

## **LEARNING OBJECTIVE 5.1 Describe how economic systems differ.**

International businesses must understand how economic systems differ. Countries around the globe typically adopt one of two economic systems: a market-based system or a command-based system. In market-based systems, supply is determined by the demand, whereas in a command-based system, supply is planned. International businesses need to understand the opportunities in foreign countries. To do so they need to look to output as a metric of economic health. Output can be increased in three main ways: by increasing labor, by increasing the skill of laborers, and by increasing invested capital. Total factor productivity (TFP) measures the efficiency with which labor and capital come together.

**Market-based economy:** an economic system in which factors of trade and production are controlled by private owners rather than by the state; also known as capitalism

**Capitalism:** an economic system in which factors of trade and production are controlled by private owners rather than by the state

**Capital:** a resource that can serve to generate wealth, such as factories, equipment, investment accounts, software, land, and education

**Industrialized:** the process of building businesses and manufacturing on a large scale

A country increases output in any of three ways:

(1) by increasing the supply and efficiency of labor

(2) by increasing the amount of investment or capital in the economy

(3) by increasing total factor productivity, or the efficiency with which labor and capital work together

**Total factor productivity (TFP):** a measure of the efficiency with which labor and capital are utilized together

## **LEARNING OBJECTIVE 5.2 Compare ways to measure countries' economic activities or output.**

To assess whether to do business in a country, international businesses need to gauge the level of opportunity in that country. Two measures, gross domestic product (GDP) and gross national product (GNP), help businesses determine these opportunities. The Human Development Index (HDI) aims to capture a broader view of national well-being. However, when only a few individuals in a country control the means of production and thus profit more from increased output than everyone else, opportunities may be concentrated.

**Gross domestic product (GDP):** the value of finished goods and services produced within a country's borders

- Personal consumption
- Business investment
- Government spending
- Net exports

**Gross national product (GNP):** is the total value of final goods and services provided by a country; it equals the gross domestic product plus the net payment outflows of a country

**Human Development Index (HDI)** a measure used to rank countries into tiers of human development, composed of factors including life expectancy, education, and per capita income

**LEARNING OBJECTIVE 5.3 Describe the tools governments use to slow down or speed up their economies.**

Governments closely monitor the growth and contraction of their economies in order to manage the well-being of their citizens. When economies grow, well-being generally increases. When economies contract, the resulting reduced consumption usually causes hardship. To avoid contraction (also called recession), governments use fiscal and monetary policies to stimulate the economy. Fiscal policy operates based on government budgets, spending, and tax rates. Monetary policy is a tool of central banks and consists of changes to monetary supply and interbank lending rates.

**Recession:** a period of GDP contraction that lasts for at least two consecutive quarters within 1 year

**Depression:** a severe, sustained period of economic contraction in one or more economies

**Control measures:**

- **Fiscal policy:** government actions intended to spark or diminish consumption
  - slow an economy that is growing too rapidly. These policies include taxation and spending actions, such as increasing government spending
- **Monetary policy:** manipulations in the interest rates, the banking rules, and the volume of currency in a country, with a goal to spark or diminish consumption
  - **discount rate** the interest rate a central bank charges commercial banks to borrow money
  - **reserve requirement** the minimum amount of cash reserves a commercial bank must hold
  - **open market operations** operations by a central bank to buy or sell government bonds, corporate bonds, or equities

**LEARNING OBJECTIVE 5.4 Explain how inflation, deflation, and the concentration of wealth affect international business opportunities.**

Other important measures of the economy, such as inflation, deflation, and the concentration of wealth, affect international business opportunities. Inflation is a condition of generally rising prices. Real GDP is adjusted for inflation. Purchasing power parity (PPP) reflects what people in one country must spend to buy the same goods as people in another country. The Gini coefficient measures the distribution of income in GDP and PPP, and it helps businesses understand the economic situation in a country and identify business opportunities.

**inflation:** the general rise in prices in an economy (2-3% is good)

- If **inflation** exceeds 50 percent in a month, it is termed **hyperinflation**
  - governments attempt to fund budget shortfalls by simply printing money

**deflation:** the general decline in prices in an economy

**real (inflation-adjusted) GDP:** GDP that has been adjusted to account for the effect of inflation on its value

**nominal GDP:** GDP that has not been adjusted to account for inflation

**law of one price:** assumption that any given good or service would carry the same price everywhere if allowed free movement across national borders

**purchasing power parity (PPP):** a measure that compares the costs of common products and services in terms of one currency

**Gini coefficient:** a measure of the distribution of wealth within a country

**Consumer Price Index (CPI):** an index that tracks the price of a specific set of consumer goods across time to identify general price increases or decreases