Free Enterprise, the Economy and Monetary Policy

free (fre) adj. *not controlled by or under the power of another; at liberty; not bound or constrained; able to move in any direction.*

enterprise (en´ter-priz) n. *energy and initiative; an undertaking, especially a big, bold or difficult one; readiness for adventure or risk; a business organization.*

Free enterprise is the freedom of individuals and businesses to operate and compete with a minimum of government interference or regulation. It enables individuals and businesses to create, produce, transform, develop, innovate and compete in the marketplace. As they are able and willing, enterprising people produce goods and services for profit, offer their labor for wages and own the resources needed to produce and sell goods and services. In this system, no one forces people to be creative, productive or enterprising. Instead, they pursue what they believe to be best for them. By producing the goods and services that society values most highly, a free enterprise system results in the greatest efficiency, or lowest costs, of any economic system. It is the system most compatible with individual freedom and political democracy.

What Is Free Enterprise?

Free enterprise means men and women have the opportunity to own economic resources, such as land, minerals, manufacturing plants and computers, and to use those tools to create goods and services for sale.

What prompts people to take the financial and emotional risk of starting a business? The main motivator is the potential to earn a profit. People also go into business for personal reasons, such as the desire for independence and the drive to be creative.

Others have no intention of starting a business. If they choose, they can offer their labor, another economic resource, for wages and salaries. The key to free enterprise is that all these people, whether they start a business of their own or work for someone else, do so voluntarily. By allowing people to pursue their own interests, a free enterprise system can produce phenomenal results. Running shoes, walking shoes, mint toothpaste, gel toothpaste, skim milk, chocolate milk, cellular phones and BlackBerrys are just a few of the millions of products created as a result of economic freedom.

The Building Blocks of a Free Enterprise System

Most free enterprise systems consist of four components: households, businesses, markets and governments.

Households—the Owners. In a free enterprise system, households—not the government—own most of the country's economic resources and decide how to use them. One of the resources that households possess is their labor, which they sell to existing firms or use to form new businesses. In addition to selling their resources where they can get the highest price or largest profit, households also act as consumers. The wages and salaries of households purchase about two-thirds of all the production in the United States. Consumers vote with their dollars, thereby directing production toward the goods and services they want businesses to provide. This is called *consumer sovereignty*.

Businesses—the Organizers. Businesses organize economic resources to produce a good or service. The people who start businesses are called *entrepreneurs*. They are the organizers and innovators, constantly discovering new and better ways to bring resources together in the hopes of making a profit. Profit fuels the engine of business. Entrepreneurs, lured by the potential for profits, create new businesses to satisfy consumers' needs and desires. The inability to make profits signals businesses to close or to reorganize their resources more efficiently. *Efficiency* means that resources are being used to produce the goods and services that society most desires at the lowest economic cost. In a competitive industry, the presence or absence of profits sends an important signal about the industry's economic efficiency.

Markets—the Brokers. How and where do buying and selling activities take place? The answer is, in markets. Although markets are not necessarily people, they act as agents—something like a stockbroker or a real estate agent—to bring buyers and sellers together. Over time, markets have become increasingly complex. Now, buying and selling can occur 24 hours a day from anywhere in the world via the Internet. A market is any place or any way that buyers and sellers

can exchange goods, services, resources or money. There are three categories of markets in a free enterprise society: resource markets, product markets and financial markets. Households go through resource markets to sell their labor to businesses. Businesses go through product markets to sell goods and services to households. And both households and businesses use financial markets to borrow and save money. Typically, businesses borrow money that households save, using financial institutions as the intermediary.

Governments—the Protectors. The cornerstone of a truly free enterprise economy is the absence of government interference in economic matters. However, the government still plays an important role in any free enterprise system. This is because unlimited freedom is impossible: one person's freedom may sometimes conflict with another's. As Supreme Court Justice William O. Douglas once put it, "My freedom to move my fist must be limited by the proximity of your chin." The main role of government in a free society, then, is to define and enforce the rules of society. Government has the coercive power to maintain law and order, protect people's right to own property and enforce voluntary contracts people enter into. In essence, government provides the umbrella under which the free enterprise system operates. Governments also provide goods, such as national defense, that the private market alone would have a hard time producing.

The Price System

The price system is the link that connects consumers, producers and markets. Prices tell us about the demand for a good, and they also tell us how scarce or abundant the good is. For example, water has great underlying value to society. If prices measured only value, then water would be extremely expensive. But we all know that water generally is not very expensive. This is because the price of water also reflects its abundance. The same concept applies to a Picasso painting. A single painting does not necessarily have a tremendous value to society; we could easily live without it. But an original Picasso is extremely expensive, while a poster print of a Picasso painting is relatively cheap. Why? Because the original is one of a kind, while the posters are numerous.

Prices provide information that is vital to making economic decisions. Without market prices, it would be very difficult for people to measure the value to society of each good and the scarcity or abundance of our resources. If we tried to make decisions without prices, as socialist countries do, then we would probably produce too many of some goods and too few of others.

The "Free" of Free Enterprise

Free markets are an extension of personal freedom. The premise of a market system is that people benefit from their own purposeful actions. Football fans stand in line for Dallas Cowboys tickets because they believe they will be better off if they can purchase tickets and go to the game. The team owner also benefits because the team must make a profit to remain in business. Both the owner and the fans are better off when tickets are sold. That's what free enterprise is all about—cooperation and mutual benefit. No one is forced to buy football tickets, no one is forced to sell football tickets, and no one is forced to play football.

A free enterprise system promotes the freedom of individuals, whether they are part of the majority or a minority. For example, when people buy pencils, they don't ask about the race of the lumberjacks who chopped the wood, the religious preference of the miners who dug up the graphite or the political affiliation of the workers who molded the aluminum casing for the eraser. Instead, they ask, Is this a good price for the product?

In a free market system, a business that expresses prejudice and discriminates in its decisions will face higher costs than firms that do not discriminate. This is because the discriminating firm will have a smaller pool of workers and other resources to choose from. Such unprofitable attitudes will put them at a competitive disadvantage, and the market will tend to drive them out. Although it is true that prejudicial attitudes still persist in a free enterprise society, it is also true that a free enterprise system does a better job than any other to make such attitudes unprofitable.

The "Enterprise" of Free Enterprise

In a free enterprise system, entrepreneurs, or risk-takers, have a strong incentive to pay attention to the votes consumers register with their dollars. This is because entrepreneurs profit by meeting consumers' wants and needs. Entrepreneurs continually strive to improve established products and discover new ones. In the end, both the producers and the consumers benefit. Producers can earn a profit, and consumers can obtain the goods and services they want.

Free markets do not cater solely to the majority. They also provide products and services that appeal to individual tastes. Societies in which one group of leaders makes all the economic decisions probably do not produce the things that groups with special interests would like to have. For example, it is doubtful that one central authority would think to produce both rap music and classical music, Super Mario Brothers and Trivial Pursuit, pizza and sushi, and Bran Flakes and Cap'n Crunch. But free markets provide all these things and much, much more. Free markets provide a vehicle for serving the individual needs of an entire spectrum of interests, whether they represent the majority or only a small percentage of people.

Adam Smith, in *The Wealth of Nations*, showed us more than 200 years ago that people pursuing their own self-interests in a free enterprise economy, as if led by some "invisible hand," end up promoting the public interest. But with all these people looking out for themselves, how does free enterprise result in such beneficial outcomes for society? That's where competition enters the picture. For example, when computers first came on the market, they had great value but were extremely costly to produce. Relatively few businesses could afford them. But the lure of profits prompted other companies to start producing computers. This added competition had two results. It prompted computer companies to cut costs in order to compete, and it led them to look harder and faster for innovations that could give their computers an edge over the others. Now, computers are much less expensive, more powerful and much more userfriendly than they used to be. Competition and the lure of profits, combined with ingenuity, continue to drive the market forward.

The benefits of competition and free enterprise are not limited to one country. If free enterprise between people in Texas and California makes those individuals better off, then free enterprise between people in Texas and Mexico must make those individuals better off as well. The larger the marketplace, the greater the choice available and the greater the competition. Competition results in greater efficiency and lower prices, whether it be between two companies in the same country or two companies on opposite sides of the globe.

Where Does the Federal Reserve Fit In?

Without a common unit of exchange, buying and selling in a free enterprise system would consist of bartering goods for goods, services for services or goods for services. Money provides a medium of exchange. It is common to all buyers and sellers. Money also is used as a unit of account. People can measure the value of a soccer ball in units of money, just as they can measure its weight in number of grams. Moreover, money can be used as a store of wealth over time. It is this function of money that the Federal Reserve is most interested in preserving.

Organized in 1913 as an independent entity, the Federal Reserve is the nation's central bank. The Fed's independence from government control separates the authority to spend money—a role belonging to the government—from the authority to manage the money supply—a role belonging to the Fed. The Fed is responsible for ensuring a supply of money and credit in the system sufficient to maintain a healthy, growing economy. At the same time, the Fed must not inject so much money into the economy that the money loses its value. If the Federal Reserve let the money supply grow too rapidly, then the amount of money in the economy would be greater than the quantities of goods and services for sale. This oversupply of money would lead to widespread escalation of prices—what we know as inflation.

Inflation is like a thief in the night. It robs people of their power to purchase goods and services and hinders the economy's ability to grow. Rapid inflation can cause political instability and make it difficult for people to plan future investments, whether they are organizing funds to buy a franchise, saving for college tuition or trying to increase the size of their workforce. By attempting to limit inflation's adverse effects, the Federal Reserve plays a vital role in building and maintaining a strong free enterprise system.

From the Federal Reserve of Dallas: http://www.dallasfed.org/educate/everyday/ev5.html