

SUGGESTED SOLUTIONS FOR BUSINESS CASE QUESTIONS FOR THOUGHT

These are suggested answers to the “Questions for Thought” that conclude each business case near the end of sections.

Section 1

1. What is the opportunity cost associated with having a worker wander across the factory floor from task to task or in search of tools and parts?

Suggested Solution

1. The opportunity cost of a worker wandering across the factory floor is forgone output—the output that worker could have produced in the time spent wandering around.
2. How does lean manufacturing improve the economy’s efficiency in allocation?

Suggested Solution

2. Lean manufacturing improves the economy’s efficiency in allocation because, for example, an automaker can more quickly switch to producing more of the types of cars that more consumers want and fewer of the types of cars that fewer consumers want.
3. How will the shift in the location of Toyota’s production from Japan to the United States alter the pattern of comparative advantage in automaking between the two countries?

Suggested Solution

3. The shift in the location of Toyota’s production from Japan to the United States means that it is likely that Japan will no longer have a clear comparative advantage in automaking vis-à-vis the United States.

Section 2

1. Why do you think it was profitable for Li & Fung to go beyond brokering exports to becoming a supply chain manager, breaking down the production process and sourcing the inputs from various suppliers across many countries?

Suggested Solution

1. By sourcing inputs from various suppliers across many countries, Li & Fung was able to allocate production to where it is most cost effective, namely to those economies that have a comparative advantage in producing a given input.
2. What principle do you think underlies Li & Fung’s decisions on how to allocate production of a good’s inputs and its final assembly among various countries?

Suggested Solution

2. Comparative advantage is the principle that underlies Li & Fung’s decisions. Inputs that require more skill or are more capital-intensive can be produced in countries that

have relatively higher-skilled workers or are relatively more abundant in capital, such as Hong Kong and Japan. Similarly, inputs that are more labor-intensive can be produced in countries that are relatively more abundant in labor, like mainland China and Thailand.

3. Why do you think a retailer prefers to have Li & Fung arrange international production of its jeans rather than purchase them directly from a jeans manufacturer in mainland China?

Suggested Solution

3. A retailer that purchased jeans directly from a manufacturer in mainland China would not benefit from the gains from trade that arise from sourcing inputs from different countries according to those countries’ comparative advantage.
4. What is the source of Li & Fung’s success? Is it based on human capital, on ownership of a natural resource, or on ownership of capital?

Suggested Solution

4. The source of Li & Fung’s success is human capital. The company understands how to use the principle of comparative advantage to exploit gains from trade in the production process. In addition, it is skilled in providing quality control and logistics.

Section 3

1. Why do businesses care about GDP to such an extent that they want early estimates?

Suggested Solution

1. Businesses care about GDP because it’s our prime indicator of the overall state of the economy. Macroeconomics tells us that the overall state of the economy matters a lot to individual firms: what’s good or bad for the U.S. economy as a whole is generally good or bad for each individual company, too.
2. How do the methods of Macroeconomic Advisers and the Institute of Supply Management fit into the three different ways to calculate GDP?

Suggested Solution

2. Macroeconomic Advisers looks at purchases to estimate GDP; in effect, it’s using the method of calculating GDP that derives the total value of output by adding up total spending on domestically produced goods and services. The Institute of Supply Management, by contrast, surveys producers to find out how much they’re producing; it is, in

a sense, using the method of calculating GDP that adds up the value of production of final goods and services.

3. If private firms are producing GDP estimates, why do we need the Bureau of Economic Analysis?

Suggested Solution

3. First, much of the data Macroeconomic Advisers uses are provided by the U.S. government. Second, both Macroeconomic Advisers and the Institute of Supply Management have only partial data, relying on educated guesswork to fill in the blanks. Only the Bureau of Economic Analysis has the scope and resources to cover the whole field. The only way the private forecasters know if they've gotten it right is by comparing their results to the BEA data when they come in.

Section 4

1. How are frictional and structural unemployment likely to be affected by the existence of online job listings?

Suggested Solution

1. Since frictional unemployment results when people need to take time to find jobs, it seems likely that an online job search could reduce frictional unemployment by making it easier to find a job. However, the evidence does not conclusively support such a claim. Structural unemployment results from wages being stuck at a level above the equilibrium wage. It is not likely that the ability to share and seek information about jobs online would significantly affect the wage level. For example, online sites like Monster.com have no impact on the minimum wage.
2. In light of our discussion of the determinants of the unemployment rate, how could improved matching of job-seekers and employers through online job listings help?

Suggested Solution

2. Improved matching of job-seekers and employers through online job listings could help reduce frictional unemployment, which occurs when workers are unemployed while searching for their next job. As a result, Internet job search could reduce the natural rate of unemployment in both the short and long run.
3. What does the fact that Monster Worldwide did badly during the 2008–2009 surge in unemployment suggest about the nature of that surge?

Suggested Solution

3. The fact that a period of high unemployment was bad for job-search companies, rather than good, suggests that not much of the rise in unemployment was frictional. More broadly, it suggests that there was a rise in cyclical unemployment rather than a rise in the natural rate.

Section 5

1. In this section we described several sources of productivity growth. Which of these sources corresponds to the “Walmart effect”?

Suggested Solution

1. Productivity growth can be the result of increased physical capital, increased human capital, or improved technology. The Walmart story, which centers on improved techniques for managing logistics, is mainly about technological progress.
2. How does the Walmart story relate to the “information technology paradox”?

Suggested Solution

2. The information technology paradox is that there have been amazing new technologies that at first didn't seem to do much for productivity because nobody seemed to know what to do with them. Walmart demonstrated just how important it is to learn how to make use of new technologies: the firm didn't invent bar-code scanners or the Internet, but it took a leading role in putting those technologies to use.

Section 7

1. Why did a national slump that began with housing affect companies like Eagle Alloy that didn't sell much to the construction industry?

Suggested Solution

1. A fall in current disposable income, as well as falls in wealth and expected future disposable income, lead to a fall in consumer spending. So the decline in housing, which reduced both wealth and income, led to a broad decline in consumer spending across America. This broad decline in consumer spending, in turn, hit companies that didn't sell much to the construction industry.
2. Why did the troubles of Muskegon manufacturers spread to other industries, like retailing?

Suggested Solution

2. The spread of trouble from manufacturing to retailing in Muskegon reflects the same principle of changes in current disposable income affecting consumer spending: laid-off workers, with their incomes significantly reduced, cut back on their purchases at local stores.
3. How does this story about Muskegon help explain how a slump in housing—a relatively small part of the U.S. economy—could produce such a deep national recession?

Suggested Solution

3. The story of Muskegon illustrates how the multiplier process takes place. The fall in housing led to a fall in consumer spending, which hurt manufacturing companies like Eagle Alloy. These companies, in turn, laid off workers, who reduced their consumer spending, hurting local retailers among others. So the story shows how a fall in investment spending—in this case, housing investment spending—can have an impact on the economy as a whole that is larger than the initial decline.

Section 8

1. How did United's problems in early 2008 relate to our analysis of the causes of recessions?

Suggested Solution

1. In early 2008, United Airlines faced sharply higher fuel prices, a price spike that affected all other businesses and consumers in the economy as well. In other words, the economy experienced a negative supply shock: a leftward shift of the short-run aggregate supply curve. Other things equal, a negative supply shock raises the aggregate price level and, in the short run, leads to a decrease in aggregate output as the economy experiences a recessionary gap. As the short-run aggregate supply curve shifts leftward, aggregate output decreases as the economy moves along the aggregate demand curve. So a negative supply shock, one of the causes of recessions, was present in early 2008: the recession reverberated throughout the economy and was felt by companies like United.
2. Chairman of the Fed at the time, Ben Bernanke, had to make a choice between fighting two evils in early 2008. How would that choice affect United compared with, say, a company producing a service without expensive raw-material inputs, like health care?

Suggested Solution

2. The two evils Ben Bernanke had to fight were an increase in the aggregate price level as the short-run aggregate supply curve shifted to the left and a fall in aggregate output as a recessionary gap developed. Determining policy in the face of a supply shock is difficult. To fight an increase in the price level, the Federal Reserve could have reduced aggregate demand—at the cost of further reducing aggregate output. To fight the recessionary gap, the Fed could have increased aggregate demand—at the cost of further raising the aggregate price level.
The Fed chose to pursue a policy of increasing aggregate demand, which—other things equal—results in a further increase in the aggregate price level. A higher price level, particularly higher prices for raw-material inputs such as jet fuel, hits companies like United Airlines particularly hard. Although eventually all prices in the economy rise after a negative supply shock, companies that use more raw-material inputs, such as airlines, are more immediately affected than companies that use fewer, such as health care providers. If the Fed had instead chosen to pursue a policy of reducing aggregate demand, this would have resulted in lowering the aggregate price level and would have benefited companies, like United, that are more immediately affected by raw-material prices.
3. In early 2008, business travel was beginning to slacken, but leisure travel was still holding up. Given the situation the overall economy was in, what would you expect to happen to leisure travel as the economy moved further into recession?

Suggested Solution

3. The negative supply shock initially raised the aggregate price level, and led to a fall in aggregate output. Business travel would be affected first: because most business travel is arranged relatively close to the date of travel with the purchase of flexible tickets that can be canceled and refunded, the quantity of business travel demanded fell soon after the rise in prices. But leisure travel would be next: because most leisure travel is arranged in advance of the travel date with the purchase of nonrefundable tickets, it is slower to respond to increases in prices. So although leisure travel was still holding up in early 2008, it was predictable that leisure travelers would also eventually reduce the quantity of travel demanded, as the leftward shift of the short-run aggregate supply curve moved the economy farther along its aggregate demand curve.

Section 9

1. Some opponents of fiscal expansion have accused it of consisting of make-work projects of little social value. What does the Garney story say about this view?

Suggested Solution

1. In this case, the projects undertaken had already been planned for some time and were waiting for funding. So they were clearly not make-work.
2. Based on this case, would you say that government spending was competing with the private sector for scarce resources?

Suggested Solution

2. Despite the stimulus funds, Garney was doing less business than it had before the recession. So there was excess capacity waiting to be used, implying that the government wasn't competing for resources with private firms.
3. If a water or sewer project is something we want to do eventually, is the depth of a recession a good or a bad time to undertake that project? Why?

Suggested Solution

3. The fact that the stimulus spending was apparently putting resources to work that would otherwise have been idle, and that it therefore wasn't competing with the private sector, suggests that a recession is a good time to undertake projects we want to do eventually.

Section 10

1. Why are gift card owners willing to sell their cards for a cash amount less than their face value?

Suggested Solution

1. A gift card is not as liquid as cash. Cash can be turned into merchandise in any store; a gift card can be used only at its issuer.

- Why do gift cards for retailers like Walmart, Home Depot, and Whole Foods sell for a smaller discount than those for retailers like the Gap and Aeropostale?

Suggested Solution

- Retailers like Walmart, Home Depot, and Whole Foods sell necessities, but the Gap and Aeropostale sell non-necessities. There will be a larger pool of potential buyers for cards from retailers of necessities than from sellers of non-necessities because more people have constrained budgets and so are shopping only for necessities. In addition, because people shop repeatedly for necessities, they know they are more likely to use up the face value of a card they can use for necessities than one usable only for non-necessities. So more potential buyers compete to buy cards for necessities, which drives their discount down compared to cards for non-necessities.
- Use your answer from Question 2 to explain why cash never “sells” at a discount.

Suggested Solution

- Cash can be used to purchase any good or service, necessity or non-necessity; it is accepted everywhere. Also, it comes in any face value you want. So there will always be an extremely large number of people willing to “buy cash” because the price of a dollar will never be less than a dollar.
- Explain why retailers prefer to reward loyal customers with gift cards instead of rebate checks.

Suggested Solution

- Most customers who receive a rebate check deposit the check into their checking account, withdraw the cash, and use it to pay for purchases. However, those purchases need not be from the issuer of the rebate check. In contrast, a gift card must be used at the retailer that issues it. Also, cash doesn’t expire, but gift cards often do. And because gift cards have a predetermined face value, it is more likely that a customer will not use it all up—unlike cash, which is always eventually spent. For all these reasons, a retailer can capture breakage on a gift card but not on a rebate check. So retailers will prefer gift cards.
- Congress has enacted legislation restricting the ability of retailers to impose fees and expiration dates on their gift cards and mandating greater disclosure of their terms. Why do you think Congress did this?

Suggested Solution

- Retailers have an incentive to adopt policies that increase breakage (the amount of a gift card that accrues to the retailer rather than the cardholder), such as imposing fees and expiration dates. Not telling customers about these policies increases breakage. So Congress has intervened to restrict these practices.

Section 11

- Why did PIMCO’s view that unemployment would stay high and inflation low lead to a forecast that policy interest rates would remain low for an extended period?

Suggested Solution

- The Taylor rule suggests that the Fed sets interest rates based on the unemployment rate and the inflation rate. If unemployment stays high while inflation is low, this would indicate that the Fed would keep policy rates low—in fact, close to zero.
- Why would low policy rates suggest low long-term interest rates?

Suggested Solution

- Long-term rates largely reflect expectations about future short-term rates. If investors expect short-term rates to stay low for a long time, this should lead to low long-term rates now.
- What might have caused long-term interest rates to rise in late 2010, even though the federal funds rate was still zero?

Suggested Solution

- Even though the federal funds rate stayed near zero in late 2010, investors expected it to rise eventually, once the economy had recovered. Increased optimism meant that investors moved up their expectation of when the federal funds rate might rise, leading to a rise in long-term rates.

Section 12

- How can a government obtain revenue by printing money when someone else actually prints the money?

Suggested Solution

- If you think about it, seignorage doesn’t really come from *printing* currency—it comes from the ability to *issue* currency. The fees De La Rue’s customers pay for printing banknotes are presumably much less than the face value of those notes.
- Why, exactly, would Gaddafi have resorted to the printing press in early 2011?

Suggested Solution

- The embattled Gaddafi regime was in the classic position of governments that resort to the printing press: it was faced with a severe need for funds to pay troops and buy weapons, yet it was politically weak (so weak that it didn’t even control all of its own country), making it hard to raise taxes. And the regime presumably couldn’t borrow, both because it lacked credibility (for good reason) and because many of the nations where it might have raised funds were supporting the rebels.
- Were there risks to the Libyan economy in releasing those dinars to its new government?

Suggested Solution

- By releasing the dinars to the new Libyan government, Britain was in effect putting that government in the position of trying to extract substantial resources through seignorage. This at least raised the possibility that the

new government—which was, inevitably, fairly weak at first—might find itself presiding over high inflation, maybe even hyperinflation.

Section 13

1. Why does the yen-dollar exchange rate matter so much for the fortunes of Caterpillar and Komatsu?

Suggested Solution

1. If we assume that both companies manufacture their products mainly in their home nations (which happens to be true), any rise in the yen (which is a fall in the dollar) raises Komatsu's costs compared with Caterpillar's, and any fall in the yen has the reverse effect. So movements in the yen-dollar exchange rate tend, other things equal, to give one company or the other a competitive advantage.
2. Why does the figure present the real rather than the nominal exchange rate? Do you think this makes an important difference to the story?

Suggested Solution

2. The real exchange rate adjusts for differences in inflation, which can alter the significance of any given nominal exchange rate for relative costs, as we saw in the Mexico-United States comparison in the text. In the specific case of competition between an American company and a Japanese company, it's crucial to correct for the fact that Japan has actually experienced *deflation* since the 1990s, but inflation has continued in the United States.
3. In 2011, Japanese policy makers were discussing possible sales of yen on the foreign exchange market. How would this affect the Caterpillar/Komatsu rivalry?

Suggested Solution

3. Sales of yen on the foreign exchange market should, other things equal, weaken the yen. This would help Komatsu at Caterpillar's expense.