

### 2-1 Basic Economic Systems & Principles

#### OBJECTIVES

- *Identify and describe basic economic principles.*
- *Discuss how economic decisions are made.*

#### UNDERSTANDING ECONOMICS

The economy and the factors that drive the economy have a major effect on both businesses and consumers. Financial decisions are influenced as much by the state of the economy as by any other factors. Effective financial planning and decision making requires an understanding of the economy and economic principles. You can't watch a news program on television or read the headlines of a newspaper without encountering the term economics. Yet ask almost anyone the meaning of economics or how economics affects their daily lives and you may have a hard time getting a meaningful answer. What is it that makes economics so important yet so difficult to understand?

#### DEFINING ECONOMICS

Economics is defined as a science, meaning that it is based on facts and principles. The principles can be used to explain events and predict what is likely to happen in the future if certain things occur. Since economics is a science, it can be used to make decisions.

Economics is the science of decision making about the allocation of scarce resources. If people had everything they needed, there would not be a need for economics. In reality people have a large number of needs and limited resources to fill those needs. Economists are scientists who study how decisions can be made that result in the best match of needs and resources. The science of economics can help an individual decide how to plan a personal budget in order to satisfy both immediate needs and long-term needs. Economics can help politicians and bureaucrats decide on the best monetary policies to increase a country's standard of living.

There are great differences in needs and the availability of resources. In your own neighborhood, some people need very little to be satisfied while others are not satisfied even as they spend large sums of money on a variety of products and services. Some people have large sums of money and other resources, while others have almost none. The same differences in needs and resources occur in your community and state as well as in various countries and regions of the world. In some areas people have high levels of consumption and a wealth of resources, while in other places people have difficulty surviving and almost no useful resources. Because of the great differences in needs and the availability of resources, economic decision making can be difficult and complex.

#### ECONOMIC PRINCIPLES

Several important principles define the science of economics.

##### Scarcity and Choice

Scarcity means that people have wants and needs that are greater than can be satisfied with the available products and services. Because of scarcity, individuals have to make choices. Choice means deciding which wants and needs will be satisfied and which will go unsatisfied.

##### Limited Resources

Resources are the means available to develop solutions for unsatisfied wants and needs. An individual's resources are time, money, and skills. People can use their personal resources to create solutions for their needs. They can use their time and skills to earn money so they can purchase the products and services they want. Companies and countries also have resources. There are three categories of those resources.

- Natural Resources. Natural resources are the materials in the world around us. They include land, water, minerals, forests, and even animals. Some natural resources such as timber and water are renewable if managed wisely. They can be replaced or renewed for a continuing supply. Other resources are nonrenewable with a limited supply. Examples of important non-renewable resources are oil and coal. There is no exact replacement for non-renewable resources when their supply is gone.
- Capital Resources. The second category of resources available to countries and businesses is capital resources. Capital resources are the human-made goods used in the production of other products and services. Examples of capital resources include factories, machines, tools, and vehicles and the many products used by businesses in their operations. Money used by businesses to purchase the things they need is also considered a capital resource.

- **Human Resources.** The final category of economic resources is human resources. Human resources are people and their skills, including both physical and mental abilities. In economics, human resources are sometimes referred to as labor. Entrepreneurs, managers, and employees use their abilities to plan, produce, and sell the products and services needed by consumers.

### **Supply and Demand**

Demand is the amount of a product or service that individuals want to buy to satisfy their wants and needs. Supply is the quantity of a product or service that has been produced by businesses with the hope of making a profit from sales to customers. Several things can affect the demand and the supply of products and services. If products or services do not meet the needs of individuals or if there are better alternatives, the demand for those products or services will be low. If businesses cannot obtain the resources needed to produce a product or service or if those resources are very expensive, the supply will be low.

The supply and demand of goods and services are not usually in balance. People have unlimited wants and needs. The availability of resources limits the supply of products and services. Individuals use their available money to buy goods and services, and they want to get the greatest amount of needs satisfaction for the money they spend. Businesses use their financial and nonfinancial resources to produce and sell goods and services. They obtain money from their customers when products are sold. They want to sell products that will provide the greatest return on the money they invested to produce and sell the products.

The price of a product or service provides the balance between supply and demand. If the price of a product is low, more people will be able to purchase it and will see it as a greater value. Demand for the product will increase. The lower price results in a greater demand. If the price of a product is high, businesses will make a higher profit and will be willing to provide more products for sale. The higher price results in a higher supply. The price at which an equal number of products will be produced and purchased is known as the market price. Prices of goods and services rise and fall based on supply and demand.

## **MAKING ECONOMIC DECISIONS**

There are two levels of economic decisions. Businesses and individuals make decisions about what to produce and what to consume. Businesses must decide how to use the resources they have available to produce and sell products and services. Their goal is to make the most profitable decisions. Individual consumers must decide how to use the resources they have available to purchase products and services. Their goal is to get the greatest satisfaction from their decisions. The level of economic decisions related to the choices of individuals and businesses is known as microeconomics.

The second level of economic decisions is known as macroeconomics. Macroeconomics relates to economic decisions made at a national level. Countries have limited resources and must be able to use those resources to meet the goals of the country and provide a reasonable standard of living and quality of life for their citizens. To do that, the people responsible for economic planning for the country must make three important decisions.

- What products and services will be produced?
- How will the needed products and services be produced?
- For whom will the products and services be produced?

## **TYPES OF ECONOMIC SYSTEMS**

The way a country makes the three economic decisions determines the type of economy it has. In a traditional economy, economic decisions are made in much the same way they always have been. There is very little government influence or control in a traditional economy. The basic needs of individuals and families are unchanged for generations. They do the same work using many of the same tools and procedures that their ancestors did. People use their time, skills, and tools to meet their basic needs and sustain their lives in the best way they know how.

In a command economy, the government has the primary influence on economic decisions. Government decision-makers determine what goods and services are needed and how and when they will be produced. They influence the work people do since the work will be devoted to producing the needed products and services. The government also determines what is available for consumers to purchase as well as the prices that will be charged.

A market economy is based on the combination of the decisions made by individual consumers and businesses. All businesses can decide what they will produce and how. They also have the freedom to set the price they think is appropriate for their

products and services. Individual consumers can also decide how they will spend their money. They are free to buy the products and services they want and determine how much they are willing to pay for each choice.

### THE U.S. FREE ENTERPRISE ECONOMY

Most countries do not have a pure form of any of the three economic systems. Developing countries in Africa and Eastern Asia that had traditional economies are now using more central government planning as well as experimenting with a market economy. Strong central economies in countries such as China are allowing some individual land ownership for farmers as well as the development of small businesses while still maintaining many government controls. European countries that have market economies also have government ownership or control of many social and human service activities.

The United States has always had a commitment to a market economy, maintaining principles of individual ownership of property and freedom for consumers and businesses to control their own economic decisions. However, laws developed and enforced by federal and state governments regulate the economy and maintain balance and fairness in the marketplace. Government restricts some economic activities that are considered harmful to citizens and regulates others to make sure consumers have access to essential products and services such as water and electricity. The government even owns and operates some business activities such as schools, police and fire protection, and the postal service when it is determined that government ownership is for the public good.

The mixed economy of the United States is often referred to as a free enterprise economy. It is based on several important principles designed to protect and promote the economic freedoms of individual consumers and businesses. Those principles include:

1. **Right of Private Ownership.** People have the right to own property. They can buy and sell property including homes, cars, businesses, and other material goods. The ownership and use of individual property is protected by law as long as it doesn't interfere with the rights of others. Businesses own the resources needed to produce products and services so they can control the basic economic decisions of what will be produced and how it will be produced.
2. **Freedom of Choice.** Each consumer and each businessperson has freedom of choice. Consumers can decide what and when to buy and how much money to spend. Businesses are free to enter into or end any business activity. They can decide what to produce, the quantity to produce, and the prices they want to charge.
3. **Competition among Businesses.** Anyone can start and operate a business if they have the resources and ability. If there is a strong consumer demand for a product or service, it is likely that several businesses will offer it. If a business is profitable, it can expect that other businesses will compete for those profits. Competition increases the number of product choices and helps to control the prices at which products and services are sold.
4. **Consumer Influence on Economic Activity.** There are few restrictions on how consumers spend their money. Because of competition, consumers usually have choices among several businesses for the products and services they want. There will be differences in the variety, quality, and price of products. Consumer decisions determine which products and services are sold as well as which businesses are successful.
5. **A Limited Government Role in the Economy.** Due to the individual freedoms in a free enterprise economy, the government plays a very limited role. The primary purpose of government is to help ensure the long-term health and stability of the economy. The government exerts some economic influence through laws regulating business practices and competition. A federal monetary policy influences business decisions and consumer spending by raising and lowering taxes, regulating the amount of money in circulation in the economy, and influencing interest rates charged to businesses and consumers.

## 2-2 Legal Forms of Business

### OBJECTIVES

- *Recognize differences in the legal forms of business ownership and organization.*
- *Explain financial implications of the business ownership decision.*

## ORGANIZING A BUSINESS

A business is easy to form in a free enterprise economy. If a person wants to start a business, it is a matter of deciding what will be bought and sold and how to attract customers. Thousands of people operate small enterprises from their own homes with little thought about how the business is organized and whether it is following proper business procedures. The form of business ownership determines the financial, managerial, and legal responsibilities of business owners.

### IMPORTANCE OF THE ORGANIZING DECISION

---

There are several factors that should encourage any business owner to be thoughtful about how their business is organized and operated. All business owners, even those with small businesses requiring little time and money to operate, want their businesses to be successful. That means they want to make a profit and have the business grow. Most new businesses fail due to poor financial planning and lack of adequate financial resources. The way a business is organized plays a major role in its financial condition. It will determine how much money is available to start the business, how additional funds can be obtained when needed, how income and expenses are allocated and accounted for, and even the amount of taxes paid by the business and business owner. The way a business is organized also determines how investors are compensated for their risk.

### ROLE OF GOVERNMENT

---

Government plays a limited role in a free enterprise economy. The two primary ways governments are involved in the organization of businesses are in legal requirements and taxation. Government has a responsibility to protect the health and safety of citizens, prevent a major imbalance of competition among businesses and between businesses and consumers, and encourage economic growth. Governments pass laws and regulations related to those responsibilities. Many business activities must be licensed and must conform to specific conditions and procedures. The government may inspect business operations or require businesses to report information about their organization and its operations.

Taxes are a fact of life for almost everyone, and businesses are no exception. Governments collect various types of taxes to fund their operations and services. Depending on the type of business organization and business activities, businesses and business owners may be subject to:

- Taxes on business and personal income
- Sales tax on products and services sold
- Employment taxes for Social Security, Medicare, and Medicaid
- Property taxes on real estate and other assets
- Special taxes imposed on particular types of businesses, products and services, or operations

### LEGAL FORMS OF BUSINESS OWNERSHIP

---

Determining the legal form of organization for a business should be done carefully to obtain the best circumstances for financing the business, maintaining profitability, and meeting government operating and taxation requirements. The four most common forms for U.S. businesses are sole proprietorship, partnership, corporation, and limited liability company.

**Sole Proprietorship.** A sole proprietorship is a business owned and managed by one person. All financial and operating decisions are made by the owner of the business. The single owner is totally responsible for the success or failure of the business. A sole proprietorship can be formed with almost no legal requirements.

**Partnership.** A partnership is a business owned and managed by two or more people under the conditions of a legal written agreement. The agreement identifies each partner's financial obligations, managerial and operational responsibilities, and how the partnership can be expanded or dissolved.

**Corporation.** A corporation is a distinct legal entity formed by completing required legal documents in a specific state. It is owned by one or more shareholders who have invested in the business and is managed by a board of directors. A corporation is treated legally as if it were an individual, meaning it can enter into contracts and is subject to taxes and business laws.

**Limited Liability Company.** A newer legal form of business ownership is the limited liability company (LLC). Limited liability companies combine features of the partnership and corporation, offering some of the advantages of each. They are formed with a written agreement that is simpler than the documents required of a corporation and more like a partnership agreement. LLCs offer more financial protection for investors than a partnership and similar to that given to stockholders of a corporation.

### ANALYZING FORMS OF BUSINESS OWNERSHIP

---

Why would a business owner want to operate a business as a corporation rather than a sole proprietorship? What advantages are offered by forming a limited liability company rather than a partnership? Many factors enter into the decision, including the amount of individual responsibility and control, the simplicity or complexity of forming and managing the business, and differences in legal requirements and liability. One of the major considerations is the financial implications of owning and operating each type of business.

### SOLE PROPRIETORSHIP

---

In a sole proprietorship, the owner has total responsibility for and control over the business. The proprietor must provide financing to start the business from his or her own savings or obtain additional financing from investors in the form of loans, credit, or other financial arrangements. The owner is also responsible for all business debts. If the business fails, the owner is personally liable for the full amount of losses. That amount may be greater than the amount originally invested by the owner.

In return for those financial risks, the sole proprietor receives all profits made by the business but must pay any required income and employment taxes on those profits. Those taxes will be assessed at the individual income tax rates of the federal, state, and local governments. Depending on the level of personal income of the owner, those tax rates may be higher than tax rates for other ownership forms.

Because there is only one owner, it may be difficult to obtain financing for the sole proprietorship. Banks and other investment sources may be concerned about the capabilities of the sole owner as a manager, especially for a new business. They may consider it too much of a risk to loan money since there is nothing more than the assets of the business and the personal resources of the owner to pay back the loan. The life of the business is dependent on one person. If the owner dies or is unable to continue business operations, the business must close or be sold, creating immediate financial pressure. The capital resources of a sole proprietorship may be limited based on the financial standing of the owner.

### PARTNERSHIP

---

Partnerships are similar to sole proprietorships from a financing viewpoint. The individual partners are responsible for providing and obtaining the financing. Each partner has responsibility and liability for the debts of the business. If one partner is unable to pay his or her share of those debts, another partner can be required to pay from personal resources. The advantage of a partnership is that there are more financial resources from two or more people than from one owner. Because the combination of partners adds expertise and skill as well as greater coverage for any business liabilities, it may be easier to obtain financing from banks, suppliers, and other investors. A disadvantage is that management decision making is shared, sometimes complicating business matters.

The life of a partnership is generally limited to the life of any partner or the decision by one partner to end the business relationship. In that way, partnerships are similar to sole proprietorships. The business could come to a sudden end, making it more risky for those providing financing. Most partnership agreements include procedures for ending the partnership, adding partners, or selling the ownership of one partner. In that way, while the specific partnership may end, the business may continue under a new partnership agreement.

Partnership income is passed through to each partner under the terms of the partnership agreement. Taxes are assessed at the individual tax rates of each owner.

A special form of partnership is the limited partnership. A limited partnership includes one or more general partners and other limited partners. General partners have operating responsibilities and are liable for all of the business's debts. Limited partners are investors. They cannot participate in day-to-day operations and management decisions. In return, their liability is limited to the amount of their investment. Limited partnerships add financial strength, but may raise questions for other investors due to the limited financial liability of many of the partners.

### CORPORATION

---

Most large businesses and an increasing number of small businesses organize as corporations. Because of the legal status of corporations, they offer many financial advantages to owners as well as to those who have financial relationships with the business.

The ownership of a corporation is controlled by the sale of stock. A private corporation can limit the number of owners and who is allowed to purchase stock. A public corporation issues stock that is sold on the open market, so anyone with the money to pay for a share of stock can be an owner. Because stock can be bought and sold, the life of the corporation is unlimited. It can continue as long as the company is financially successful.

The ownership and management of a corporation is separated. Overall direction of the corporation is in the hands of a board of directors. Day-to-day leadership and operations is handled by people with management expertise hired by the directors. Due to the breadth of involvement and specialized expertise, the success rate of corporations is much greater than sole

proprietorships or partnerships. They have a much lower financial risk for investors and other companies offering financing to the business.

Initial financing is easier to obtain for public corporations since it is accomplished through the sale of shares of stock. One investor does not need a great deal of money to become an owner. Hundreds of individuals as well as other businesses and organizations can purchase stock with different levels of investment. A major benefit of investing in a corporation is that the liability of a stockholder is limited to the amount invested. Even if the corporation has losses well beyond the value of its assets, investors will have no greater liability than the cost of their stock.

The major financial disadvantage of corporations is that profits can be taxed twice. First, corporations must pay taxes on their profits. The corporate tax rate may be lower than many individual tax rates. Stockholders also expect corporations to pay dividends. Dividends are a percentage of corporate earnings allocated to each share of stock. Stockholders must pay individual income tax on the value of dividends received. Also, when stock is sold, the owner may have to pay taxes on any increase in value of the stock from the time it was purchased.

Most corporations are legally known as Subchapter C corporations. That name comes from Subchapter C of the Internal Revenue Service code, which regulates how the income and expenses of most corporations are treated for purposes of taxation. A special circumstance that avoids the double taxation is a Subchapter S corporation. Subchapter S corporations are smaller corporations that have special tax rules from the Internal Revenue Service and many states. Paperwork is simplified and profits are not taxed at the corporate rate.

Instead, earnings flow through to the stockholders. The stockholders then pay individual taxes on their earnings. Stockholder liability is still limited to the amount of the original investment. Because of the special rules and limitations on size, access to large amounts of financing is reduced.

### **LIMITED LIABILITY COMPANY (LLC)**

The limited liability company is a unique form of business ownership that combines advantages and disadvantages of partnerships and private corporations. Ownership is restricted to the partners. Similar to a corporation, the partners have limited liability for the debts of the firm. Like a partnership, income is taxed at the individual rate of each owner based on the profits distributed. The LLC is relatively new and has not been fully legally tested in many states. Many investors are reluctant to provide financing until those legal concerns are clarified. The financial health of the business is very dependent on the resources of the owners and their management capabilities.

#### ***FOCUS ON: Financial Activities of a Business Start-Up***

*Many people think about starting their own business but most do not. The most common reason given is "I didn't have enough money to get the business started." It is true that many businesses require thousands of dollars just to open the doors and many thousands more to continue operations long enough to make a profit. And it is also true that most people who want to start a business do not have the personal savings, cannot find investors, and are unable to get a start-up loan from a bank. Some creative entrepreneurs have found innovative ways to obtain the money they needed to start their businesses. Here are some examples. Jon was able to start a lawn care business by bartering. He traded services with other businesses when he didn't have enough money on hand to buy them. He provided an equal value of lawn care services in exchange for printing of brochures and business cards, legal expenses, and repair and maintenance of his equipment. He didn't receive any cash for that work but also didn't have to directly pay for those expenses. Ervin had restored an antique car that had increased in value over the years. He sold the car for over \$40,000, which he used to start a web design business. Ervin knew he would miss the car but felt the sale was worth it to be able to open his business. Sheila and her husband owned a home on which they had paid over 40 percent of the mortgage. They obtained a home equity loan equal to 50 percent of their home's current value. Sheila used the money to open a day care center. She knew they were risking the loss of their home if the business didn't succeed, so she planned carefully for the business. Eunice used much the same strategy when she borrowed against a paid-up life insurance policy. The insurance policy remained in effect and the amount of the loan would be deducted from the payout to her beneficiaries in the event of her death. Nadji was particularly creative when locating funding to start a business to build custom outdoor furniture. He had a very good credit rating with high credit limits on his two credit cards. He used the credit cards to purchase needed tools and materials. He already had three orders from customers and asked them for a 10 percent deposit which he used for his other immediate expenses. While the interest rate on the amount financed with his credit cards was high, he was able to complete the orders in three months. He earned enough money from those sales to pay off his credit card balances and purchase materials and supplies for the new orders he had received.*

**2-3 Types of Financial Markets****OBJECTIVES**

- *Discuss the purpose and general structure of financial markets.*
- *Describe the major types of financial markets.*

**THE NEED FOR FINANCIAL MARKETS**

"Money makes the world go around" is more than the lyrics of a song. Money really does make the financial world go around. Money allows companies to obtain the resources they need to operate their businesses. Companies use money to build factories and assembly lines; purchase equipment, raw materials and supplies; and pay the salaries of the personnel needed to produce goods that can be sold to customers. Consumers need money for large and small items, one-time and everyday purchases. Homes, automobiles, food, clothing, entertainment, and vacations all require money. From inexpensive daily purchases to the very costly items that require both savings and loans, money is the resource that allows consumers to meet their wants and needs.

**EXCHANGING FINANCIAL RESOURCES**

Some people need money while others have money. For people who have a short or long-term financial need, the options are to earn the money or to borrow from those who have money in order to meet those needs. People who have money can use their financial assets to earn even more. They can invest or loan the money to those with financial needs in order to get a financial return. While it is possible for individuals who need money and those who have money to make individual agreements on the terms of their exchange, that procedure would be difficult and certainly time-consuming. Financial markets and financial institutions have developed to make those exchanges easier and more convenient. A financial market is an organized process for the exchange of capital and credit. Common financial markets are stock markets, bond markets, commodity markets, and currency markets. Some basic principles of financial exchange guide the activities of those markets and institutions.

**PRINCIPLES OF FINANCIAL EXCHANGE**

People who need to borrow money from others must pay to do so. People who loan or invest money with others do so to obtain a financial return. A financial return is a profit earned from an investment. Most investments are made to gain the greatest financial return. However, investments come with financial risks. A financial risk is the possibility that an expected profit will not be achieved. Investments are evaluated to determine the level of risk. Investments with higher financial risks offer the opportunity for a greater financial return, while low-risk investments offer a lower return. With greater risk, there is a higher probability that the expected return will not be realized. The low-risk investments pay less but have a greater likelihood of achieving the expected return.

The term of an investment is the length of time the invested money is controlled by others. Long-term investments may be made for many years or even without an ending date identified. Short-term investments may only have a term of a few days or a few months.

Businesses use money to pay for the resources needed to run the business. Money can be obtained by offering ownership in the business or by obtaining long- and short-term financing from non-owners. Ownership financing in sole proprietorships, partnerships, and limited liability companies comes directly from the resources of the owners. Those ownership investments typically are made for the life of the business. Ownership financing in corporations comes from the sale of stock. Stock in public corporations is bought and sold regularly. Some stock owners hold their stock in companies for many years, while others hold the stock for only a short time.

Non-owners provide both short-term and long-term financing for businesses. A typical way for businesses to obtain financing without offering ownership is to borrow money from financial institutions. Short-term and long-term loans to purchase raw materials, inventory, supplies, and equipment or to pay ongoing operating costs are often obtained from banks or from the suppliers of the goods purchased. Expensive purchases of property such as land or buildings are financed with mortgages. Companies and other organizations such as state and local governments, schools, and universities may issue bonds that promise to pay investors an identified interest rate for a specified time period.

**COMMON FINANCIAL MARKETS**

Financial markets assist in the exchange between buyers and sellers. When a large group of people have interests in the same products and financial resources, a market serves as a common location where those resources can be bought and sold.

Sellers want to obtain the highest possible price for the resources they own. Buyers want to purchase those resources at the lowest possible price. Financial markets help to identify the supply and demand for a specific resource in order to determine its current market price. The financial market also manages the exchange between buyers and sellers with policies and procedures for placing orders, making payments, and transferring ownership.

### COMMODITY MARKETS

---

Commodity markets trade raw materials and other basic production resources. Oil, electricity, grain, livestock, chemicals, metals, and gold are examples of commodities. Major commodity markets include the Chicago Board of Trade, the New York Mercantile Exchange, the London Metal Exchange, and the International Petroleum Exchange of London. There are even very specialized commodities exchanges such as the New Orleans Cotton Exchange and the Coffee, Sugar, and Cocoa Exchange in New York. Two types of markets exist for the sale of commodities.

#### Spot Markets

Spot markets buy and sell products for immediate (on-the-spot) delivery.

#### Futures Markets

Futures markets are contracts negotiated for the sale of products at some future date. For example, an airline may negotiate a futures contract for a large amount of aviation fuel to be delivered in six months so they will have an adequate supply at a guaranteed price. A farmer may negotiate a futures contract to sell cattle at a specific price to be delivered in four months. By negotiating a certain future price for each of the commodities, the airline knows what its fuel costs will be and the farmer knows what price he will receive for the cattle when they are ready for market. Negotiated prices reduce some of the risk in the purchase and sale of commodities.

### OPTIONS MARKETS

---

Option markets are similar to futures markets, in that they give the holder the right to buy or sell the underlying commodity for a specific price before a specific date in the future (known as the expiration or exercise date), but options have some significant difference from futures, and are traded quite differently. The main difference is that options contracts only give the right to buy or sell the underlying commodity, whereas futures contract have the obligation to buy or sell the underlying commodity. The buyer of the options contract can choose whether or not to exercise their right.

Options markets trade options contracts, which specify the underlying security, the expiration date, and the strike (or exercise) price. Day traders can trade options contracts to make a profit on the difference between the buying price and the selling price (when the options are sold before expiration), or to make a profit from the underlying security when they are exercised. As with futures contracts, options contracts are traded by day traders and longer term traders, and also by non traders with an interest in the underlying commodity. When traded for the underlying commodity, options contracts work the same way as futures contracts, but only give the right to buy or sell the underlying commodity rather than the obligation.

### STOCK MARKETS

---

A stock market is the organized exchange of the ownership shares of public corporations. The buying and selling of stock occurs in stock exchanges. Stock exchanges used to be physical locations where representatives of buyers and sellers actually met to negotiate for the purchase and sale of stocks. Today with the development of computer technologies and the Internet, sales are often completed electronically. The New York Stock Exchange still places buy and sell orders on the trading floor of the exchange located on Wall Street in New York City. Another major U.S. stock exchange, NASDAQ, is a virtual exchange. There is no physical trading floor at its New York office. All offers and bids between sellers and buyers are matched electronically.

### OTHER FINANCIAL MARKETS

---

Companies use other methods to obtain financing. Capital markets are used to finance intermediate or long-term debt of one year or longer. Stock markets are one type of capital market. Another is the bond market. A bond is a financial instrument that obligates the issuer to pay the bondholder the principal plus agreed-upon interest at the end of a designated period. Bonds are often issued for terms of 5, 10, and 20 years or even longer. Bond markets offer newly issued bonds of companies and government agencies for sale as well as buying and selling existing bonds.

Money markets specialize in buying and selling financial instruments for short time periods of a year or less. The federal government offers short-term securities known as treasury bills. Some cities offer municipal notes to obtain cash for city operations. The government securities are repaid from taxes or other revenues. A common form of money market financing



familiar to many individuals are certificates of deposit (CDs) offered by banks and other financial institutions. Businesses raise money needed for short-term operating expenses by selling commercial paper. The various types of short-term securities are sold and traded through banks, government offices, and securities dealers.

### **PRIMARY AND SECONDARY OFFERINGS**

When an organization makes stock available for the first time or issues new bonds, it is known as a primary offering. The primary offering is also referred to as the initial public offering (IPO). Primary offerings are used to raise new capital for an organization. That organization receives the proceeds from the sale of the IPO.

Buyers may choose to hold the stock and bonds or they may decide to resell them. When an investor offers stocks and bonds for resale, they are known as a secondary offering. The original organization is not involved in the secondary sale, so it does not receive any money. The value of securities increase and decrease based on supply, demand, economic conditions, and other market factors. Investors buy and sell securities on the secondary market with the hope of making a profit on their eventual sale.

## **2-4 Global Financial Activities**

### **OBJECTIVES**

- *Recognize the importance of global business.*
- *Identify several types of international financial activities.*

### **GOING GLOBAL**

It is difficult today for most businesses to operate without being affected by the global business environment. Changing technology in communications makes information exchange around the world almost instantaneous. Improvements in production processes and distribution methods make it possible to move raw materials, supplies, and finished goods quickly from place to place. This allows lower-cost production and access to customers in many countries. Trade agreements negotiated between countries and regions of the world reduce trade restrictions and encourage free trade. Corporate ownership is often multinational. Business investments are made with little regard for country boundaries. Whether by choice or not, businesses are facing global competition and are adjusting their decisions and operations to reflect the global marketplace. A global business, or multinational business, is a company that transcends national boundaries and is not committed to a single home country.

### **IMPORTANCE OF INTERNATIONAL BUSINESS**

Over the past 20 years, U.S. business investments in other countries have grown from under \$500 billion to nearly \$2.5 trillion. At the same time, foreign companies have made business investments in the United States. Those foreign investments have grown from about \$200 billion to over \$1.5 trillion over the 20-year period. Multinational investments have been made in almost all industries. Those investments are not limited to ownership of companies in other countries. Businesses may form formal partnerships or less formal working agreements. One company may share a technology or process with another, offer management help, or provide a business activity that is needed by the foreign company for effective competition in a new market. One of the major forms of international investment is providing long-term and short-term loans and other types of financing to foreign businesses. Reasons for companies to make international business investments include:

- To expand their markets
- To increase operating efficiency and reduce costs
- To reduce political, legal, and regulatory hurdles they might otherwise face in other countries
- To diversify their operations
- To gain a greater return on their investments

### **PROBLEMS FACED IN INTERNATIONAL BUSINESS**

It is not easy to shift business activities from one country to another. Each country has different political, economic, and legal environments. The culture of business in the new country may mean a different approach to business relationships, different management practices, and even different beliefs about ethical issues. Specifically, businesses have to consider:

- Language and cultural differences affecting company employees and customers
- Differences in the stability of the government that might result in political risks
- Different economic philosophies leading to more or less government influence on the economy and on businesses
- Different money systems and fluctuating monetary values between Currencies

**INTERNATIONAL FINANCE**

International business requires international finance. Money flows from one business to another across country borders. Individual and organizational investors look to foreign markets for investment opportunities. Special considerations affect international finance.

**FOREIGN CURRENCIES AND RATES OF EXCHANGE**

When products and services are bought and sold globally, payments move from one country to another. Usually each country has its own currency. The currency of another country is a foreign currency. If a U.S. business wants to purchase goods from a member of the European Union it will need to convert U.S. dollars to euros. In the same way, if a Japanese automobile manufacturer ships pickup trucks to Mexico, pesos will need to be converted to yen. To make the conversion from one currency to another, an exchange rate must be established. An exchange rate is the value of one currency in terms of another. Exchange rates in the U.S. are often expressed in terms of how much of a foreign currency is required to purchase one dollar. For example 1.23 CAD/USD means that it takes 1.23 Canadian Dollars to purchase one U.S. Dollar.

Exchange rates are established in the foreign exchange market. The foreign exchange market is where one currency is exchanged for another. The foreign exchange market is not one organization or one location. It is a series of interconnected entities including large banks, governments, multinational businesses, and smaller retail businesses that exchange small amounts of currencies for individuals.

There is not just one exchange rate at a given time between two countries' currencies. The exchange rates cannot vary a great deal or it would make exchanging currencies too difficult and risky. Today's technology allows participants involved in currency exchanges to compare rates worldwide and make exchanges where they can get the best rates.

The foreign exchange market is the largest trading market in the world, handling over \$1½ trillion each day. The largest volume of currency exchange occurs in the United Kingdom, which accounts for nearly ⅓ of all exchanges. The other countries with large exchange volumes are the United States and Japan.

The exchange rate for a country's currency is based on the supply and demand for that currency. If few U.S. dollars are available for exchange yet a large amount are demanded, the exchange rate will increase. The difference in the value of a country's imports and exports affects supply and demand and therefore the exchange rates. If the U.S. is importing more goods than it is exporting, it will need to convert more U.S. dollars to other currencies. Converting to other currencies increases the demand for those currencies and decreases the exchange rate for U.S. dollars.

**INTERNATIONAL CAPITAL INVESTMENTS**

One way for businesses and individual investors to participate in the global economy is to invest in businesses from other countries. Those investments can be in the form of direct investment through short-term and long-term loans to foreign or multinational businesses. Investors will want to consider the rate of return on the investment compared to other possible uses of their money. They will want to study the possible risk of the investment. Risks may be higher or lower than similar investments in U.S. firms.

A second method of international investment is by participating in foreign stock markets. While the U.S. stock markets offer trading in many international businesses, many countries have their own stock exchanges that offer stock trading for the corporations headquartered in their countries. Trading rules and procedures may be different from one exchange to another, so investors need to have expert advice and assistance before participating in a new stock market.

The major U.S. exchanges have well-known market indexes that provide information on the overall performance of the stock market. Those include the Dow Jones Industrial Average, the NASDAQ Composite, and the Standard and Poor's (S&P) 500. The stock markets of other countries have their own market indexes.

- Germany: XETRA DAX
- Japan: Nikkei 225
- Great Britain: FTSE 100
- Hong Kong: Hang Seng

**Chapter Summary**

- *Financial decisions are influenced as much by the economy as by any other factors. Effective financial planning and decision making requires an understanding of the economy and economic principles.*
- *Businesses and individuals make decisions about what to produce and what to consume. Microeconomics is about economic decisions related to the choices of individuals and businesses. Macroeconomics is about economic decisions made at a national level.*
- *The way a business is organized plays a major role in its financial condition. It will determine how much money is available to start the business, how additional funds can be obtained when needed, how income and expenses are allocated and accounted for, and even the amount of taxes paid by the business and business owner.*
- *Many factors enter into the decision about the form of business ownership. These include the amount of individual responsibility and control, the simplicity or complexity of running and managing the business, and differences in legal requirements and liability. A major consideration is the financial implications for owning and operating each type of business.*
- *Financial markets and financial institutions have developed to facilitate exchanges between those who need money and those who have money. A financial market is an organized process for the exchange of capital and credit. Some basic principles of financial exchange guide the activities of those markets and institutions.*
- *Sellers want to obtain the highest price possible for their resources while buyers want to purchase those resources at the lowest price. Financial markets help identify the available supply and demand for a specific resource in order to determine the market price at a particular time. The market manages the exchange between buyers and sellers.*
- *Corporate ownership is often multinational and business investments are made with little regard for country boundaries. A global or multinational business is a company that transcends national boundaries and is not committed to a single home country.*
- *International business requires international finance. Money must be exchanged from one country's currency to that of the other country. Businesses and individual investors participate in the global business economy by investing in businesses of other countries.*