

CHAPTER 2

The Market System and the Circular Flow

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MICROECONOMICS



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LEARNING OBJECTIVES 1/2

LO2.1 Define and explain laissez-faire capitalism, the command system, and the market system.

LO2.2 List the main characteristics of the market system.

LO2.3 Explain how the market system answers the five fundamental questions:

1. What to produce?
2. How to produce?
3. Who obtains the output?
4. How to adjust to change?
5. How to promote progress?

LEARNING OBJECTIVES 2/2

LO2.4 Explain the operation of the “invisible hand.”

LO2.5 Describe the mechanics of the circular flow model.

LO2.6 Explain how the market system deals with risk.

2.1 ECONOMIC SYSTEMS 1/4

- Economic systems determine production, distribution, change accommodation, and technological progress in response to the economic problem.
 - Vary based on ownership of production factors and methods of motivating and coordinating economic activity.
 - Most national economies are mixed, featuring market and command systems elements.

Laissez-faire Capitalism

- “Keep the government from interfering with the economy”
- Power of government needed to
 - Protect private property from theft
 - Provide a legal environment for contract enforcement
- People interact in markets to buy and sell

The Command System

- It is known as socialism or communism
- Government ownership of resources
- Decisions made by a central planning board
- Examples: North Korea, Cuba, Myanmar

The Market System

- It is a mix of decentralized decision-making with some government control
- Systems found in much of the world
- Private markets are the dominant force
- Private ownership of resources
- Self-interested behaviour

Private Property

- Property rights ensure mutually agreeable economic transactions, encouraging cooperation, investment, innovation, and economic growth.
- These rights also incentivize maintaining or improving property, protect intellectual property, and allow focus on productive activities instead of property protection.

Freedom of Enterprise and Choice

- **Freedom of enterprise**
 - Freedom of enterprise allows entrepreneurs and private businesses to obtain and use economic resources freely.
 - They can produce and sell goods and services in markets of their choice.

Freedom of Enterprise and Choice

- **Freedom of choice**
 - Enables owners to employ or dispose of their property and money as they see fit.
 - Global Perspective 2.1 highlights the varying degrees of economic freedom across different economies.

GLOBAL PERSPECTIVE 2.1

- The Index of Economic Freedom measures economic freedom in 178 economies based on categories such as trade policy, property rights, and government intervention.
- Each country is categorized as free, mostly free, moderately free, mostly unfree, or repressed and ranked from 1 to 184.



Source: The Heritage Foundation

2.2 CHARACTERISTICS OF THE MARKET SYSTEM 4/9

Self-interest

- Self-interest gives direction and consistency to what might otherwise be a chaotic economy.

Competition

- Competition among buyers and sellers diffuses economic power within the businesses and households that make up the economy.

Market and Prices

- The decisions on each side of the market determine product and factor prices that guide resource owners, entrepreneurs, and consumers.

Technology and Capital Goods

- The market system rewards innovators directly, encouraging rapid development of advanced capital goods.
- Advanced technology and capital goods enhance production efficiency, avoiding the inefficiencies of direct production methods.
- Efficient production through capital goods results in significantly higher output.

Specialization

- Use resources to produce specific goods or services rather than a full range.
- Division of labour (Human Specialization)
 - Makes Use of Differences in Ability, Fosters and Learning-by-doing and Saves time.

Specialization

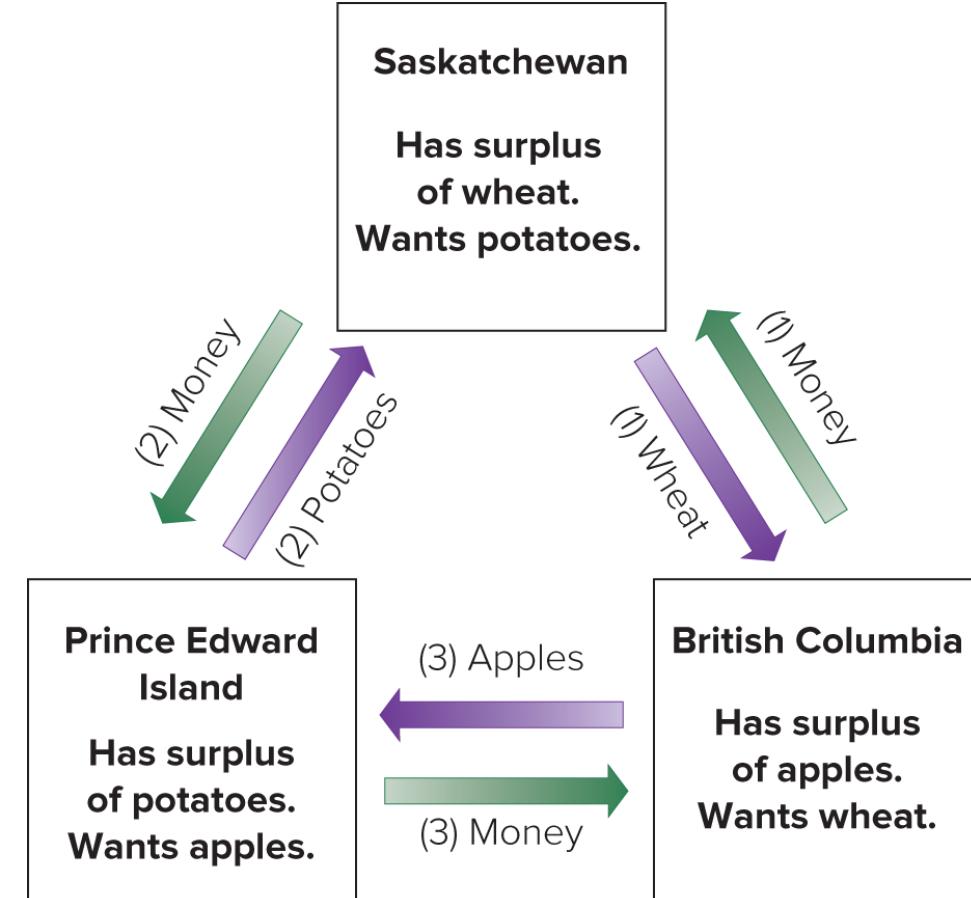
- Geographic specialization (Regional and International)
 - Allows areas to focus on producing goods suited to their geographic conditions, increasing overall efficiency and output.
 - Leads to exchanging surplus products, enhancing resource utilization and providing a wider variety of goods for all regions involved.

2.2 CHARACTERISTICS OF THE MARKET SYSTEM 8/9

Use of money

- Money is primarily a medium of exchange, making trade easier.
- Specialization necessitates exchange, which is facilitated by money.
- Barter requires a coincidence of wants, posing problems for trade without money.

FIGURE 2-1
Money Facilitates Trade When Wants Do not Coincide.



Active But Limited Government

- Modern market systems feature an active but limited government role.
- Market systems promote resource efficiency but have inherent market failures.
- Governments can often enhance market efficiency by addressing these failures.
- However, government interventions can also lead to significant resource misallocations, known as government failures.

2.3 FIVE FUNDAMENTAL QUESTIONS 1/9

1. What goods and services will be produced?
2. How will the goods and services be produced?
3. Who will get the goods and services?
4. How will the system accommodate change?
5. How will the system promote progress?

2.3 FIVE FUNDAMENTAL QUESTIONS 2/10

1. What will be produced?

- The goods and services that create a profit ($TR > TC$).
- **Consumer sovereignty determines the types and quantities.**
 - Dollar votes reflect the wants and needs of consumers.
 - Determine which products and industries survive or fail.

2.3 FIVE FUNDAMENTAL QUESTIONS 3/9

2. How will the goods and services be produced?

- Minimize the cost per unit by using the most efficient techniques
 - The right mix of labour and capital
 - Optimal location of production facilities
 - Technology
 - Prices of the necessary resources

Table 2-1 Three Techniques for Producing \$15 Worth of Bar Soap

		UNITS OF RESOURCE					
		Technique 1		Technique 2		Technique 3	
Resource	Price per unit of resource	Units	Cost	Units	Cost	Units	Cost
Labour	\$2	4	\$8	2	\$4	1	\$2
Land	\$1	1	1	3	3	4	4
Capital	\$3	1	3	1	3	2	6
Entrepreneurial ability	\$3	1	3	1	3	1	3
Total cost			\$15		\$13		\$15

Technique 2 is economically the most efficient because it is the least costly.

3. Who will get the output?

- **Consumers with the ability and willingness to pay will get the product.**
 - Ability to pay depends on income.
 - Income depends on (a) property and human resources and (b) resources price in the factor market.
 - Willingness to pay depends on preference.

2.3 FIVE FUNDAMENTAL QUESTIONS 5/9

4. How will the system accommodate change?

- Changes in consumer tastes
 - Market systems adjust to consumer preferences.
 - Example: a shift toward fruit juice raises prices and profits in that industry while lowering milk prices.
 - Higher prices attract competitors to the expanding fruit juice industry, causing the milk industry to scale down or exit.

2.3 FIVE FUNDAMENTAL QUESTIONS 6/9

4. How will the system accommodate change?

- Changes in technology
 - New production techniques can make existing resource allocations inefficient.
 - Industries adopting advanced technologies gain a competitive edge, attract resources, and expand output, ensuring market efficiency.

4. How will the system accommodate change?

- Changes in resource prices
 - Fluctuations in resource availability and prices require market adjustments, leading industries with higher costs to contract or innovate.
 - Industries with lower resource costs expand, reallocating surplus resources to support growth.

2.3 FIVE FUNDAMENTAL QUESTIONS 8/9

5. How will the system promote progress?

- **Technological advance**
 - The market system incentivizes technological advancement, improving products and processes.
 - Firms introducing new products or cost-saving methods gain profits, compelling rivals to innovate or fail.
 - This dynamic can lead to creative destruction, where new technologies completely replace outdated products and methods.

2.3 FIVE FUNDAMENTAL QUESTIONS 9/9

5. How will the system promote progress?

- **Capital accumulation**
 - Most technological advances require additional capital goods.
 - Who counts the dollar votes for capital goods?
 - Entrepreneurs and business owners use part of the profit to purchase capital goods to receive higher profits in the future.

2.4 THE INVISIBLE HAND 1/6

In 1776, Adam Smith published The Wealth of Nations.

- Market systems align private and social interests.
- The tendency of competition to promote society's interests despite individuals and firms pursuing their own goals.
- In competitive markets, businesses strive to create better products to increase profits, benefiting society.

2.4 THE INVISIBLE HAND 2/6

In 1776, Adam Smith published The Wealth of Nations.

- Businesses aim to minimize production costs, conserve resources and benefit society.
- The market system creates a unity between individual and societal well-being through competition.

Three special merits of the market system:

1. Efficiency

- In use of resources
- In use of techniques of production
- In the development of new and more efficient techniques

Three special merits of the market system:

2. Incentives

- The market system encourages skill acquisition, hard work, and innovation.
- Lower-cost production raises profits while freeing up resources to be used elsewhere.

3. Freedom

- Economic agents are free to further their self-interest, subject to the rewards and penalties imposed by the market system.

The demise of the command systems

- **Command systems fail to produce adequate amounts of goods and services.**
 - Examples: Soviet Union, North Korea, and pre-reform China
- **The Coordination Problem**
 - Central planners had to coordinate millions of individual consumers, resource suppliers, and business decisions.
 - Set output targets for all goods.
 - A failure in any single industry caused a chain reaction of repercussions.

The demise of the command systems

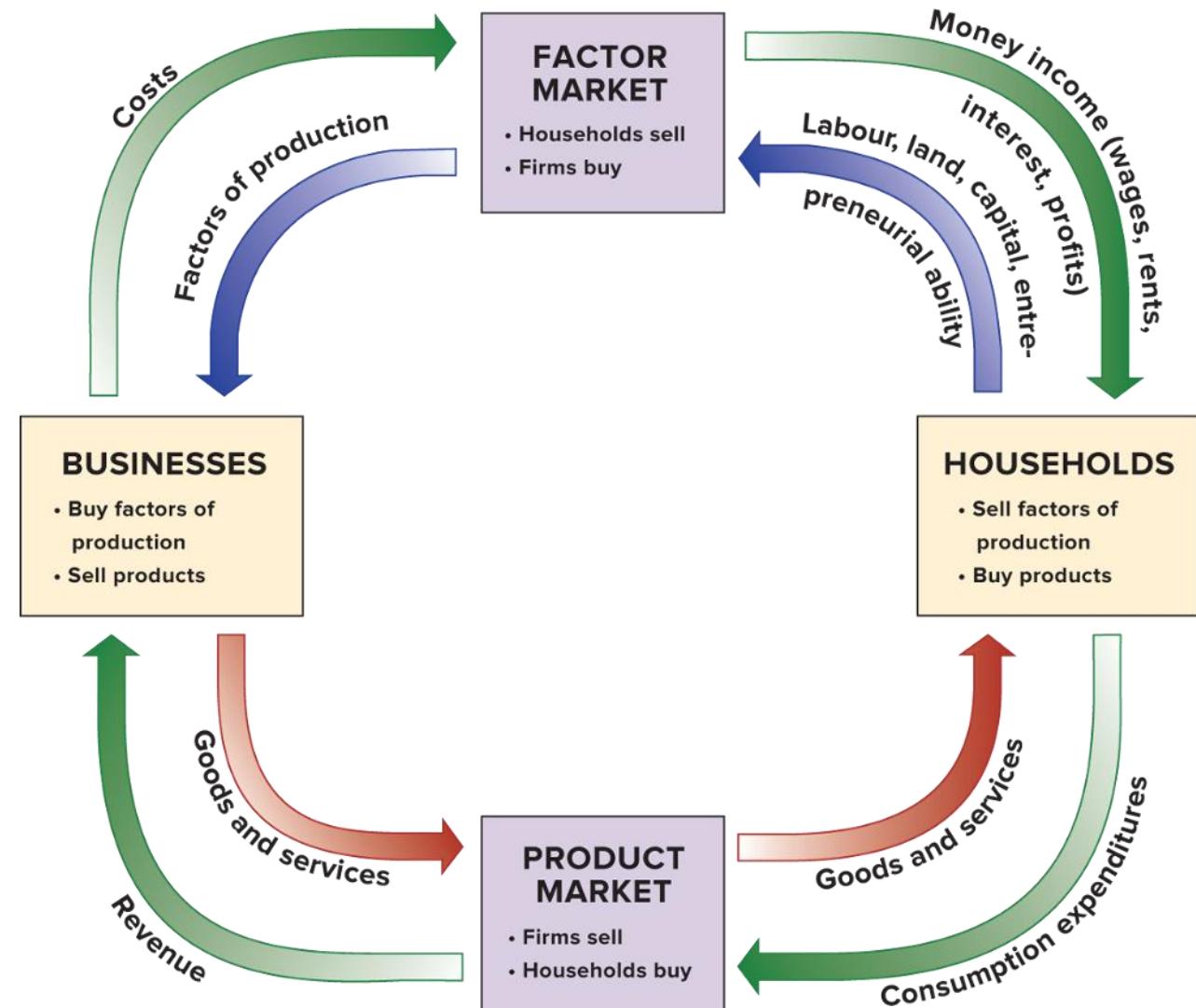
- **The Incentive Problem**
 - Suppose the government misjudged how many automobiles, shoes, and chickens were wanted at the government-determined prices.
 - Persistent shortages and surpluses of those products often arose.
 - No adjustments for surplus or shortage
 - No incentive for managers to adjust as they were rewarded for meeting assigned targets.

Dynamic market economy

- Generates continuous goods, services, resources, and money flows.
- Figure 2-2 shows these flows, grouping decision makers into businesses and households and dividing markets into factor and product markets.
- The simplified economy in Figure 2-2 excludes government involvement.

FIGURE 2-2 The Circular Flow Diagram

- Households own resources, earn income, and buy goods; businesses buy resources and sell goods.
- Households sell resources for income and spend it on goods.
- Businesses generate revenue by buying resources and selling goods, with resources and money flowing in opposite directions.



Households

- One or more persons occupying a housing unit.
 - Buy the goods and services provided by businesses in the product market.
 - Obtain the income needed to buy the products by selling resources in the factor market.
 - Wages, rents, interest, and profits flow to households for labour, land, capital, and entrepreneurial ability, respectively.

Businesses

- Economic entities that purchase factors of production in the factor market and sell goods and services in the product market.
1. **Sole Proprietorship:** an unincorporated business owned and operated by a single person.

Businesses

2. **Partnership:** two or more individuals pool their financial resources and business skills to operate the business and share the profits/losses.
3. **Corporation:** an independent legal entity that can acquire resources, own assets, produce, sell, incur debts, extend credit, etc.

2.5 THE CIRCULAR FLOW MODEL 5/6

Product Market

- Where the goods and services produced by businesses are bought and sold.
- Households use the income they receive from the sale of resources to buy goods and services.
- The money spent on goods and services flows to businesses as revenue.

2.5 THE CIRCULAR FLOW MODEL 6/6

Factor Market

- Where households sell resources to businesses.
 - Households sell resources to generate income.
 - Businesses buy resources to produce goods and services.
- Productive resources flow from households to businesses.
- The money flows from businesses to households as wages, rents, interest, and profits.

2.6 HOW THE MARKET DEALS WITH RISK 1/5

Producing goods and services is risky

- Input shortages, changing consumer preferences, and natural disasters pose significant risks to production.
- Effective risk assessment and management are essential for an economic system to reach its full potential.
- The market system places financial consequences on business owners, rewarding good risk management and penalizing poor decisions.

2.6 HOW THE MARKET DEALS WITH RISK 2/5

The Profit System

- Entrepreneurial ability organizes the other three resources of land, labour, and capital toward productive uses.
- The system is a profit-and-loss system.
 - The entrepreneurs gain profits if they choose wisely but suffer losses if they choose poorly.
- Poor risk management in command economies.
 - The central planners do not risk losing money if they make bad decisions.

2.6 HOW THE MARKET DEALS WITH RISK 3/5

Shielding employees and suppliers from business risk

- Dealing with losses
 - Only a firm's owners are subject to business risk and losing money.
 - The firm's employees and suppliers receive their contracted wages and payments whether the firm is earning a profit or generating a loss.

2.6 HOW THE MARKET DEALS WITH RISK 4/5

Benefits of restricting business risk to owners

- Attracting inputs
 - Many people avoid risk, preferring regular pay and timely payments over potential losses.
 - Concentrating business risk on owners and investors reassures workers and suppliers.
 - This security helps firms attract labour and inputs, fostering innovation and growth.

2.6 HOW THE MARKET DEALS WITH RISK 5/5

Benefits of restricting business risk to owners

- **Focusing attention**
 - The profit system aids in prudent risk management.
 - It does this by aligning responsibility and rewards for managing risk effectively.
 - Owners can manage risk themselves or hire a skilled manager.
 - A full-time job is dedicated to the specialized task of managing business risk.

Hasta la Vista, Venezuela

- Venezuela, once prosperous, now starves. What caused the economy to crumble?
- Economic collapse began with Hugo Chavez's election in 1998.
 1. Inefficient allocation of scarce resources.
 2. Printing money led to hyperinflation.
 3. Population exodus, worsening the downward economic spiral.



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Hasta la Vista, Venezuela

- Bolivarian Socialism.
 - Nationalization and reduced business autonomy caused mismanagement and corruption, especially in the oil industry.
 - Hyperinflation soared due to excessive money printing, leading to severe shortages of essential goods and services.
 - In 2021, the government relaxed some economic controls, allowing some business operations to resume, but the future remains uncertain.

CHAPTER SUMMARY 1/4

- Laissez-faire capitalism is a system where the government mainly protects private property and enforces contracts.
 - It is based on private ownership of resources, individual economic freedom, self-interest as the driving force, and competition as a regulatory mechanism.
 - It involves specialization, advanced technology, and the use of money as a medium of exchange to facilitate easy trade and greater specialization domestically and internationally.

CHAPTER SUMMARY 2/4

- The market system produces goods based on demand, ensures revenue covers costs, and promotes efficiency through competition.
 - Consumer preferences drive businesses, income influences distribution, and the system adapts to changes and encourages technological advancement.
 - In a market economy, competition aligns self-interest with social interest, guiding businesses and suppliers through an "invisible hand" to act in ways that benefit society.

CHAPTER SUMMARY 3/4

- Command economies in the Soviet Union and pre-reform China failed due to central planning coordination problems.
 - Rigid numerical targets for managers created incentive issues, contributing to the failure.
- The circular flow model depicts the exchange of factors of production and products between households and businesses.
 - Businesses buy factors from households and sell products to them, while households sell factors to businesses and buy products from them.

CHAPTER SUMMARY 4/4

- The market system places business risks on owners, motivating them to manage risks wisely.
- This approach attracts risk-averse workers and suppliers by shielding them from business risks.