economy:

a) Households: Owners of the factors of production, particularly labor, land, and entrepreneurship.

b) Firms: Businesses or industries that use the factors of production to produce goods or services.

3) Actions of These Parts:

a) Producers: A producer is one who provides or creates something.

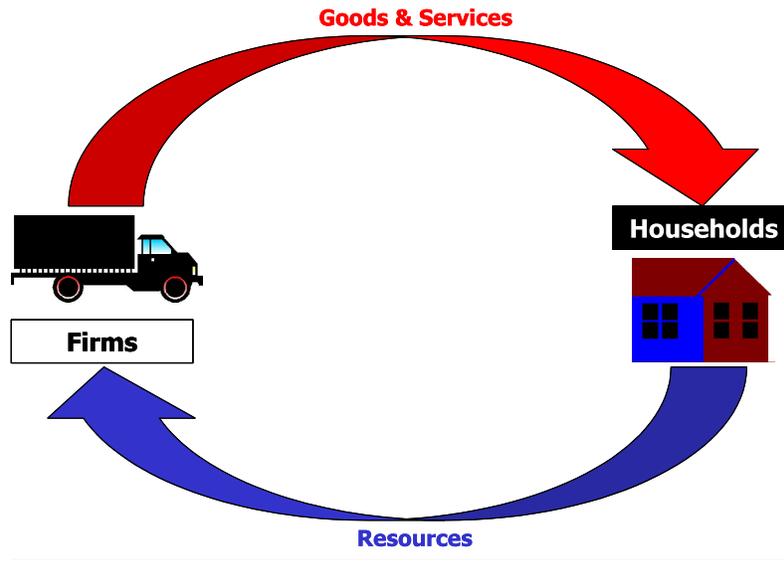
i) *Households:* Households produce or own factors of production that are utilized by firms.

ii) *Firms:* Firms use factors of production to create goods or services that are utilized by households.

b) Consumers: A consumer is one who uses or purchases something.

i) *Households:* Households buy and use goods and services that are made by firms.

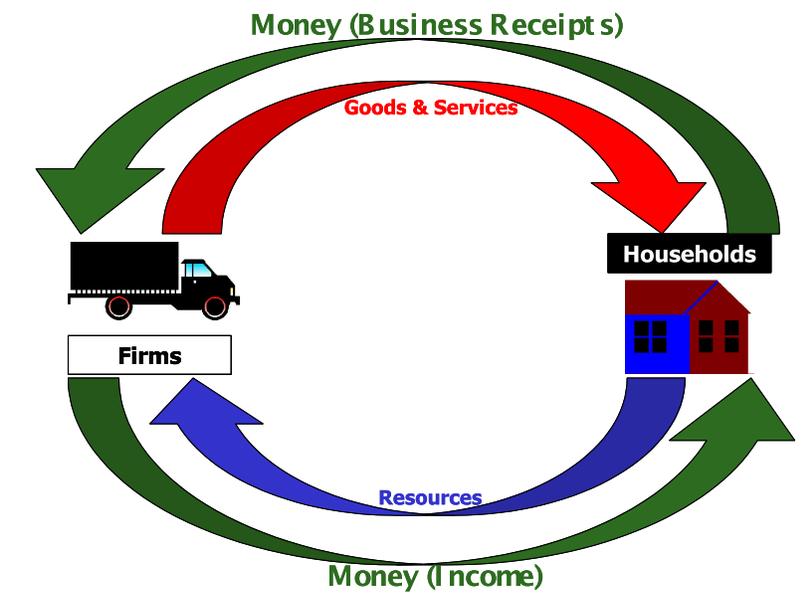
ii) *Firms:* Firms buy and use factors of production that are controlled by households.



Barter Economy
 A barter economy is one where goods and services are exchanged for each other. That is, 1 person must trade some item that they have for an item that they want. This system can become complicated if the person who has what you need does not need what you have to trade.

4) Medium of Exchange:

- In order to make trade easier, people began to use a standard item, or currency
- a medium of exchange is an accepted item that people agree to trade for goods and service instead of using another good or service



Money Economy
 When barter becomes too complicated and difficult in order to get the desired goods and services, money was invented so that everyone would have something to trade with. Producers and Consumers agree that their products or service has a certain value that they exchange for money.

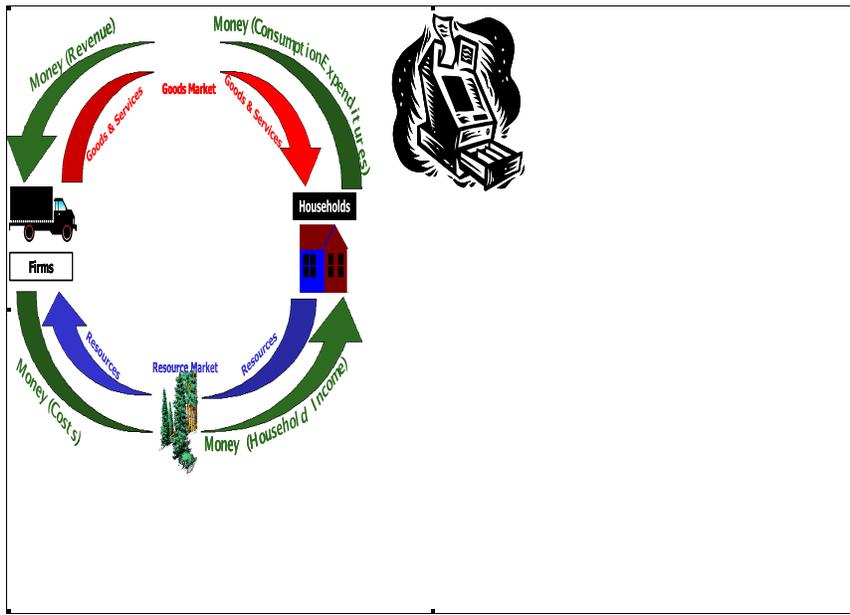
C. Markets

- A way of buyers and sellers to get together to obtain the resources they need
- makes meeting the needs of firms and households easier

1) Product Market (Goods Market): This is where consumer goods are purchased.

2) Factor Market (Resource Market): This where the factors of production can be purchased. However it does not have to be a physical place.

- e.g. Stores like Home Depot are factor markets to a contractor.
- e.g. The purchase of some items like labor, does not occur in an actual store, but a “job market” exists.



Market Economy
 In a market economy, people will continue to use money as a medium of exchange however they will establish institutions that will make it easier to find the people who are selling what the consumer needs.

CHAPTER 5. DEMAND

A. What Is Demand?

- the desire, ability, and willingness to buy a product
- this is the action of consumers
- demand measures the actions of consumers

1) An Introduction to Demand

a) Importance of Knowing Demand

- essential to understanding how a market economy works

b) Ways Consumers Can Know Demand

- visit other shops and gauge the reactions of consumers to different prices
- poll consumers about prices and determine demand from this data
- study data compiled over the past years which show consumer reactions to higher and lower prices

B. Law of Demand

- at higher prices, consumers will buy (demand) less
- at lower prices, consumers will buy (demand) more
- it is said that price and quantity demanded has an inverse (or negative) relationship – that is, they go in opposite directions

C. Demand Schedule & Demand Curve

1) Demand Schedule

- a listing that shows the quantity demanded at all prices that might prevail in the market at a given time
- it is a chart showing how many items would be demanded at different prices

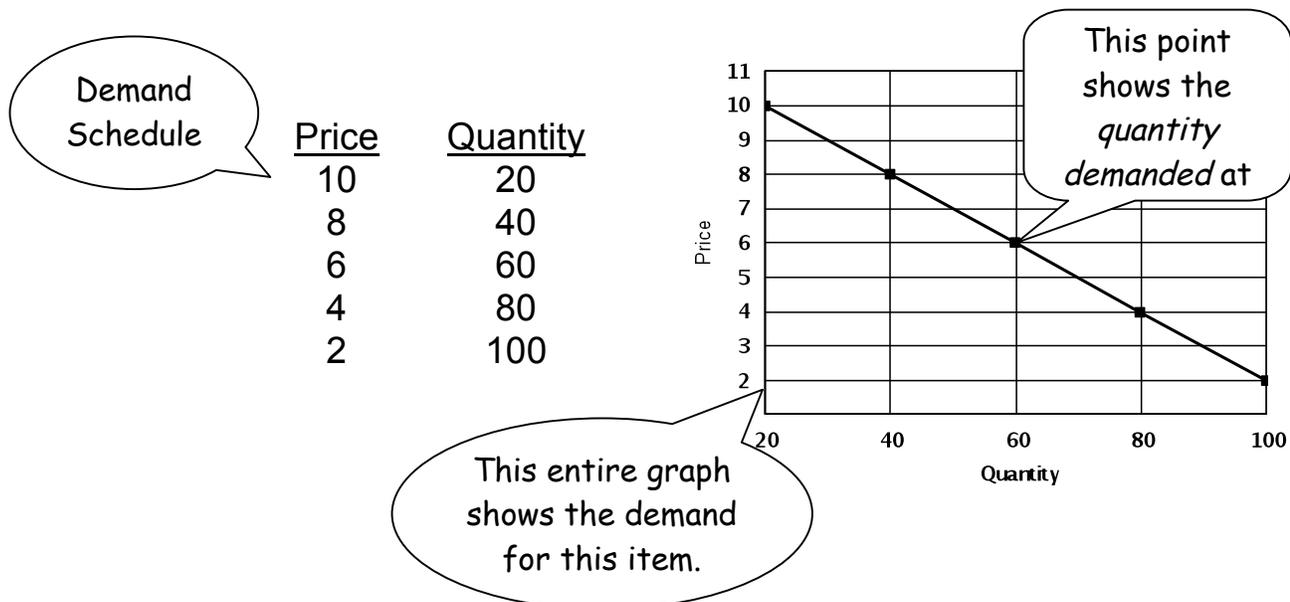
2) Demand Curve

a) What is it?

- a visual representation of demand
- a graph of the data on the demand schedule
- a graphic representation of the number of items people would buy at different prices

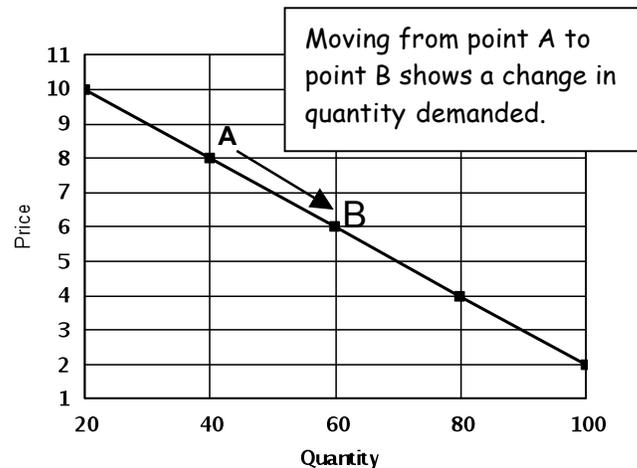
b) Slope

- negative slope
- a “downward” trend
- shows a negative relationship: as price increases, quantity demanded decreases, and vice versa



3) Changes in Quantity Demanded

- quantity demanded changes when there is a change in the price
- for example, if the price increases, the quantity demanded (items people are willing to buy) will decrease
- on a graph this is represented by moving to a different point on the SAME curve



D. Determinants of Demand

- these are things that would affect the way people think about an item they buy
- this change in thinking will cause consumers to buy either more or less of the item at all prices

1) Changes in the Number of Customers

- if the number of people in a particular area or region should increase, there will be a greater demand for items in that area, regardless of the price (the opposite is true for a decrease in population)

2) Changes in Consumers' Income

- if consumers, in general, find that they have more income, they will spend more money on goods and services – therefore, a change in income will impact the number of items bought at every price

3) Changes in Consumers' Tastes

- popularity of items and styles come and go, and as a result, so will the number of the item people will buy, at any price
- the change in personal preference may be the result of a change in season or be the result of a dying fad
- if consumers no longer find the low-rise style of jeans appealing, they will stop buying it

4) Changes in Consumers' Expectations

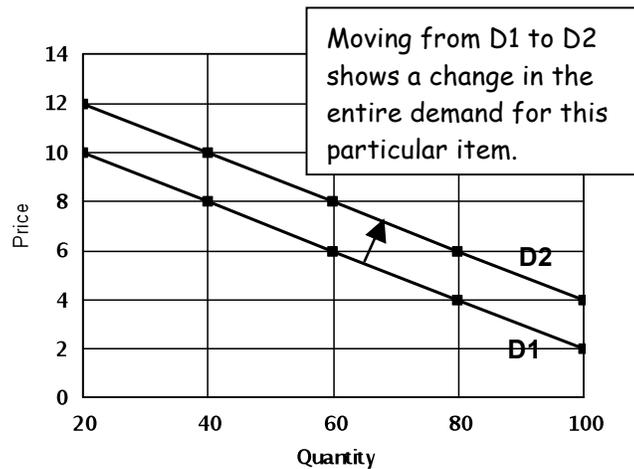
- this relates to a variety of causes
- anything that causes consumers to believe a change is coming in the near future will cause consumers to change the way they behave now
- if consumers expect there to be higher gas prices next week, they will go out and make sure to fill their cars today

5) Changes in the Price of Substitutes

- there are goods that are often times used in place of each other
- a change in the price of an item that consumers are not using but can be used instead of one that consumers are presently using will affect how many of the item they will continue to buy
- if the price of a substitute good decreases, some consumers will change their consumption from the good they are using to the cheaper good they can use in its place (and vice versa)
- if the price of potato chips increases, the quantity of potato chips demanded will decrease but there will be more people who will want to buy pretzels instead

6) Changes in the Price of Complements

- there are many types of items that are commonly used with another item
- when there is a change in the price of one of the items in that pair, it will not only affect the quantity demanded of that good, but will also affect how many people will buy of its complement
- if the price of peanut butter goes up, the quantity of peanut butter demanded will go down, and the number of people willing to buy jelly will go down too



E. Diminishing Marginal Utility

1) Marginal Utility

- “utility” means “usefulness”
- *marginal utility* is defined as “the amount of satisfaction added ‘at the margin’”
- the usefulness of adding more of the same item – or, how much more useful will one more of this item be to me?

2) Diminishing Marginal Utility

- this occurs whenever the additional item added is less useful than the previous item added
- the more you buy, the less useful each additional item is to you
- this is an important concept to a firm who has to determine if they should produce more items or hire more workers – “if I hire an additional worker, will the firm continue to make a profit?”

F. Elasticity of Demand

- how much will a change in price affect the quantity demanded

1) Elastic Demand

- demand is elastic when a relatively small change in price causes a relatively large change in the quantity demanded
- these items are usually not necessities or they have numerous and affordable substitutes

2) Inelastic Demand

- a given change in price causes a relatively smaller change in quantity demanded
- these items are usually necessities and have few or no substitutes

3) Specific vs. General Market

a) Specific Market

- examines the elasticity at an individual site
- if one store raises prices it is likely to see an elastic reaction if consumers can go elsewhere to get the same item at the old, lower price, and vice versa

b) General Market

- examines the elasticity of the entire market for an item
- if the price of an item increases everywhere, if the item is a necessity, there will be very little change in the quantity demanded

CHAPTER 6. SUPPLY

A. What is Supply?

- the number of items producers are willing to offer at different prices
- can be represented on a schedule or a curve (graph)

1) Everyone is a Supplier

- anyone who offers an economic product for sale is a supplier
- anyone who offers their services as a worker (labor) is a supplier

a) A Supplier's Decision

- “how much should I offer at various prices?”

B. Law of Supply

- this states the goal of producers (firms)
- at higher prices, producers will want to sell more than at lower prices
- price and quantity have a positive relationship, that is, as price increases, quantity supplied increases
- demonstrates a producer's desire to maximize profits

C. Supply and the Supply Schedule

1) Supply Schedule

- a listing that shows the quantities offered at each and every possible market price

2) Supply Curve

a) What is it?

- a visual representation of supply
- a graph of the data on the supply schedule
- a graphic representation of the number of items producers will be willing to sell at different prices

b) slope

- positive slope
- an “upward” trend
- shows a positive relationship: as prices increase. quantity supplied also increases (the opposite is also true)

3) Change in Quantity Supplied

- the amount offered for sale in response to a change in price
- on a graph, moving to a different point on the SAME curve represents a change in the numbers of items offered for sale

D. Profit Motive

- the reason why businesses are begun in a the United States is to make a profit
- it is believed that if a greater profit can be made in a certain industry, more people will begin businesses will open up in that industry
- this also helps to explain the “upward” slope of the Supply Curve, or the positive relationship between Price and Quantity Supplied: if a firm believes it can make more money, it will attempt to make more items

E. Determinants of Supply

- these are things that would affect the way businesses think about items they produce
- this change in thinking will cause businesses to sell either more or less items at all prices
- a change in supply causes the entire picture of supply to change
- on the graph, it causes the entire curve to move or shift

1) Changes in the Cost of Resources

- a producer has fixed amount of money with which to buy factors of production
- if the price of these resources changes, it will affect how much of the resources they can afford to buy
- for example, if the cost of wood pulp increases, a paper company will not be able to buy as much wood pulp, and therefore will not be able to make as much paper – the supply of paper will decrease if the cost of wood pulp increases

2) Productivity

- productivity refers to how efficiently (or how well) resources are being used
- firms attempt to be as efficient as possible
- the incentive workers feel or the condition of machinery can contribute to how productive those resources will be
- for example, a business gives workers improved training in the production of paper from wood pulp, these workers will be better at their jobs and the amount of paper they will produce in the same amount of time with the same number of resources will increase

3) Technology

- technology refers to the extent to which tools are created, invented, and used in production
- new technologies can change the productivity of resources by either making them more or less efficient and will therefore effect how many items a company produce with the same number of resources
- for example, a paper manufacturing company develops a new technology that will be able to make paper using less wood pulp, therefore, the firm can still buy the same amount of wood pulp but can now make more paper – if the wood pulp is more productive then the supply of paper will increase

4) Changes in Government Policies

- the government, in its attempts to protect consumers, workers, and the environment, will force producers to make safer product or create safer methods of production
- safer products cost more to produce and have the same effect as increasing the cost of inputs
- for example, the government changes its standard on pollution reducing the amount of pollutants that be expelled into the atmosphere; our paper factory must alter its machines in order to produce less pollution; the new change to the machines slows the machines down resulting in less paper production

5) Changes in Taxes and Subsidies

- **tax**: a fee paid to the government to help the government provide goods and services to the public
- **subsidy**: money given by the government to businesses to increase the production of certain products it believes will benefit society as a whole but which the government itself could not afford to do
- if the government changes the amount of money a firm has, either by changing the taxes it pays or the subsidies it provides, then it affect how much money the firm has to run its business
- for example, the government increases its tax on businesses; our paper manufacturing company will have to pay higher taxes and will therefore be unable to buy as many resources because it will have less money

CHAPTER 7. THE INVISIBLE HAND

- Adam Smith wrote in his book The Wealth of Nations that if consumers and producers were left alone to do what was in their own best interests, market would regulate themselves and government would not have to be at all involved in business
- This notion is known as *Laissez-faire*; loosely meaning for the government to leave the economy alone
- He argued that when everyone behaved in their own best interest, markets would be guided by common sense which he termed "*the Invisible Hand*"
- *The Invisible Hand* is the guiding force behind the Law of Demand (people will buy more at lower prices) and the Law of Supply (firms will produce more at higher prices); since neither can have it entirely their way, a compromise must be reached

A. Equilibrium

1) A Compromise

- sellers want high prices – but consumers will not buy
- buyers want low prices – but producers will not produce
- neither side can get exactly what it wants, so some adjustment is necessary

2) Market Equilibrium

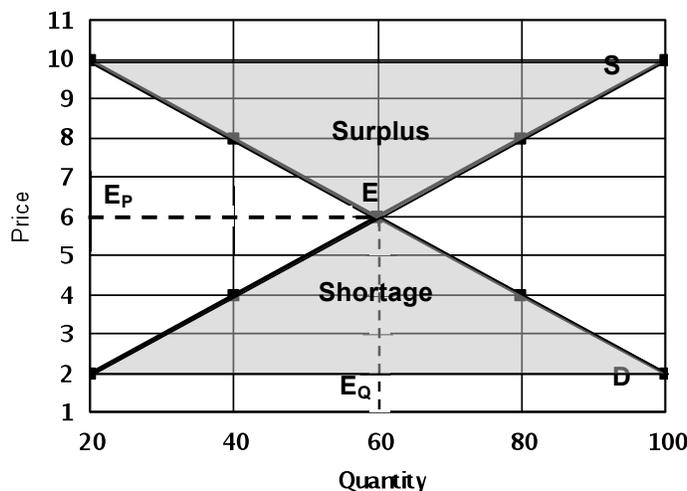
- in a competitive market, the adjustment process moves toward market equilibrium
- the price at which the quantity demanded equals the quantity supplied
- when this happens, every item offered for sale is sold and everyone who wants this item at that price, gets one
- ideally this would show the greatest efficiency of the market, there will be no waste and nothing left over

B. Surplus

- this occurs when the quantity supplied is greater than the quantity demanded
- this is because the item is being sold at a price that is too high
- a surplus causes sellers to lower prices

C. Shortage

- this occurs when the quantity supplied is less than the quantity demanded
- this is because the item is being sold at a price that is too low
- a shortage causes sellers to raise prices



E = Equilibrium
E_Q = Equilibrium Quantity
E_P = Equilibrium Price

D. Prices

1) Prices as Signals

- in a market economy, prices are used by producers and consumers to make decisions
- prices are used by firms to determine how many to produce
- prices are used by consumers to determine how many to buy
- they also help answer the three basic economic questions: "What to produce", "How to produce", and "For whom to produce"

2) Advantages of Prices

a) Prices Are Neutral

- prices are the result of competition between buyers and sellers and therefore does not favor either
- remember, the price is the compromise between consumers and producers

b) Prices Are Flexible

- prices can change as a result of all manner of events
- since buyers and sellers react to events, the way they view items in the market will change (it will change supply or demand or both); these changes will alter the compromise between the two sides resulting in a different price
- this happens without government involvement

c) Prices and Freedom of Choice

- freedom of choice is a cornerstone of American culture
- a market economy provides consumers with a variety of products as various prices giving them the option of which products to buy and when

d) Prices Are Familiar

- within an economy, people understand price
- all items are for sale in the same terms – dollars and cents – this gives all consumers and producers a frame of reference by which they can gauge personal value

CHAPTER 8. TYPES OF BUSINESSES

A. Business Combinations

1) Single Proprietorship (Sole Proprietorship)

- most common form of business organization in the U.S.
- a business owned and run by one person

a) Forming a Sole Proprietorship

- easiest form of business to start
- no one way exists for setting one up
- most open for business as soon as they set up operations

b) Strengths

1) *Ease of Start-up*

- all it takes is a person with an idea

2) *Ease of Management*

- decisions are made quickly by one person
- can be very flexible, can change gears on a moments notice

3) *Profits*

- the one owner keeps all of the profits

4) *Taxes*

- the only taxes paid are personal income taxes, not corporate taxes

5) *Psychological*

- freedom of being your own boss
- high degree of personal satisfaction

6) *Ease of Exit*

- getting out of the business is just as easy as getting in, just decide to stop

c) Weaknesses

1) *Unlimited Liability*

- owner is personally and fully responsible for all losses and debts of the business
- owner can lose personal belongings if the business fails and must pay more than the business worth

2) *Raising Financial Capital*

- banks and lenders usually do not want to lend money to a sole proprietor because they are usually not very profitable, they are a risk

3) *Size and Efficiency*

- it is difficult to buy enough capital necessary to make the business efficient due to financial limitations

4) *Limited Managerial Experience*

- usually the sole proprietor knows his craft or service well but not the intricacies of running a business

5) *Attracting Qualified Employees*

- not having enough money to offer fringe benefits makes it difficult to attract qualified people, they are usually drawn to larger companies that have greater chance for success

6) *Limited Life*

- when the owner dies, quits, or sells the business, then the firm ceases to exist legally

2) Partnerships

a) Description

- a business owned by two or more persons
- shares many of the same strengths and weaknesses of a sole proprietorship

b) Forming a Partnership

- formed in the same way as a sole proprietorship, all it takes is an idea
- partners agree in a legal document, called *articles of partnership* how to divide costs and profits and losses and even the terms of dissolution (break-up) if it should ever be necessary

c) Strengths

1) *Ease of Start-up*

- just an idea is all it takes

2) *Ease of Management*

- each partner brings different ideas and area of expertise to the business

3) *Taxes*

- no corporate income taxes
- only personal income tax for each of the partners

4) *Raising Capital*

- has the resources of all the partners to raise capital
- being a bigger business, they are more likely to secure loans from banks

5) *Efficiency*

- more people to specialize in different tasks

6) *Attracting Qualified Employees*

- the bigger the firm, the more money it has to attract more qualified and talented workers

d) Weaknesses

1) *Financial Responsibility*

- each partner is responsible for the acts of all the other partners
- unlimited liability

a) *limited partnership*

- limits the liability for the investor to only the amount of money that was loaned

2) *Limited Life*

- when a partner dies, quits, or a new partner is added the original firm legally ceases to exist, the firm must be reorganized to continue but it may have a slightly different look

3) *Potential Conflict*

- more partners means more chances for differences of opinion that cause the business to fail or take away from the personal of the partners

3) Corporations

a) Description

- business organization recognized by law as a separate legal entity
- has the right to buy and sell property, enter legal agreements, and sue / be sued

b) Forming a Corporation

- must file for permission from the national or state government where it will have its headquarters
- if approved the government will issue a charter
- the charter identifies how much stock will be issued as well as how much money will be raised by sale of stock

c) Strengths

1) *Ease of Raising Financial Capital*

- selling stock to investors to get the money necessary to start the business
- can issue bonds to investors, basically a loan, a promise to pay the money back in full plus interest

2) *Efficiency*

- the board of directors can hire the best management for each of its respective departments

3) *Limited Liability*

- investors can only lose the amount of money they spent on the stocks

4) *Unlimited Life*

- the business continues to exist even if ownership changes
- so long as the business stays in business it is recognized as a legal entity

d) Weaknesses

1) *Difficult to Start-up*

- it is expensive to get a charter

2) *Little Owner Involvement*

- stockholders have little say in how the business is run after they have voted for members of the board of directors

3) *Taxes*

- since it is its own legal entity, it must pay corporate income taxes which are usually higher than personal income tax

4) *Government Regulation*

- because this business is bigger and has more power, the government keeps a more careful eye on it.

B. What Must Be Done To Form A Corporation:

1) Registering the Corporation

a) Articles of Incorporation

- The people involved must file a series of papers including **articles of incorporation**.
- These papers vary from state to state but generally require the founders to give the following information:
 - 1) Name, address, and purpose of the corporation.
 - 2) Names and dresses of the initial **board of directors** (the people starting the corporation).
 - 3) Number of shares of **stock** to be issued (we'll talk about stocks very soon)
 - 4) Amount of capital to be raised by issuing the stock.
- If all of these are approved, then the state will grant the founders a corporate charter.

2) Selling Stock

- Stocks are small pieces of the company.
- These represent a percentage of the corporation.
- The money received from selling these stocks is the money used to buy the factors of production used to start the business.

a) Stockholders

- the people who bought stocks
- they become part owners of the corporation and are therefore partially entitled to the decision making process of the corporation.

3) Naming a Board of Directors

- the group of people who direct (make the decisions for) the corporation
- they are stock holders that are chosen annually by the votes of all the stockholders
- the greater the percentage of stock a stockholder owns, the more votes they have.

C. What are Stocks and How do they work?

- stocks represent a portion of a corporation
- stocks are sometimes called **shares** because the stockholders *share* ownership of the corporation.
- ownership of stock shows how much of that corporation the shareholder owns – if a person owns 10% of all the stock for that corporation, then they own 10% of the corporation and are therefore entitled to 10% of the profits

D. How do stockholders make money by buying stock?

- There are 2 ways stockholders can make money through the ownership of stock

1) dividends

- since stockholders are part owners of the corporation, they are entitled to part of the profits
- the amount they receive is proportionate to the number of shares they own
- the board of directors sets the **dividend rate** which is the amount of money a stockholder will receive for each share they own

- it is important to note, that dividends are only paid when the corporation makes a profit since this payment comes out of their profits

2) speculation

- when a person buys stock they buy it at a specific price
- the price of the stock is determined by supply and demand
- there is limited supply of stock available which is limited by the initial articles of incorporation
- making money from speculation depends on the value of the stock when they sell it:
 - 1) if the price is higher than what they bought it for then they will make that much money per share;
 - 2) if the price is lower than what they bought it for then they will lose that much money per share.

a) effect of demand

- the demand for the share has the greatest effect on its value
- if the corporation does well then the demand for the share will increase, the result is an increase in its price
- if the corporation does not do well, then the demand for the share will decrease, the result is a decrease in its price.

3) Two Types of Stocks

COMMON STOCK	PREFERRED STOCK
1) Common Stock is issued by ALL corporations; it is the stock most often bought and sold.	1) Issuing Preferred Stock is optional. Not all corporations offer preferred stock
2) Holders of Common Stock have voting rights in the corporation. As a group, they elect the board of directors, who is also a stockholder.	2) Holders of preferred stock have no voting rights in the corporation.
3) Common Stock pays dividends based on a corporation's performance. If the company does well the dividends will be high; if it does poorly the dividends will be low or not at all.	3) Preferred Stock pays a fixed dividend. This rate does not change regardless of the corporation's performance. This amount MUST be paid BEFORE the common stock holders receive their dividend. This will usually cause a lower dividend rate to be paid to the common stock holders.
4) Value of Commons Stock rises and falls in relation to the corporation's performance and what investors expect it to do in the future.	4) Value of Preferred Stock changes in relation to how well the company is doing.
5) If a corporation fails, holders of Common Stock are the last to be paid with whatever money is left after paying all creditors and holders of preferred stock.	5) If a corporation fails, holders of preferred stock must be paid before any holders of common stock but after paying off all other creditors.

CHAPTER 9. LABOR

- Labor is in a unique position. Businesses need labor because it fulfills 2 roles:
 - 1) factor of production (resource)
 - 2) source of demand.

***** In order for businesses to make a profit they must satisfy the labor force's financial needs because the labor force also creates demand (they buy products).*****

A. Wages

- The value of employees is determined by the supply & demand for that worker.
- Factors of Production are purchased according to a firm's profit: the more money it makes the more resources it can buy.
- This is called **DERIVED DEMAND**. The *demand* for a factor of production is *derived* from (comes from) how much that company sells. In other words, if sales increase, then the demand for labor will also increase so that the firm can increase production to meet the demand.
- The amount a company is willing to spend on a resource depends on the price it can charge for its final product. The more money the company makes, the more it will spend on production. (But you already knew that from the law of supply!!!)

1) How many workers should the company hire? Companies will only hire workers if they are useful and can still increase their profit.

a) diminishing marginal utility

- is a measure of a worker's usefulness.
- this is a type of **Diminishing Returns** - at a certain point, the addition of another worker will increase your productivity less and less.

b) equilibrium wage rate

- is where the number of jobs (demand) and workers (supply) are exactly the same (where the lines intersect on a graph).

2) Categories of workers: There are two ways to classify workers:

a) by the type of work they do:

- Blue-Collar workers
- White-Collar workers
- Service workers

b) and by skill:

- Unskilled workers
- Semi-skilled workers
- Skilled workers
- Professionals

B. Unions

- A **Labor Union** is an association of workers organized to improve wages and working conditions for its members.

*****Main idea: Unions are based on the idea that workers in a group will have more influence on management than will one individual working alone.*****

1) Types Of Unions:

a) Craft Union: made up of skilled workers in a specific trade or industry (carpenters, printers, shoemakers). The first organization of national labor unions was the American Federation of Labor (AFL) in 1886.

b) Industrial Unions: made up of all workers in a particular industry, regardless of job or skill level (United Mine Workers). The first major effort to organize industrial unions was not begun until the formation of the Congress of Industrial Organizations (CIO) in 1938.

2) Union Organization:

Today there are three levels of union organization:

a) Local Unions:

- (also called “locals”) consist of all members of a union in a particular manufacturing plant, company, or geographic area.
- Responsibilities: deals directly with a company or management council by first negotiating a contract and then making sure the terms of the contract are kept.

b) National/International Unions:

- represents locals nationwide.
- Responsibilities: provides lawyers, professional negotiators, and other staff members to help negotiate between a local and a particular company.

c) Federations:

- made up of National and International Unions. This is the AFL-CIO.
- Responsibilities: represents its member unions in both federal and state congresses with lobbies for pro-labor legislation. It also offers training and advice to the leadership of the member unions.

3) Labor Legislation

ACT	ALSO KNOWN AS	YEAR	SIGNIFICANCE
Sherman Act		1890	This act states that all combinations that interfere with business are illegal. This law was originally intended to restrict certain business practices but eventually was used against labor unions.
Clayton Act		1914	This act helped clarify the use of the Sherman Act. It says that the Sherman Act was designed for use against business combinations and not against unions. Therefore unions should be allowed to be organized.
Norris-LaGuardia Act	Federal Anti-Injunction Act	1932	The courts can not issue an injunction that prevents people from using action in a labor disagreement providing the actions are peaceful and do not violate the rights of others. Injunctions may not be issued that prevent: <ul style="list-style-type: none"> • people from going on strike • people from joining a union • payment of unemployment benefits or strike insurance to anybody on strike • others from helping a person involved in a labor dispute • peaceful assembly that promotes the interest of the labor dispute
Wagner Act	National Labor Relations Act	1935	Lists the rights of employees: <ul style="list-style-type: none"> • self-organization • collective bargaining through representatives of their own choosing • engaging in activities for the purpose of collective bargaining or other mutual aid or protection Lists what are considered "unfair labor practices:" <ul style="list-style-type: none"> • interfering with any of the right that are listed above • preventing a worker from talking with a union representative • discriminating based on union membership • discriminating against workers who have filed complaints against the firm • refusing to bargain collectively with labor representatives Establishes and empowers the National Labor Relations Board (NLRB): <ul style="list-style-type: none"> • may prevent any person from engaging in any unfair labor practice listed above • if it is found that unfair labor practices have been committed, the Board may call a hearing on the grievance (STATUTE OF LIMITATION: 5 days to 6 months) • may petition a US Court of Appeals to issue an injunction in order to provide some form of temporary relief • a person who feels believes that they have been unjustly served by a decision by the Board may appeal to a US Court of Appeals.

Taft-Hartley Act	Labor Management Act	1947	This act was a response to fears of labor unions that arose after the Wagner Act. Outlaws the following acts of unions: <ul style="list-style-type: none"> • violence and intimidation • secondary boycotts • strikes that compel an employer to commit an unfair labor practice • limited union activities which are designed to coerce employees in deciding to join a union This act also prohibits closed shops and limited union shops.
Landrum-Griffin Act	Labor Management Reporting and Disclosure Act	1959	This act further strengthened the Taft-Hartley Act. It regulates the internal affairs of unions.

C. Labor-Management Relations

- **goal of firms:** low wages and benefits to keep costs low and profits high.
- **goal of unions:** increase wages and benefits for members.

Obviously, both sides can't have everything they want.

1) **Collective Bargaining** is a form of compromising.

a) STEP 1: **Negotiation:** Representatives from both sides will sit down and work out an agreement where both sides will gain a little and lose a little. In other words, a compromise.

b) STEP 2: **Mediation:** If neither side agrees to the others terms they will choose a neutral *mediator* who will suggest solutions and works to keep both sides talking to each other.

- A mediator is a person or group of people who will hear a list of demands from both sides and then will come up with a compromise and present it to both sides. This agreement does not have to be accepted.

c) STEP 3: **Arbitration:** If mediation fails then the two sides will submit their demands to a third party who will come up with a solution. The opposing side must agree in advance to accept the arbitrator's decision.

-----OR-----

If the sides do not agree to arbitration (or the law does not require arbitration) then the sides may regress to their weapons to get what they want.

D. Minimum Wage and The Supply & Demand Of Labor

- **Minimum Wage:** Lowest wage that can be earned by a worker. The first minimum wage was established by the Fair Labor Standards Act of 1938.

1) **Minimum Wage is a Price Floor.** Labor needs to be purchased just like any other resource. The government wants to make sure that the people who provide the labor receive a fair price for their resource.

- This is just another way of saying that this is the lowest that can be charged for labor. This has various effects:

a) Minimum wage has no effect on firms that hire skilled labor because skilled labor earns substantially more than minimum wage. Minimum wage will never reach their salary.

b) According to the law of demand, at higher prices consumers will demand less. The same is true of labor. If the price of labor goes up, firms will be willing to hire fewer people.

- This creates a surplus of workers from which firms can choose. This leaves the potential for discriminating hiring practices.

CHAPTER 10. ECONOMIC PATTERNS

National Income Accounting:

- a system of statistics and accounts that keeps track of production, consumption, savings, and investment in the economy
- used to study the total amount of good or services the economy as a whole produces

National Income and Product Accounts (NIPA)

- accounts used to measure how the economy is doing and to trace long-term trends

A. Gross Domestic Product

- Gross Domestic Product = GDP
- the dollar amount of all final goods and services produced within a country's national borders in a year

1) Measurement

- all final goods and services produced in a 12-month period are multiplied by their prices to get the dollar value of production

2) Sampling and Survey Methods

- used to estimate all of the goods and service produced and their respective prices
- most figures used to compute GDP are based on reliable estimates while a few others are based on educated guesses
- the result is GDP is an estimation

3) Intermediate Products

- products that are used in making other products are excluded from the GDP
- if these products were not eliminated from the calculation, they would be counted twice in the GDP and would make GDP seem larger than it actually is

4) Secondhand Sales

- when a product is bought new, for the first time, it is counted as production for that year
- buying a used item does not constitute new production, it is merely the purchase of an existing item
- the purchase of used goods is not counted in the GDP

5) Production Within National Borders

- regardless of who owns a company, if the item is made with in the borders of a particular country, it is counted in that country's GDP
- foreign companies producing their items in the US will have their production count towards the US GDP
- remember, our GDP measure how productive Americans are, foreign companies in the US use American workers

6) Other Considerations

a) Reporting Delays

- since GDP measures so many goods and services values given on a particular date correspond to data collected months before
- even after GDP numbers are released, these results will continue to be revised and will continue to delay the measurement

b) Composition of Output

- GDP does not measure what types of items are being produced
- just because the GDP increases, it does not mean that what was produced is beneficial, and vice versa

c) Quality of Life

- people value more than just money, they also place a value on their happiness and comfort
- just because GDP increases, it does not mean that what was produced is beneficial, and vice versa, it may be damaging to something the individual places value on

i) Measure of Economic Welfare

- this would be an adjustment of GDP to reflect quality of life issues

d) Exclusion of Nonmarket Activities

- any business transaction that is not measured by the government is not part of GDP
- when a person gets paid in cash and does not declare it on their annual taxes, it is not measured by the government, and therefore not part of GDP

e) Illegal Activities

- the purchase of an illegal good or service is not measured in GDP because the government does not know about that transaction (if they did then arrests would be made)
- these activities are part of the underground economy

7) *Importance of GDP Analysis*

- even though GDP is a “best estimate” it is a good indicator of economic health
- economists make predictions based on the GDP and how it increases or decreases quarter to quarter

a) Economic Performance

- the change in GDP reflects how the economy is doing
- people react to changes in the economy, government leaders predict that people will become unhappy when GDP declines
- people tend to blame government leadership for poor economic performance, therefore government leaders will create new economic policies in order to improve the GDP

B. Measuring Economic Growth

- short-term measurement
- real GDP is useful for measuring economic growth for short periods, 1 to 5 years
- real GDP is calculated quarterly (every 3 months)

1) Real GDP per Capita

long-term measurement

- real GDP per capita produces a more accurate comparison for periods of time longer than 5 years
- real GDP per capita divides real GDP by the population thus showing, on average, how productive each person is
- this measurement takes population into account when comparing different countries
- by comparing growth of real GDP per capita to the growth of the population economists can predict the health of the economy

2) Importance of Economic Growth

a) Standard of Living

- increased production per capita will cause more productive people to be able to afford more goods and services
- by purchasing things that make life easier people can get more enjoyment out of life by having more free time to devote to family, hobbies, or recreational activities

b) Government Spending

- the productive people are, the greater the tax base becomes
- more tax revenue translates into more and better public services provided by government

c) Domestic Problems

- economic growth creates more jobs and more income for people
- more person wealth will alleviate problems, such as poverty, unemployment, and other social problems

d) Helping Other Nations

- economic growth allows people to be able to afford more goods, including those imported from foreign nations
- greater demand for foreign goods stimulates economic growth in the foreign nation(s)
- the foreign nations whose economies grow can afford to buy American made product, thus causing economic growth in the United States

e) Global Role Model

- many nations are developing their economic systems, the success seen in the US may cause these nations to choose economic systems similar to ours

3) Factors Influencing Economic Growth

a) Land

- the amount and types of resources available limits what and how much can be produced
- most nations need to import at least some of their resources

i) Conservation

- most resources will eventually run out, as a result, nations must learn to conserve their limited supplies
- nations are spending money on developing and using renewable resources so that there will always be a supply

b) Capital

i) Capital-to-Labor Ratio

- the average amount of capital each worker uses in his or her job
- greater production results in higher capital-to-labor ratios
- higher capital-to-labor ratios usually encourages economic growth

ii) Creating Capital Goods

- when people save, more money is available for banks to loan out
- when businesses borrow money, they spend it on increasing capital (new machinery or repairing machinery, building new factories, etc.)
- the government can encourage people to save by changing interest rates so that the consumer will get a greater return on the money they put away in the bank

c) Labor

- workers are needed in order for their to be any sort of production
- better trained and more skilled workers allow for greater efficiency and production
- a larger population has more people to contribute to the work force, thus increasing production
- “a happy worker is a productive worker”

d) Entrepreneurs

- without entrepreneurs to take risks, new methods of production are not possible and therefore economic growth is slow
- as a result, the government implements policies that encourage people to take risks and invest their time and money in developing new ideas

4) Productivity and Growth

a) Historical Record

i) Labor Productivity

- generally speaking, the more work done by labor, the more production that will occur
- labor is the variable in the equation due to the factors affecting their motivation and dedication to their work
- large populations do not guarantee high levels of productivity if the labor force is unskilled, unhappy, or unmotivated

b) Effects

- lower levels of productivity will cause there to be a decreased supply of domestic products
- this lower supply will be supplemented with foreign goods
- when people buy the foreign goods, domestic producers lose money and are forced to make cuts, often times by laying off workers
- as unemployment rises, fewer people can afford to purchase the items they were buying while they were still employed, therefore domestic producers will cut back on production
- the result, smaller economic growth and declines in productivity

c) Causes

- despite efforts to understand what causes these changes in economic growth, no one can know for sure because there are so many different factors involved

C. Business Cycle

1) Phases of the Business Cycle

- the phases are sometimes difficult to determine because of the delays in reporting of GDP
- a) Recession
 - occurs when the real GDP declines for two quarters (6 months)
- b) Peak
 - the point where the real GDP stops growing (more commonly, when the economy stops growing)
 - this is the last thing before a recession
- c) Trough
 - the turnaround point at the end of a recession
 - the real GDP stops going down (more commonly, when the economy starts growing again)
- d) Expansion
 - the period of recovery after a recession
 - the real GDP increases quarter after quarter (more commonly, the economy is growing)
 - this will continue until another peak is reached
- e) Depression
 - a severe recession
 - usually long lasting and accompanied by high unemployment, shortages, and idle capital

2) Causes of Business Cycles

a) Capital Expenditures

- when the economy is growing, businesses will spend more money on expanding their production by buying new capital (buildings, machines, etc.)
- once companies believe they have expanded enough, they will stop and as a result, the companies that they bought the new equipment from sees a decline in profits
- declines in profit result in cutbacks, layoffs, which may eventually result in a recession

b) Inventory Adjustments

- retail stores adjust their inventory based on economic predictions
- this will cause the amount of money spent in different industries to change and will cause the business cycle to change

c) Innovation and Imitation

- innovation (new inventions, methods, ideas) causes the innovator to have an advantage in the industry
- competing firms must invest money in trying to keep up with the innovator thus causing economic growth
- once all of the companies catch up with the new innovation, investment slows and so will the economy

d) Monetary Factors

- interest rates (the price a person has to pay in order to borrow money) will cause a change in the number of people who want to borrow money
- the government will lower rates to encourage more borrowing which means more spending and a growing economy
- after a while the government may raise interest rates to alleviate other problems which means less new borrowing and therefore less spending resulting in a slowing economy

e) External Shocks

- our economy is influenced by pressure from outside sources
- policies and problems in other nations affect the prices of the goods produced in those countries and the demand for US goods in those countries
- in either case, prices in the US are affected

3) Predicting Business Cycles

a) Econometric Models

- algebraic equations that are used to determine how money is flowing in the economy
- (don't worry about the formulae, they are not necessary for our understanding of economics)

b) Index of Leading Indicators

- different things in the economy are measured, sometimes for reasons we don't understand, such as the length of the workweek, size of inventories, and the sale of durable goods
- many of these measurements are used to help predict changes in economic growth
- in general, when the leading indicators turn down for 3 months in a row economists predict a recession on the horizon

D. Unemployment

1) The Unemployment Rate

- people are considered unemployed who are available to work and make a specific effort to find a job during the past month and who worked less than 1 hour for pay or profit
- unemployed are also those who work in a family business without pay for less than 15 hours a week
- the unemployment rate is the number of unemployed people divided by the total number of people in the civilian workforce
- recessions cause a sharp increase in unemployment rates, while periods of expansion see a slow decrease in the unemployment rate
- the unemployment rate is very sensitive to downturns in the economy and is one of the lasting effects of a recession

2) Limitations of the Unemployment Rate

a) dropouts

- people who become frustrated and quit looking for work are not considered unemployed, they “dropout” of the civilian workforce

b) lower-wage jobs

- people who are highly skilled but are forced to find new work will sometimes take minimum wage jobs while looking for a job that demands and pays for their skills
- even though these people may have taken a huge reduction in wages, they are still employed and are therefore not part of the unemployment rate

3) Kinds of Unemployment

a) Frictional Unemployment

- these are people who are “between jobs”
- these people may be looking for new work because they were fired, laid off, or quit

b) Structural Unemployment

- this occurs when changes in the economy causes a decline in the demand for specific types of workers and their skills

i) reasons

- people's tastes change and therefore no longer demand a particular item
- industries change the way they operate becoming more efficient or merging with similar companies and laying off duplicate workers (not changes due to technology)
- government operations may cause different sectors of the population to become unemployed due to changes in priorities and policies

c) Cyclical Unemployment

- this is the unemployment that results from changes in the business cycle
- these are long term trends, usually covering 3-5 year periods

d) Seasonal Unemployment

- this occurs when the demand for specific types of workers are not needed during certain seasons of the year
- this is a short term pattern usually occurring year after year

e) Technological Unemployment

- this reflects those who are put out of work due to automation, that is those who are replaced by machines because they are more cost efficient

4) The Concept of Full Employment

- full employment is not an absolute zero unemployment rate, it is the lowest unemployment rate possible with the economy growing and all factors of production being used as efficiently as possible
- that is, full employment occurs when adding additional workers will not increase production
- today, economist generally accept full employment to be below 5%

E. Inflation.

1) Measuring Inflation

a) Price Level

- this is the extent of prices in one point of time compared to prices at another period of time
- this shows how much items cost, in general, at two different points in time

b) Inflation

- this is the rate at which the price level changes
- since it is known that prices will not remain the same, this measurement shows by what percentage the price level has changed over time

i) deflation

- on rare occasions, price levels may decrease, this is called deflation

2) Degrees of Inflation

- price levels may change at different rates, from slow to fast

a) Creeping Inflation

- this is when price levels rise at a rate of about 1 to 3 percent

b) Galloping Inflation

- this is when price levels rise at a rate greater than 3 percent, sometimes as high as 100 to 300 percent

c) Hyperinflation

- this is when price levels rise at ridiculous rates

3) Causes of Inflation

a) Demand-Pull

- this occurs when all sectors in the economy buy more than the economy can produce
- this increased demand causes shortages and will force sellers to raise prices

b) Government Deficit

- when the government spends more money than it has it is said to be running at a deficit
- if there is a deficit, the Federal Reserve may expand the money supply, if this happens, there will be more money in circulation and therefore there will be higher prices as more people want more of that money

c) Cost-Push

- increased cost force businesses to raise prices to cover
- this may be the result of labor groups that force new conditions in the workplace that cause the manufacturer to spend less money, as a result, they will charge higher prices to make up for the losses
- sometimes there are external factors that force costs up and as a result cause prices to rise

d) Wage-Price Spiral

- this is the result of a never ending cycle where an increase in wages causes a producer to charge higher prices to pay its workers, this will result in a demand for higher wages to cover the rate of inflation, and so on.

e) Excessive Monetary Growth

- this is when the money supply grows faster than real GDP
- the extra money that is either created or freed up will have a demand-pull effect on the price level

4) Consequences of Inflation

a) The Dollar Buys Less

- as prices rise, a dollar will be able to buy less and less

- for example, today, if a person spends \$1 on an item, it would have cost a person in 1933 only 6¢ to buy the same item
- this hurts retired people more than others because their fixed income will not adjust for the rate of inflation

b) Spending Habits Change

- as prices rise, people will be less likely to buy expensive items, such as durable goods, because they can no longer afford them
- loans also become more expensive and items that usually require loans to purchase, such as houses and cars, will see a decline in purchases

c) Speculation Increases

- the result of inflation is higher prices, some people see this as an opportunity to buy items that they know they can resell later at a higher price (this is called speculation)
- this may result in some structural unemployment as less money is spent on conventional purchases

d) The Distribution of Income Is Altered

debtor: a person who borrows money

creditor: a person who loans money

- inflation affects the buying power of a dollar, when a person pays back a loan over 5, 10, 30 years, when the loan is finally paid off, the buying power of the dollar is less, therefore the value of the money loaned out by the creditor is less after it is paid returned

CHAPTER 11. MONEY

A. Value of Money.

- 1) Money alone has very little value.
- 2) The value of money comes from the things it can be exchanged for.
- 3) In the U. S. today, we use **FIAT MONEY**, this means that it is money because the government says it is.

B. Functions of Money.

1) **Medium of Exchange**

- we use money to trade for the things we need and want.

2) **Measure of Value**

- we can compare the value of different items because we know how much money each item is worth.
- Today, money is a symbol of the value of the work/labor we perform.

3) **A Store of Value**

- we can accumulate (save) money so that (hopefully) when we are ready to use it, it will have the same value.

C. Characteristics of Money

1) **Portability**

- money must be convenient enough that it can be easily transferred from one person to another.

2) **Durability**

- it is important for the physical money will last a good amount of time before falling apart. We don't want it to crumble into nothing before we have a chance to use it.

3) **Divisibility**

- money needs the ability to be broken down into smaller amounts so that people will use only the amount that is needed.

4) **Stable Value**

- from week to week, month to month, a person must have confidence that their money will have the same buying power.

D. How Money Works

1) Most money flows through the economy in the form of a check.

- a) The consumer writes a check for payment on some good or service.
- b) The producer accepts this payment and deposits it in the business' account at their bank.
- c) The producer's bank credits (adds) to the company's account the amount of the check.
- d) The bank now deposits that same check in its account in the **Federal Reserve (FED)**.
- e) The Fed credits the producer's bank with the amount of the check and debits (subtracts from) the account of the consumer's bank the amount of the check. The check is then sent to the consumer's bank.
- f) The consumer's bank gets the check and debits the consumer's account for the amount of the check.

2) **The Growth of Money**

a) inflation

- this is seen as a rise in prices, but why?

i) If the supply of money increases, and the number of goods and services available remains the same, then people will be able to afford more things and there will be a shortage.

ii) In order to prevent a shortage, companies will need to raise prices to meet the need for their item.

b) How does the supply of money increase?

- i) Money supply increases because banks give loans with the money that is deposited.

ii) Expansion Multiplier

- Using the following formula, anybody can determine how much expansion their money will have when they make a deposit in the bank.

$$\text{Amount of Expansion} = \text{deposit} \times \frac{1}{\text{reserve requirement}}$$

iii) Banks are required to hold on to a certain amount of money that they receive through deposits so that they can pay people who make withdrawals.

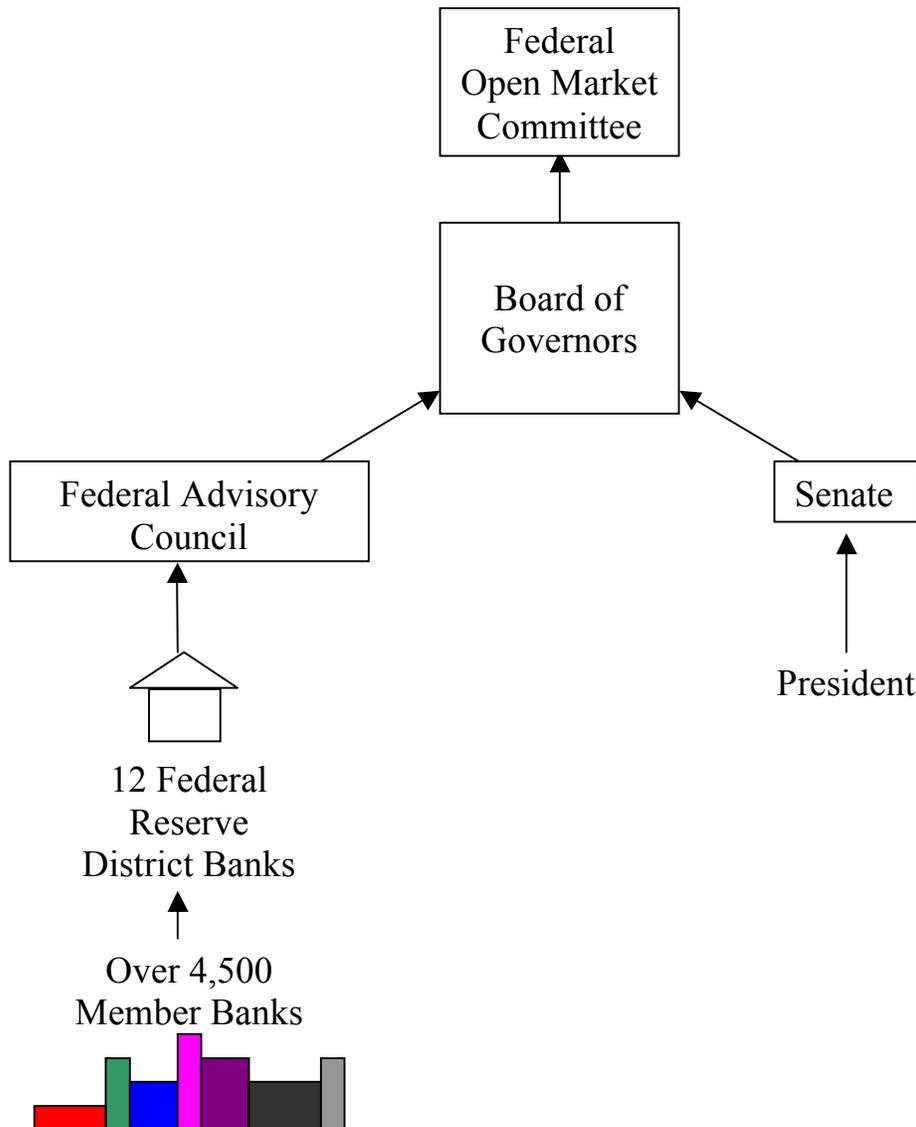
iv) This is VERY IMPORTANT: THE EXPANSION OF MONEY IS **NOT** HOW MUCH INTEREST YOU WILL RECEIVE ON YOUR ACCOUNT. It is the most money that the bank can loan out based on your initial deposit.

CHAPTER 12. THE FEDERAL RESERVE SYSTEM (THE FED)

A. Purpose

- The Federal Reserve System was created in 1913 to serve as a bank that can lend money to other banks in times of need. All national banks were required to join the Fed.

B. Structure



1) Board Of Governors (Federal Reserve Board)

a) Consists of 7 members appointed by the President and approved by the Senate. They serve for 14 years.

b) Jobs of the Federal Reserve Board:

- sets general policies for the Fed and member banks to follow
- regulates certain operations of state-chartered member commercial banks
- conducts some aspects of monetary policy
- makes annual reports to Congress
- puts out a monthly bulletin that reports on national and international monetary matters

2) Federal Open Market Committee (FOMC)

a) Consists of the 7 members of the Board of Governors and 5 district Reserve bank presidents

b) Jobs of the FOMC

- meets 8 times per year

- makes decisions about the growth of the money supply and the level of interest rates

3) Federal Advisory Council

- a) meets 4 times per year with the Board of Governors
- b) consists of 12 members, each appointed by a Federal Reserve Bank
- c) Provides feedback to the Federal Reserve Board on matters concerning the overall health of the economy

C. Responsibilities of the Fed

1) Monitoring Reserves

- The Fed makes sure that banks maintain the reserve requirement, no more, no less.
 - a) Importance of Reserves
 - to clear checks
 - to control the money supply (expansion of money)

2) Regulating Foreign Banks

- Because there are so many foreign bank branches in the US, the Fed needs to protect the US economy by monitoring their practices.

3) Monitoring Bank Mergers

- If 2 banks merge, the resulting bank will control a larger portion of the economy. As a result, the Fed makes sure detrimental mergers do not occur.

D. Tools of the FED

- In order for the government to regulate the value of money, as in Article I, section 8 in the US Constitution, a central bank was created.
- the central bank, through the FOMC has three tools at its disposal in order to influence the economy in the way they desire.

1) Reserve Requirement

- banks are told by the FED what percentage of all deposits it must keep in its vaults
- this reserve requirement affects how much money a bank can loan
- a high reserve requirement ensures that the bank keeps more money in its vaults and therefore prevents it from loaning out more money
- a low reserve requirement lets the bank know that it can keep less money in its vault and loan more money

2) Discount Rate

- also known as the Federal Funds Rate
- this is how much a bank has to pay the federal reserve in order to borrow money from it
- this rate (a %) will also cause banks to change the rate of money they loan
- a higher discount rate means a higher loan rate and less money borrowed from the bank
- a lower discount rate means a lower loan rate and more money borrowed from the bank

3) Open-Market Operations

- this is when the FED buys and sells bonds to and from banks and the public
- this allows the FED to control the supply of money
- if the FED buys bonds from the banks and the public, it is paying cash for them and is therefore putting more money in circulation
- if the FED sells bonds to the banks and the public, it is receiving money and is therefore taking money out of circulation

E. How the FED Fixes the Economy

1) Tight Money Policy

- if there is too great a rate of inflation, the FED will need to find a way to reduce the amount of money being spent in the economy
 - a) Reserve Requirement**
 - to decrease the amount of money that is being spent, the FED may choose increase the *reserve requirement*
 - a higher reserve requirement means that banks must keep more cash in their vaults resulting in less money in the economy
 - b) Discount Rate**
 - banks base the rate (price) of a loan on the rate the FED charges to borrow money from it
 - by raising the discount rate, the price of loans would rise, and fewer people would borrow money
 - c) Open-Market Operations**
 - in order to reduce the amount of money in circulation, the FED will sell bonds to banks and the public
 - the cash the FED receives for these bonds are not spent by the FED and are simply taken out of the economy

2) Loose Money Policy

- if there is a recession (usually accompanied by unemployment) the FED will do whatever it takes to get more people to spend money
 - a) Reserve Requirement**
 - if the FED lowers the reserve requirement, banks will be able to loan out more money
 - by loaning more money, more people want to buy things resulting in the need for more workers (lower unemployment)
 - b) Discount Rate**
 - if the FED lowers the discount rate then it will loan money to banks at a lower rate
 - if banks are receiving lower interest rates for loans from the government, then they will loan out money at lower rates as well
 - if it is cheaper to borrow money, more people will do it, resulting in more people buying things, more workers will be needed (lower unemployment)
 - c) Open-Market Operation**
 - to get more people to spend money, more people will be needed to make and sell goods
 - if the FED buys back bonds from the banks and the people then it is putting money into the economy that was not there before
 - more money in the economy means higher demand, which results in a greater demand for labor – lower unemployment