Chapter 7

International, National, and Local Economics

Economics is a social science that analyzes the choices made by people and governments in allocating scarce resources. While this definition sounds rather scientific, most people have a fairly intuitive understanding of the laws of supply and demand. When making purchasing decisions, we all decide what products or activities fit into our schedules, budgets, and needs; and through these economic choices, we vote for what we want to be available in our market and at what price. The economic system is the social institution through which goods and services are produced, distributed, and consumed. As you can surmise, the economic decisions that we make affect economic systems that are often global in scope. There is a combination of domestic and international policies that allocate resources, commodities, labor, tariffs, and so on that go into the price composition of the goods and services that we purchase and consume. These factors, however, emerge on a couple of different levels that economists study: microeconomics and macroeconomics.

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MICROECONOMICS AND MACROECONOMICS

Microeconomics is the study of small economic units such as individual consumers, families, and businesses. It is the study of the individual parts of the economy and how prices are determined and how prices in turn determine the production, distribution, and use of goods and services. Macroeconomics refers to the study of a country's overall economic issues. Although these two disciplines are often addressed separately, they are interrelated, as macroeconomic issues help shape the decisions that affect individuals, families, and businesses.

Another area of economics focuses on the global impact of emerging markets. The financial markets of developing economies in Asia such as China, India, Indonesia, Malaysia, South Korea, Taiwan, and Thailand are among the most important. In Latin America, Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela are also demonstrating large amounts of economic/financial activity. Africa has five countries considered emerging markets in the international arena: Ghana, Ivory Coast, Kenya, Nigeria, and South Africa. In Europe, the Czech Republic, Greece, Hungary, Poland, Portugal, Russia, and Turkey are all markets that are striving toward the financial stability of the European Union (EU).

SUPPLY AND DEMAND

The basic relationships in the study of economic systems are the factors that drive the forces of these economies: supply and demand. Supply refers to the willingness and ability of sellers to provide goods and services for sale at different prices. Demand refers to the willingness and ability of buyers to purchase goods and services at different prices.

Factors Driving Demand

The study of economics focuses on the "wants" of the players in a market and the limited financial resources that they have to spend on their wants. The dynamics between supply and demand can be

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best understood when looking at a demand curve. Demand is defined as the relationship between the price of the good and the amount or quantity the consumer is willing and able to purchase in a specified time period, given constant levels of the other determinants—tastes, income, prices of related goods, expectations, and number of buyers. The graph of the demand curve demonstrates the amount of product that buyers will purchase at different prices. Typically demand rises as the price of a product falls and demand decreases as prices rise. The sensitivity of the changes in price and demand is called price elasticity.

Products and services have different degrees of price elasticity. For example, if gasoline increases in price, overall demand may not be proportionately reduced (i.e., a low degree of price elasticity), as people still need gas to fuel their vehicles (assuming there are no substitutes or alternatives—for example, a move toward using public transportation). If, however, the price of airline travel increases greatly, it may be likely that demand for air travel will have a greater than proportionate decline. This means that there is a relatively high degree of price elasticity.

Businesses need to carefully monitor the factors that may affect demand. If they aren't keeping a careful eye on these different demand elements as related to their business, assuredly their competitors will find a competitive advantage that can affect an organization's long-term survival.

Factors Driving Supply

The supply aspect of an economic system refers to the relationship between different prices and the quantities that sellers will offer: Generally, the higher the price, the more of a product or service that will be offered.

The law of supply and demand states that prices are set by the intersection of the supply and the demand. The point where supply and demand meet identifies the equilibrium price, or the prevailing market price at which you can expect to purchase a product. All of these factors of supply and demand, then, come down to setting a price for the product or service that the market will bear.

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ECONOMIC SYSTEMS

In the twentieth century, there were primarily two competing economic systems that provided answers to the questions of what to produce and for whom, given limited resources: "command economies" directed by a centralized government and "market economies" based on private enterprise. History has proven that, worldwide, the central command-economy model has not sustained economic growth and has not provided long-term economic security for its citizens.

Private Enterprise

In fact, many government-controlled economies are turning to privatization to improve incentives and efficiency. Privatization is the selling of government-owned businesses to private investors. This trend has provided an opportunity for U.S. firms to own businesses in foreign countries that previously prohibited U.S. investment. Why is this trend appearing? We will take a look at the four different types of market structures that are currently identified in the private enterprise system.

The private enterprise system, or market economy, is centered on the economic theory/belief/philosophy of capitalism and competition. Capitalism is an economic system in which businesses are rewarded for meeting the needs and demands of consumers. It allows for private ownership of all businesses. Entrepreneurs, desiring to earn a profit, create businesses that they believe will serve the needs of the consumers. Capitalist countries offer foreign firms opportunities to compete without excessive trade barriers.

As a result of the ineffectiveness of command economies, governments tend to favor the hands-off attitude toward controlling business ownership, profits, and resource allocations that go along with capitalism and market economies with competition regulating economic life and creating opportunities and challenges that businesses must handle to succeed.

A Taxonomy of Competition. There are four different types of competition in a private enterprise system: pure competition, monopolistic competition, oligopolies, and monopolies.

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Pure competition is a market or industry in which there are many competitors. It is easy to enter the market, as there are few barriers to entry and many people/organizations are able to offer products that are similar to each other. In a market where there is pure competition, a lower price becomes the key factor and leads buyers to prefer one seller over another, and there is likely to be little differentiation between products. Additionally, the amount that each individual seller can offer constitutes such a small proportion that when acting alone it is powerless to affect the price. Therefore, individual firms in these commodity-like markets have very little control over the price.

Monopolistic competition means that there are fewer competitors, but there is still competition. In this market environment, it is somewhat difficult to enter the market. The barriers to entry could be due to location, access to commodities, technology, or capital investment levels. The result is that there are usually differences in products offered by competing firms; perhaps they serve the same function, but there are differentiations that rely on consumer preferences to make a choice. Due to the differentiation factor, individual firms are able to have some sort of control over the prices. They can choose to charge a premium or a discount to set their product apart and affect the demand.

Oligopoly is a market situation with few competitors. The few competitors exist due to high barriers to entry, and a few large sellers vie for, and collectively account for, a relatively large market share. The products or services in this market may be similar (telephone companies) or they may be different (supermarkets). In the oligopolistic market situation, the individual firms do have some control over prices (Whole Foods Market can charge more for produce/products than Albertsons) and can create differentiation or vie for more of the market share by having price be part of their consumer acquisition strategy.

Unlike the board game, a monopoly exists in the private enterprise system when there is absolutely no other competition. That means that there is only one provider that exists to provide a good or service. In this case, it is often the government that regulates who can enter the market, so there are no specific barriers to entry. But the government regulations ensure that there are no competing products or services in the market. The lack of competition yields considerable

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power over prices in a pure, or unregulated, monopoly, but there is little control over prices in a regulated monopoly. An example of a pure monopoly is the issuance of a patent for a drug, in the case of a pharmaceutical company. Some pharmaceutical drugs have no current substitute, in which case the patent holder pharmaceutical company has a monopoly in the production/distribution of that drug. In this case the government guarantees that no other company can produce the drug, and that provides a sufficient market entry barrier. Monopolies of this sort, however, arise rarely because pharmaceutical drugs may have substitutes and the regulatory barriers to entry are typically temporary (for a period of a few years).

Planned Economies

In addition to the private enterprise system, planned economies are another market structure in the world economy. In a planned economy, government controls determine business ownership, profits, and resource allocation. Countries that existed with planned economies, however, have not been highly successful.

The most common theory of a planned economy is communism, which purports that all property is shared equally by the people in a community under the direction of a strong central government. It is an economic system that involves public ownership of businesses. Rather than entrepreneurs, the government decides what products consumers will be offered and in what quantities. As the central planner, the government establishes trade policies that historically have been very restrictive in allowing foreign companies the opportunity to compete. Communism was proposed by Karl Marx and developed and implemented by V. I. Lenin. In Marxist theory, "communism" denotes the final stage of human historical development in which the people rule both politically and economically.

The communist philosophy is based on each individual contributing to the nation's overall economic success and the country's resources are distributed according to each person's needs. The central government owns the means of production and everyone works for state-owned enterprises. Further, the government determines what people can buy because it dictates what is produced.

Looking specifically at China and Russia, we can see what led to

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the failure of communism. First of all, their constitutions had little or no meaning, so although the government created laws, they bore no power. Second, the government owned the means of production and made all of the economic decisions. Therefore, market forces were not allowed to work, and the laws of supply and demand were not followed. Third, the citizens of these countries had limited rights and all the citizens were subject to Communist Party control. Individuals existed to serve the state and had virtually no freedom for themselves. All of these factors contributed to the downfall of communism and as a result, China and Russia are currently privatizing and borrowing other capitalistic methods in an attempt to improve their economic situations and convert to a more market-based economy. They are desperately trying to get the market to find an equilibrium for their goods and services that we all too often take for granted.

Socialism

Another economic system is socialism, which is characterized by government ownership and operation of major industries. For example, when telecommunications, gasoline, or some other major industry is owned by the government, this is considered a socialistic economy. Socialism is an economic system that contains some features of both capitalism and communism. Socialist governments allow people to own businesses and property and to select their own jobs. However, these governments are involved in providing a variety of public services, such as generous unemployment benefits, comprehensive health care for all citizens, and public transit. These public services are paid for by high tax rates on income. Entrepreneurs, not surprisingly, have less incentive to establish businesses if the tax rates are excessively high.

Socialism is based on the belief that major industries are too important to a society to be left in private hands; however, private ownership is allowed in industries considered to be less crucial to social welfare.

As socialism is retreating, there are new theories of regulation emerging. The new theories aren't aiming to regulate economic relations between individuals, as socialism did, but rather they seek to regulate social relations in general. For example, there is a desire to

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increase the “social capital” in communities. If “social capital” is defined as norms and networks that encourage cooperation and trust between individuals, then the existence of social capital can be beneficial. It reduces transaction costs, assists the diffusion of knowledge, and can enhance the sense of community well-being. The questions arising now, however, are whether the government *can* create social capital and, even more fundamental, if the government *should* create social capital. Although the traditional form of socialism is no longer touted as a successful market structure, remnants of it can still be seen in today’s economy.

The majority of market economies that we see today, however, are mixed market economies. These are economic systems that display characteristics of both planned and market economies. In the mixed market economy, government-owned firms frequently operate alongside private enterprises. Good examples of this can be found in Europe where the respective governments have traditionally controlled certain key industries such as railroads, banking, and telecommunications. What is seen today, however, is a trend toward privatizing many of these state-owned industries. In 1986 the United Kingdom privatized the gas industry, in 1987 it privatized the steel industry, and in 1989 water was privatized. Today, Austria is following suit and is proceeding with the privatization of steel, oil, and chemicals.

FOUR STAGES OF THE BUSINESS CYCLE

The business cycle, also called the economic cycle, refers to the recurring series of events of expansion, boom, bust, and recession. The length of business cycles over time are rarely alike. The business cycle experiences periodic cyclical expansions and contractions in overall economic activity. For example, the United States has experienced 11 complete business cycles since the end of World War II. Business cycles are relevant because business decisions and consumer buying patterns differ at each stage of the business cycle, and it is important to know where you are in a business cycle when developing your organizational strategy.

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Prosperity, or the "boom" part of the business cycle, occurs when unemployment is low, strong consumer confidence leads to record purchases and as a result, businesses expand to take advantage of the opportunities created by the market. A good example of the market experiencing prosperity took place in Silicon Valley from 1998 to 2001. Suddenly the market identified technology as the next big business opportunity, so companies were adopting online technologies at a record pace; brick and mortar businesses were creating electronic marketplaces for the first time. As common sense tells us, no economy can sustain a boom forever and as we saw in Silicon Valley, a recession, and sometimes a spot-depression (a short-term slow-down), can follow the prosperity stage.

A recession is a cyclical economic contraction that lasts for at least six months. Economists agree that a recession results in a downturn lasting for at least two consecutive quarters. During a recession consumers frequently postpone major purchases, such as homes and vehicles, and businesses slow production, postpone expansion plans, reduce inventories, and cut workers. As a result, unemployment rises and consumer demand decreases.

A depression is classified as a recession, or economic slowdown, that continues in a downward spiral over an extended period of time. It is also characterized by continued high unemployment and low consumer spending. Many economists suggest that sufficient government tools are available to prevent even a severe recession from turning into a depression. For example, federal, state, and local governments can make investments to improve the country's infrastructure as a means of bringing the market out of a depression. They can invest in transportation systems and public facilities such as schools and universities, or perhaps they can loan money to small businesses to help the economy grow. Governments can also influence the economy through regulations in fiscal and monetary policy, which will be discussed in more detail later in this chapter.

Eventually these tools contribute to the next stage in the business cycle: recovery. The recovery period is when economic activity begins to pick up. Consumer confidence improves, which leads to increased spending on big items such as homes and vehicles. Unemployment also begins to fall, and people are working and contributing to the economy again.

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THE STABILITY OF A NATION'S ECONOMY

As already discussed, economies are the result of an interrelated mixture of numerous forces.

Productivity

The gross domestic product (GDP) is the value of all goods and services produced within a nation's borders each year. It is a very popular economic indicator and provides a benchmark for the nation's overall economic activity.

Productivity is the relationship between the goods and services produced and the inputs needed to produce them. During expansionary periods, productivity tends to rise as fewer resources are needed to produce greater levels of output. During recessions, then, productivity might stagnate or decrease overall.

Inflation and Deflation

Price-level changes are related to the value of the economy's currency. Inflation is a period of rising prices caused by a combination of excess demand and increases in the costs of the factors of production. "Inflation" is defined as a rise in the general level of prices of goods and services over a specified period of time. In the United States, the rate of inflation is usually measured as the percentage change in the consumer price index (CPI), which includes the prices of a wide variety of consumer goods and services in categories such as food, clothing, medical services, housing, and transportation.

Demand-pull inflation occurs when there is an excess of demand relative to supply. In these conditions, a relative shortage of products or services gives producers the leverage to increase prices. Cost-push inflation occurs when there are rises in the costs of the factors of production. The costs of either the labor, commodities, or manufacturing rise and push prices up to cover the increased costs.

Hyperinflation is a period characterized by rapidly rising prices. We remember the images of people from Communist Russia standing in long lines to purchase bread because of hyperinflationary costs.

Inflation impacts the economy because more money is needed to

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sustain a given standard of living. If people receive a fixed income and suddenly the cost of bread increases dramatically, it is easy to see the negative impact caused by this increased price.

Inflation can be good news, though, to those who are experiencing a rising income or those with debts at fixed interest rates. Businesses, however, find it difficult to make long-range plans in high inflationary conditions, because budgeting and forecasting depend largely on the prices of products and services needed to conduct business. Low inflation, in contrast, makes it easier for businesses to make long-term plans—it becomes easier to predict prices and costs. Low inflation is also associated with low interest rates, encouraging major purchases by consumers and fueling business expansion.

Deflation is the price-level change referred to during a period of falling prices. While deflation sounds good, it can have disastrous consequences; the Great Depression was a general period of deflation. Prices fell, but so did employment and wages for those lucky enough to be employed, as well as availability of most goods and services.

Relative price levels are measured by two common indicators. The consumer price index measures the monthly average change in the prices of a basket of goods and specific services. The producer price index (PPI) looks at prices from the seller's perspective (finished goods, intermediate goods, and crude goods).

Employment Levels

Employment levels have a major impact on a nation's economy. In fact, the unemployment rate is one of the most popular economic indicators that most people intuitively use to understand the state of the economy. The unemployment rate is usually expressed as the percentage of total workers who are actively seeking work but are currently unemployed. These indicators tend to increase during recessions and decrease during expansions.

Because the unemployment rate is so important, we're going to discuss some different categories that have been created to characterize an economy's state of unemployment.

Frictional unemployment is when someone is temporarily not working. A good example is a recent graduate who is looking for work but has yet to find a job. *Seasonal* unemployment occurs when people

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are not working during some months, but they are not looking for a job during that period. People involved in the tourism industry or seasonal farmworkers are good examples of this. *Structural* unemployment results when people are not working because there is no demand for their particular skill set. An example might be someone who graduates with a Ph.D. in medieval economics. There is a relatively low demand for people with this skill set, so structural unemployment results for many in that field. People who fall into this category, however, may be training for a new job and developing new skills while they look for work. *Cyclical* unemployment results when there is an economic slowdown and people are looking for work but there aren't enough jobs. This was the case for many MBAs who graduated in 2001 and 2002. The economic recession resulted in fewer jobs, and even highly skilled graduates with advanced degrees had difficulty finding work.

The unemployment rate does not include the so-called discouraged workers, out-of-work people who are no longer looking for jobs.

International Diversification

As a company, one way to mitigate some of these economic uncertainties is to diversify the effects by maintaining markets in two or more countries. Diversifying into two separate market economies/environments reduces risks by hedging economic bets across multiple economic systems.

Another area in which diversification makes sense for the international business is in the political risk dimension. Political risk represents the risk that another country's political actions may adversely affect a business. Carried to an extreme, a foreign government may take over a U.S. firm's foreign subsidiary without compensating the U.S. firm. A more common risk is the threat of higher tax rates or restrictions on the repatriation of profits to the U.S. parent firm. In general, large-scale political events—such as military coups, social unrest, and currency crises—are referred to as macropolitical risks. Conversely, small-scale events—such as expropriation, discriminatory regulation, and terrorism—are referred to as micropolitical risks.

One of the most basic political risks that you can mitigate is the fluctuations in exchange rates. Exchange rate risk, or currency risk, is the risk of an investment's value changing because of change in the currency

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exchange rates. For example, a weak dollar is likely to increase both foreign sales and profits. These results are due to the lowering of the selling price of the exported goods, because fewer units of the foreign currency are now required to purchase U.S.-made goods or services. A strong dollar is likely to decrease exports and profits. The appreciation of the U.S. dollar against a foreign currency causes the purchase price of U.S. goods abroad to increase so that it takes more units of the foreign currency to buy a given amount of U.S.-made goods.

Monetary and Fiscal Policy: Managing an Economy's Performance

Monetary policy is the regulation of the money supply and interest rates by a central bank, such as the U.S. Federal Reserve, in order to control inflation and stabilize currency. In the United States the Fed is responsible for managing this process. If the economy is heating up, the Fed can withdraw money from the banking system, raise the reserve requirement, or raise the discount rate to make the economy cool down. This is referred to as a restrictive monetary policy and slows economic growth. If growth is slowing, the Fed can reverse the process—increase the money supply, lower the reserve requirement, and decrease the discount rate. This is referred to as an expansionary monetary policy, with lower interest rates.

Fiscal policy is the decision that the government makes to spend money or increase taxes for the specific purpose of stabilizing the economy. Government increases in spending and lowering of taxes tend to stimulate economic growth, while decreasing government spending and increasing taxes tends to slow economic growth. This makes sense when we think about the individual taxpayer's disposable income. The more money individuals have, the more they will be able to spend on goods and services in the market and therefore stimulate market growth.

The primary sources of government funds to cover the costs of its annual budget are raised through taxation of its citizens, fees collected from business, and borrowing against assets. The U.S. federal budget has gone from a surplus to a deficit in recent years—it is overspending its resources. In order to fund this budget deficit, the federal government will have to borrow billions of dollars in the coming years.

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GLOBAL ECONOMIC CHALLENGES OF THE TWENTY-FIRST CENTURY

As U.S. economies and policies become increasingly interrelated across borders and oceans, we face a more complex economic picture. The opportunities that go along with this more global picture are great, but so too are the challenges. Cellular telephones, computers, disease-resistant crops, satellites, biotechnology, and fiber-optic networks are among the twentieth-century technologies that will shape political, social, and economic realities well into the twenty-first century—realities that include the continuing globalization of business, culture, and health care. So what are the specific challenges that we need to be aware of?

International Terrorism

> Surprise, when it happens to a government, is likely to be a complicated, diffuse, bureaucratic thing. It includes neglect of responsibility but also responsibility so poorly defined or so ambiguously delegated that action gets lost. It includes gaps in intelligence, but also intelligence that, like a string of pearls too precious to wear, is too sensitive to give to those who need it. It includes the alarm that fails to work, but also the alarm that has gone off so often it has been disconnected. It includes the unalert watchman, but also the one who knows he'll be chewed out by his superior if he gets higher authority out of bed. It includes the contingencies that occur to no one, but also those that everyone assumes somebody else is taking care of. It includes straightforward procrastination, but also decisions protracted by internal disagreement. It includes, in addition, the inability of individual human beings to rise to the occasion until they are sure it is the occasion—which is usually too late.

The report, *Countering the Changing Threat of International Terrorism*, written by the National Commission on Terrorism, begins with these words by Thomas C. Schelling. In this succinct and clear description of surprise, the many elements of international terrorism are captured. Terrorism succeeds because of the element of surprise and, unfortunately, surprise is a factor that we cannot always control.

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It used to be that international terrorism happened to Americans only when we were not on our home turf. September 11th, however, showed us that we are no longer safe within our own borders. Terrorist attacks are becoming more lethal, too. Most terrorist organizations active in the 1970s and 1980s had clear political objectives. They tried to calibrate their attacks to produce just enough bloodshed to get attention for their cause, but not so much as to alienate public support. Today, as we have seen, the objectives are increasingly religious, economic, or personal (against an ethnic group) in nature.

In his paper "International Terrorism in the 21st Century," Frank Goldstein points out a couple of options to counter the new threats posed to nations due to international terrorism. One option, which received some success after the World Trade Center bombing in 1993, is the economic incentive or bounty. The U.S. government offered a reward of several million dollars for information leading to the person or persons responsible for the bombing. An informant in Pakistan provided the information that led to the arrest of an individual in Islamabad, Pakistan, and he was immediately taken to the United States to await trial.

Although the bounty or reward program seems to have succeeded in 1993, continued terrorist activity demonstrates that these issues of international terrorism are very complicated.

A second option for global nation states to thwart terrorism is "national resolve." It should be acknowledged that a foolproof system against terrorism in democratic societies does not exist. Simple procedures such as better intelligence and improved physical security of critical sites will, in most cases, deter a particular terrorist group.

Economics, technology, and the whims of both criminals and psychotics will produce ongoing and, at times, spectacular events. A result of terrorism in the United States will be more public and political efforts to counter terrorism by the West. Sadly, terrorism in the third world and in developing countries will continue almost unabated.

Shift to a Global Information Economy

The information economy is affecting supply chains, digital technologies, information and communication technologies, technology-

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enabled marketing; it is pushing businesses to go wireless, changing organizational structures, and increasing the value of intellectual property.

Some think the movement to an information economy is being oversold as the key to economic opportunity. Information technology can help people learn how to absorb knowledge generated elsewhere and combine it with local needs and local knowledge and may help raise real economic returns on investments, but there are still more familiar development challenges (e.g., structural unemployment, social inequality, and an undereducated workforce).

Aging of the World's Population

The world's population is getting older and older as a result of dropping fertility rates and urbanization. Europe provides an excellent example of how the aging population is changing policy and business. Fertility rates have plummeted, especially in southern Europe, to the point that every 10 Italian women are expected to have just 12 children in their lifetimes, and every 10 Spanish women just 11. As a group, the countries of the EU are going to see their populations shrink, unless they allow significant levels of immigration.

The situation right now is not unique to Europe. In fact, well over half of the world's elderly (people aged 65 and older) now live in developing nations (59 percent in 2000), and this is projected to grow to 71 percent by 2030. Many developing countries have had significant downturns in their rates of natural population increase, and as this process accelerates, age structures will change.

Consumers

It is important to consider that businesses ultimately fail or succeed because of consumer preferences and their ability to manage scarce resources. Whether your business provides a product or service to the end user or to an intermediary, your product or service may or may not be chosen depending on consumer preferences. Part of what goes into the consumers' choice is the perception of quality.

U.S. consumers have the perception that certain foreign-made

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goods are of higher quality than U.S.-made goods. In the past this has been true, for example, of cars and electronic goods made in Japan. French wine and Swiss watches are other examples of goods that some U.S. consumers believe are better than similar domestic products.

Another factor that goes into consumer preferences is as simple as personal buying habits. This includes taking into account where people like to shop, what brands they prefer, and what associations they might have with your product or service.

SUMMARY

Creating a long-term global strategy is a complicated but important task. As is evident throughout this chapter, no country is an economic island, and the economy truly is global. A growing number of businesses have become true multinational firms, with operating facilities around the world. They have figured out how to mitigate their risks both politically and economically, but they have also found how events in one nation can reverberate around the world.

As U.S. businesses contemplate and engage in global expansion, there are endless opportunities, but also potential risks. The U.S. market is also attractive to foreign firms. For an organization to be successful in today's global economy, its owners and stakeholders must look across borders and understand the global community.

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