Understanding Our Economy

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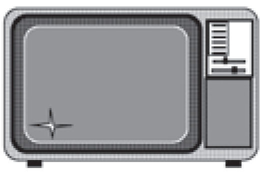
Contents

Introduction: What Is Economics?

Pick up the paper, listen to the news, eavesdrop on a conversation. The word *economics* is likely to be used. Obviously, it concerns us. Economics must be important. But what, exactly, is economics?

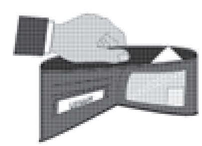


Economics is a study. Some might insist it is a science. Others claim it to be an art. Let's compromise and say that economics is a study, an important member of the social sciences. It is a study of how people and society use resources to produce and distribute items for consumption. It deals with the understanding of money and wealth and the use of land, labor, and capital as means of turning resources into useful commodities.

Economics is closely related to various social sciences. For example, the history of our nation is a history of economics as well. Our Civil War was as much an economic conflict as it was a social one. The student of political science can't understand politics without seeing the effect of politics on economics and vice versa. Similar relationships exist for geography, sociology, and other social sciences.

In *Understanding Our Economy* we will explore a number of the ways in which the study of economics directly affects you and the way you live. We will begin with some basic economic theory. Then we will move to several areas of economic understanding that have a great deal to do with the way you and I live. Next, we will touch on our relationship with the economy of the world. Finally, we will briefly explore consumer economics and its place in your life.

As you read, pay special attention to the words in bold type. You will be asked to use them in exercises in each chapter. Many of these terms are contained in the Glossary on page 154.



Reread the second paragraph in this introduction. Without looking ahead in the book, list 10 or 12 items you would expect to study in learning about economics and our economy.

The third paragraph on the previous page touches on the relationship between economics and other social sciences. Mention half a dozen or so historic events, political happenings, or geographic settings that illustrate the interrelationship of economics and other social sciences. (Examples: The California Gold Rush changed history. The failure of the Russian wheat harvest in 1975 brought about increased U.S.-Russian trade. Geography delayed exploitation of Alaska's oil and gas discoveries.)

$ Chapter 1: Supply and Demand

In 1974, the United States was in the grip of the most serious **recession** since the Great Depression of the 1930's. The automobile industry had been especially hard hit by reduced buying. Traditionally, reduced buying (**demand**) was met by lower prices in an effort to encourage buying and stimulate the economy. However, the automobile industry elected to hold its prices. One major firm even raised its prices sharply. Their reasoning was simple: "Americans want new cars. We are selling fewer cars than normal. By raising our prices, we will make a greater **profit** on each car sold. Thus, even though we sell fewer cars, we will make as much total profit as before."

The thinking of this auto manufacturing firm was exactly the opposite of what might have been expected. They guessed that people's desire for new cars would outweigh fears of recession, lack of money, and loss of jobs. They guessed wrong! New car sales kept on declining. The firm was forced to cancel its price increase. Soon auto manufacturers were offering **rebates** (cash refunds) to anyone who would buy a new car.

One of the authors told a friend, "The auto manufacturers thought the law of **supply** and demand had been repealed. They were wrong. The law of supply and demand is still in effect."

It is that same law of supply and demand that causes automobile makers to offer cash rebates today when they wish to stimulate the sale of new vehicles. The cash rebates that were a new wrinkle in selling cars and trucks in the 1970's became a recognized part of the economic scene.

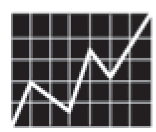
An additional sales feature became popular as auto manufacturers in the United States were forced to meet foreign competition. This selling technique was the extended warranty. During the 1970's a dealer warranty generally covered the power train or engine and transmission. This warranty, or guarantee, was good for one year or 12 thousand miles in most cases. By the close of the 1980's, extended warranties were good, in some cases, for up to five or six years and for as many as 70 thousand miles. Many dealers offered "bumper-to-bumper" warranties for the first three years. These warranties covered absolutely every part of the automobile.

Why did auto makers offer these vastly improved warranties? The answer was simple: it was due to the law of supply and demand.

Exactly what is the law of supply and demand? To begin with, it is not a law passed by Congress. It is a principle of economics. It says that items that are scarce or in short supply tend to be costly. Items easily obtained or plentiful tend to be less expensive.

For any number of reasons, there may be more people who want a product than there are products for sale. When this happens, the price of that product is likely to rise. When there are more goods for sale than people want or need, the prices of those goods are likely to drop until they reach the point where people will buy the unsold goods.

This principle of supply and demand may be affected by many outside factors. These are government regulation, advertising, money supply, inflation, and recession. However, such factors do not change the principle. They only affect the way it operates. When people's needs and wants call for certain items, these items are likely to rise in price. When there is less demand for items, those items will drop in price.



Of course, some sort of price must be set to begin with. The principle of supply and demand will adjust that price up or down in keeping with the demands of the **consumer** and the ability of the supplier or **producer** to provide for these demands.

Before the producer can begin to provide for consumer demands, several questions must first be considered: (1) What will be produced? (2) How will these things be produced? What determines which consumers need this product? (3) For whom will these things be produced?

The first question depends upon the consumer. What does the consumer need or want? More important, what will consumers buy? There is little to be gained by producing things for which there are no buyers. This lesson was learned rather painfully by the auto manufacturer already mentioned.

The second question is quite complicated. It involves figuring out all the possible methods of production to determine which way is cheapest. Another economic principle states that the most efficient means of production (the cheapest) will take the place of more costly methods. The producer must consider such things as location and supply of raw materials; transportation costs for both raw materials and finished product; available labor and its cost; cost of building and maintaining a plant; utilities, advertising, and management costs.

Finally, the producer must decide for whom things will be produced. Some items (a loaf of bread, for instance) are needed and desired by just about everyone. But what about a new **luxury** sedan? Many people may desire it but few can afford it. Some who can afford it won't buy it. Each producer must make a decision about his or her products in view of potential customers.

Before the principle of supply and demand ever comes into play, a number of decisions have been made as to what will be supplied, how, and to whom.

- Select a product (something manufactured or grown) that is needed by the vast majority of individuals.

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- List all the things that have to be considered in order to produce this product in the most economical manner possible.

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- What determines which consumers need this product?

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- What determines which potential buyers want this product?

- What determines who will actually buy the product once it is produced?

- Now choose a product that is not absolutely needed but is desired by a vast number of people.

- What things must the producer take into account in producing this product at the lowest possible cost so that more people can afford it?

- What determines which consumers will actually purchase the product when it is produced? In short, for whom will the product eventually be produced and why?

Once we have a product ready to **market**, we have to contend with supply and demand. Let's assume the producer has decided to manufacture widgets. Everyone wants widgets. He can make them at a price that allows him to **compete** with other widget makers. He has determined that every family whose yearly **income** is over $20,000 will buy and use widgets.

The producer puts his widget on the market at $3.00. During one month, he sells 1,000,000 widgets. He is elated! Next month he raises his price to $5.00 and sales drop to only 500,000 widgets. Now the poor fellow is so upset he can hardly eat and sleep.

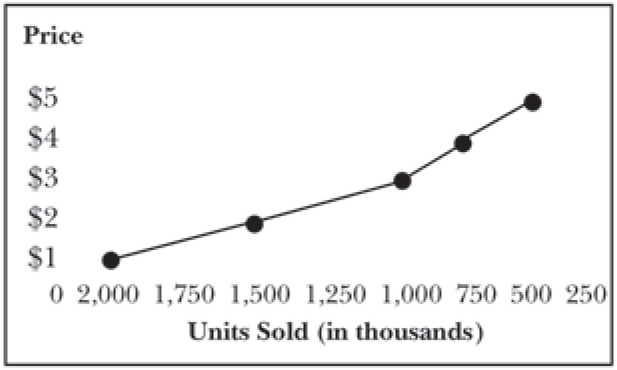
"Why not lower the price and see what happens?" his wife suggests.

Mr. Widget Producer lowers the price of widgets to $1.00. The next month sales jump to 2,000,000 widgets. Now that widgets are selling again, he raises the price to $4.00. He is astounded to see widget sales drop to 750,000. Quickly he drops his price to $2.00 and widget sales soar to 1,500,000.

The producer's widget experience looks like this:

Price	Widget Sales Per Month
$5.00	500,000
$4.00	750,000
$3.00	1,000,000
$2.00	1,500,000
$1.00	2,000,000

If we put this information on a graph, it looks like this:



Two very important concepts are illustrated by the above graph. First, when the price of a product increases, there is less demand for that product. (This assumes that other things stay the same and only the price changes.) Second, the greater the supply of the product there is for sale, the lower the price it brings.

These simple concepts have a great deal of bearing on our entire economic system. Time and again you can see how these two concepts influence various parts of our economy.

- If our widget producer sets his price at $1.50, how many widgets can he expect to sell if the above demand graph is correct?

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- If you were told that this widget producer sold 625,000 widgets in one month, what would you suspect he had charged for his widgets?

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- There are logical reasons why fewer items are sold as the price per item rises. Explain this basic principle of economics.

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It is also reasonable for prices to drop as more and more products are offered for sale. Explain the logic in this.

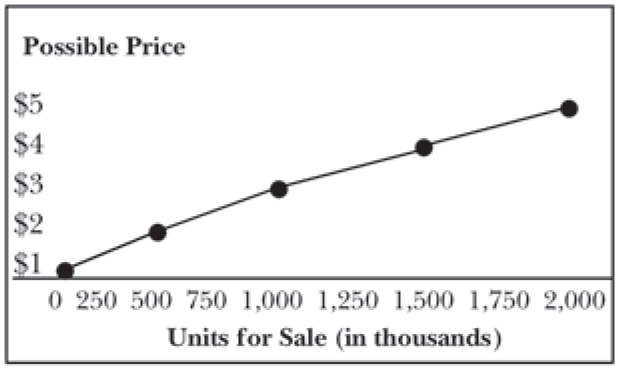
Just as our widget producer is beginning to feel he has things under control and he understands how demand is related to price, something happens. Due to the costs of materials, labor, transportation, and marketing, he finds he cannot afford to make widgets to sell at low prices.

His bookkeeper tells him that he cannot put widgets on the market to sell for $1.00. However, if the price of widgets is raised to $2.00, the company can supply 500,000—enough so that every **retail** dealer can have a few on the shelves. At $3.00, the company can manufacture 1,000,000 of the handy gadgets. A price of $4.00 will see 1,500,000 on the market, and if the price rises to $5.00, 2,000,000 widgets will be available for sale.

The widget producer's figures look like this:

Possible Price	Widget Available for Sale
$5.00	2,000,000
$4.00	1,500,000
$3.00	1,000,000
$2.00	500,000
$1.00	0

When the bookkeeper makes a graph, it looks like this:



How many widgets can the company produce at a price of $2.50?

If the company were to produce 1,250,000 widgets, what would you expect the market price to be?

Explain why our widget producer can supply more widgets at the higher prices.

It is easy to see that the widget producer and the widget buyers are likely to have different ideas about widgets. The producer wants to make lots of high-priced widgets. The consumers will buy only so many high-priced widgets, but will buy lots of widgets at a lower price. Things look somewhat like this:

Price	Consumers Will Buy	Producer Will Manufacture
$5.00	500,000	2,000,000
$4.00	750,000	1,500,000
$3.00	1,000,000	1,000,000
$2.00	1,500,000	500,000
$1.00	2,000,000	0

A quick look at the chart tells us that the best probable market price for widgets is $3.00. Why?

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If the market price for widgets were to be set at $1.00 or $2.00, the price would soon be likely to rise to $3.00. Why would that happen?

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If the producer tries to get $4.00 or $5.00 for his widgets, he will probably have to drop his price to $3.00. Explain why this is so.

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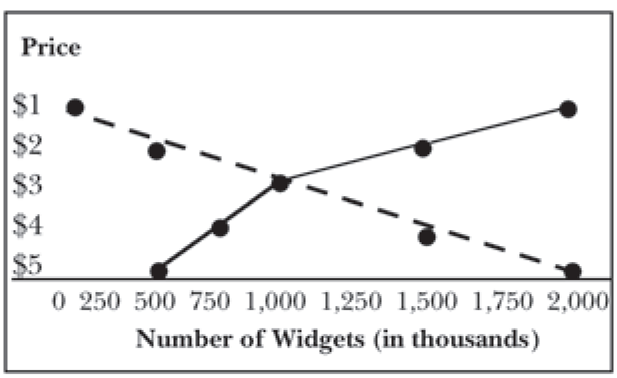
When we put this information on a graph, it looks like this:



The solid line shows how the demand for widgets looks. The dotted line represents the producer's willingness to supply widgets. At the point where the two lines or curves cross each other, we have what is called the **equilibrium market price**. This simply means that is the point at which supply and demand balance.

Once again, our widget producer feels he completely understands the manufacturing and marketing of widgets. Once again, he is wrong. He only partly understands his business. For instance, he later learns that people are more likely to buy widgets in the summer and fall than in the winter and spring. He also discovers that consumers in the South and West are less likely to buy widgets than consumers in other parts of the nation. Thus, he finds that his sales drop during part of the year and that he has to increase his advertising in some parts of the nation.