

# Chapter 2

Economic Systems  
The Market System  
The Five Fundamental Questions  
The Invisible Hand  
Demise of Command Systems  
The Circular Flow  
Last Word

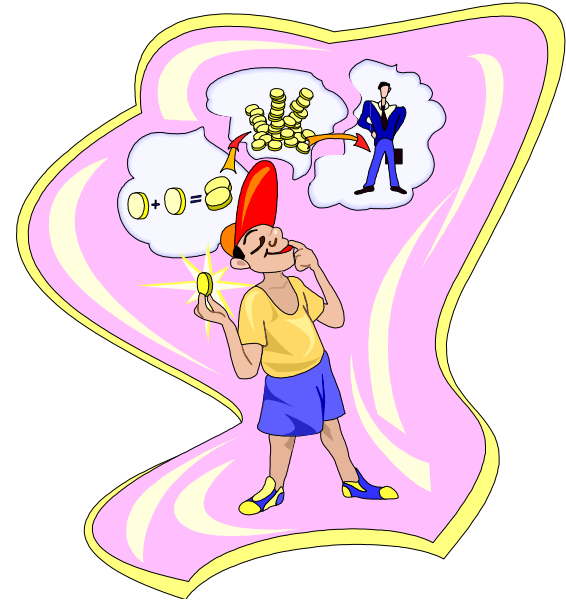
Key Terms



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# The Market System and the Circular Flow

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# Chapter Objectives

- **Command Systems vs. Market Systems**
- **Characteristics of a Market System**
- **How Markets Determine What to Produce, How to Produce, and Who Receives the Output**
- **How Market System Adjusts to Change and Promotes Progress**
- **The Mechanics of the Circular Flow**

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# Economic Systems

- **Economic System Defined** - Societies develop economic systems to solve the economizing problem and answer the **3 economic questions**.
  - **What to produce?** (Consumer Sovereignty, Dollar Votes)
  - **How to produce?** (Available Technology, Prices of Needed Resources)
  - **For whom to produce? (distribution)**
    - How will the system accommodate change?
    - How will the system promote progress?



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# Economic Systems

- **Economic Systems are classified based on the following:**
  - Ownership of Factors of Production
  - Method Used to Motivate, Coordinate, and Direct Economic Activity

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# Economic Systems

- Traditional – the allocation of scarce resources (and nearly all other economic activity) stems from ritual, habit or custom.
  - Strengths – everyone knows their role, relatively stable.
  - Weaknesses – tends to discourage new ideas and innovation, lack of progress, lower standard of living.
    - EX – native or tribal societies.



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# Economic Systems

- **Command System** – government owns the factors of production, makes economic decisions, and allocates resources. Examples include socialism or communism.
  - **Strengths** – ability to adjust and change quickly.
  - **Weaknesses** – lack of consideration of individuals, discourages new ideas/innovation, “coordination problem”, “incentive problem”.
    - EX – “old” Soviet Union, Cuba, China, North Korea.



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# Economic Systems

- Market System (capitalism) - the factors of production are owned by individuals, people and firms answer the three basic questions, dollars act as votes.
  - Strengths – freedom for producers and consumers, little gov. interference, choice, competition.
  - Weaknesses – creates winners and losers, must have 3 things – competition, access to information and choice, resources must be transferable.
    - EX – no *pure (laissez-faire)* capitalism in the world but Hong Kong is closer than us!



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# Economic Systems

- **Mixed Market** – a combination of command and market economies. Typically the factors of production are still privately owned but there is significant government interference in the economy.
  - The best of both worlds or failure to accomplish one true system?
    - EX – U.S and most other democratic nations.



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# The Market System

## Characteristics

- Private Property– individuals and firms own the resources.
  - Encourages investment
  - Encourages innovation & change
  - Encourages economic growth
  - Encourages specialization and trade

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# The Market System

## Characteristics

- Freedom of Enterprise – entrepreneurs and firms are free to obtain resources and produce their choice of goods and services.
- Freedom of Choice – producers and consumers have choice in how they apply their reproductive resources and how they spend their profits.

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Source: Heritage Foundation ([www.heritagefoundation.com](http://www.heritagefoundation.com)) and *The Wall Street Journal*

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# The Market System

## Characteristics

- Self-interest – the motivating force in the economy.
  - Resource owners try to get the highest price
  - Consumers want the lowest price
  - Producers must produce something of value at the lowest possible cost
- 1776 *Wealth of Nations* by Adam Smith
  - Efficiency
  - Incentives
  - Freedom

*The “Invisible Hand”*



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# The Market System



## Characteristics

- **Competition** – the regulatory force in the market system.
  - Lowers prices, Raises wages
  - Encourages efficiency (in production, utilization of resources, and consumption)
  - Several buyers and sellers
  - Freedom of entry (and exist) to industry
- **Markets and Prices** – buyers and sellers come together to communicate decisions about resources, production, pricing, etc.
  - Each player acts in their self-interest by responding to the overall market demands.



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# The Market System

## Characteristics

- Technology and Capital Goods essential because of the impact on productivity.
  - Constant improvement and innovation is rewarded by increased productivity and profits.
- Specialization/Division of Labor – essential not only to allow for choice and freedom in the market, but also efficiency!



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# The Market System

## *Characteristics*

- Private Property
- Freedom of Enterprise
- Freedom of Choice



## GLOBAL PERSPECTIVE

Free	Mostly Free	Mostly Unfree	Repressed
1- Hong Kong 3- Ireland 9- United States	22- Belgium 33- Spain 44- France	81- Brazil 111- China 122- Russia	150- Cuba 152- Venezuela 157- North Korea

Source: Heritage Foundation ([www.heritagefoundation.com](http://www.heritagefoundation.com)) and *The Wall Street Journal*

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# The Market System

## *Demise of Command Systems*



*USSR*



*Yugoslavia*



*East Germany*

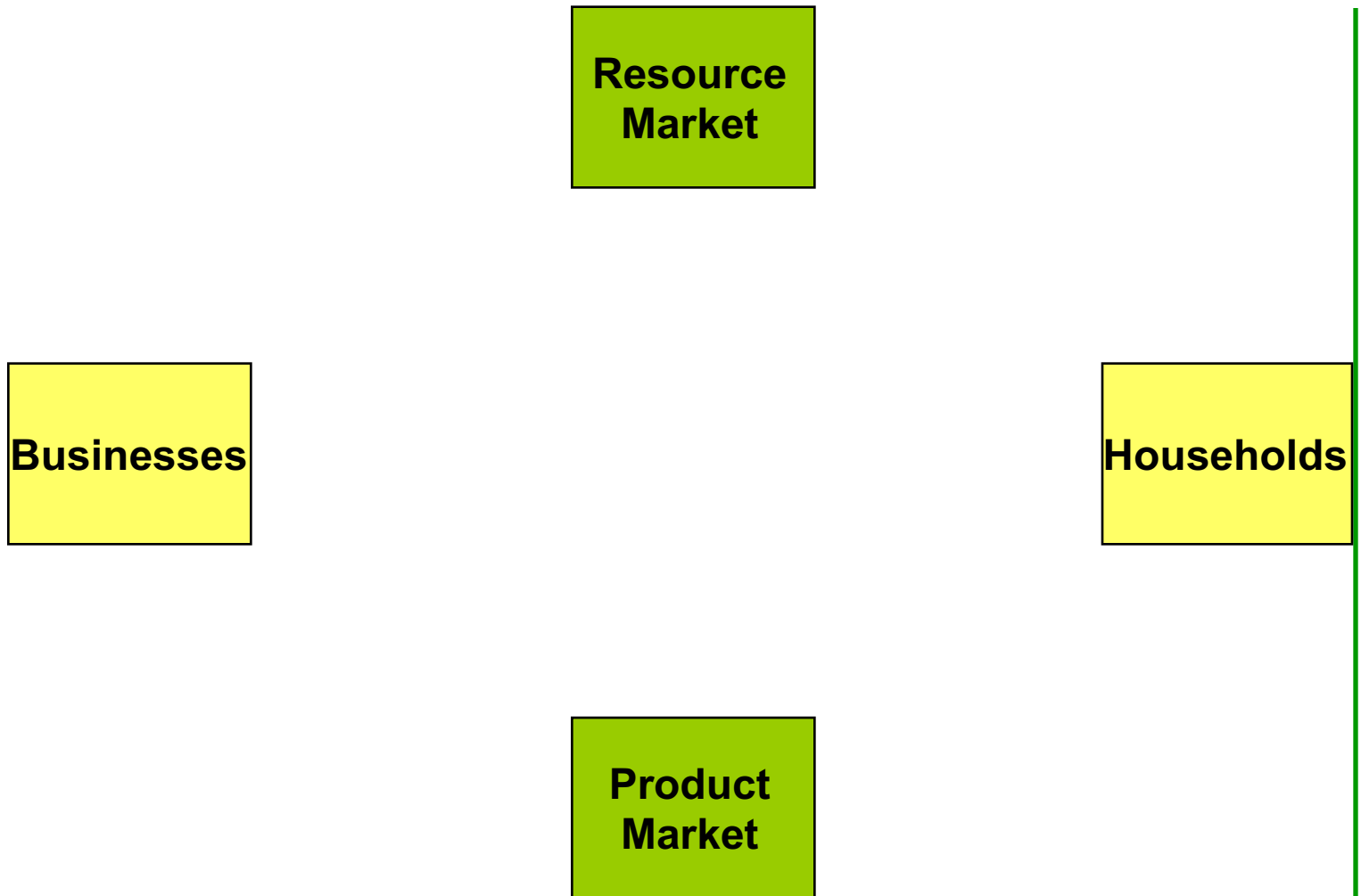
- **Two Insurmountable Problems**
  - **The Coordination Problem**
  - **The Incentive Problem**

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# Circular Flow



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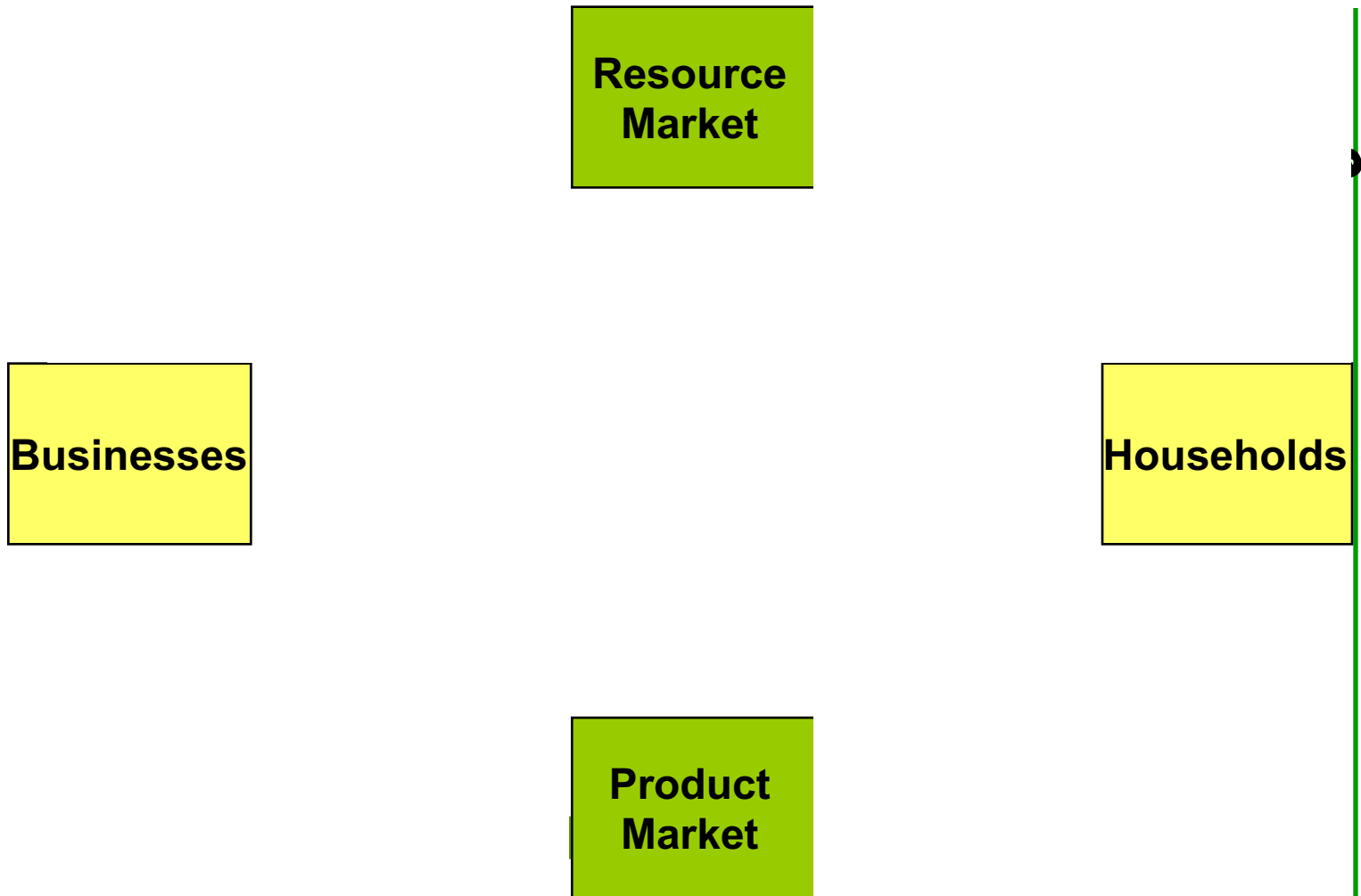


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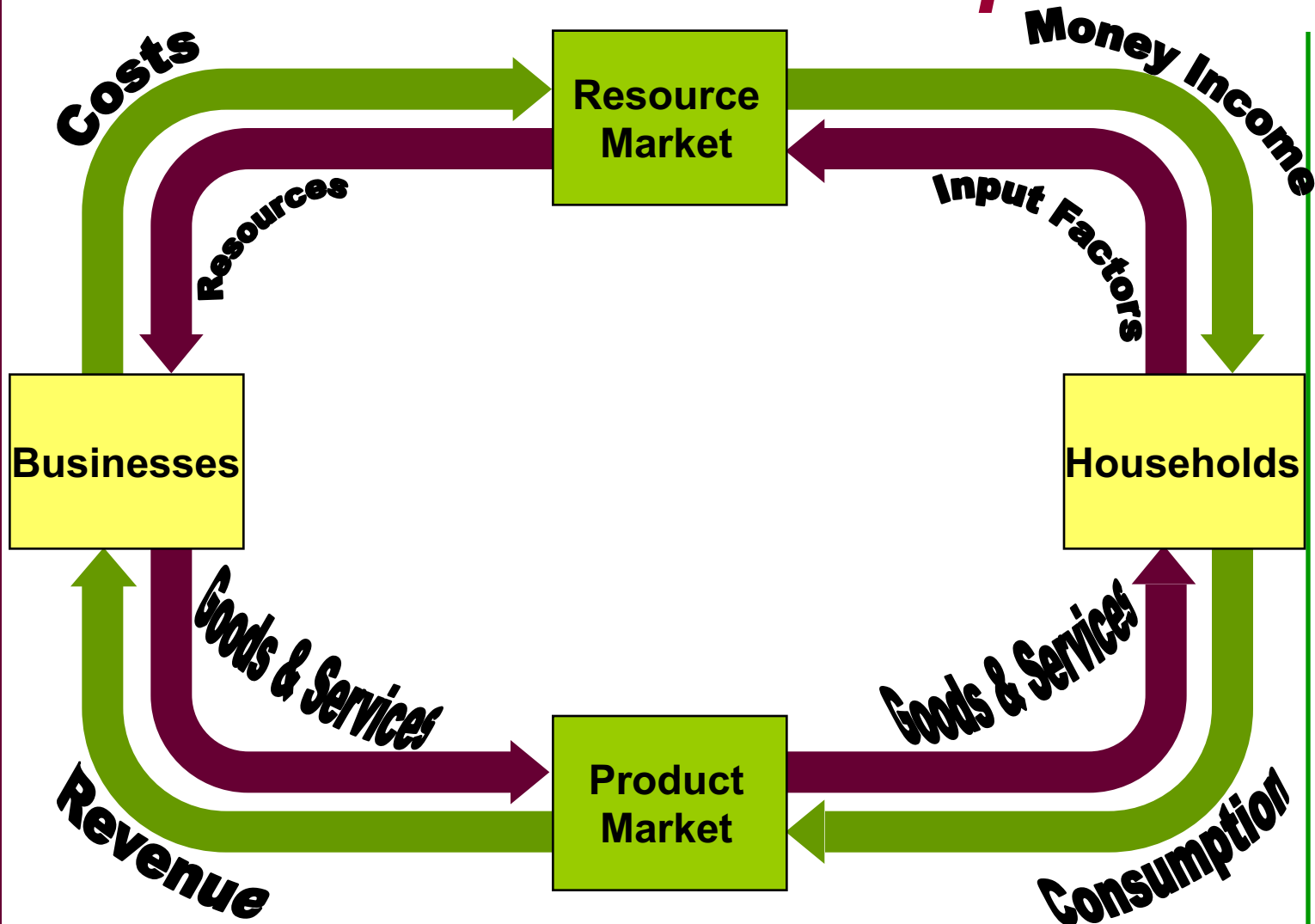
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# Circular Flow

## Both Flows Are Equal



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# Shuffling the Deck



*Markets Systematically and Purposefully Rearrange the World's Resources*

- **Extreme Number of Playing Card Combinations**
- **Tens of Billions of Worldwide Resources**
- **Many Combinations Useless**
- **Private Property Facilitates Best Choice Selections – Mutual Accommodations**
- **Result is a Complex and Productive Arrangement of Resources**
- **Many Small Decisions that Others Find Helpful**

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- economic system
- command system
- market system
- private property
- freedom of enterprise
- freedom of choice
- self-interest
- competition
- market
- specialization
- division of labor
- medium of exchange
- barter
- money
- consumer sovereignty
- dollar votes
- creative destruction
- “invisible hand”
- circular flow diagram
- resource market
- product market

Key Terms



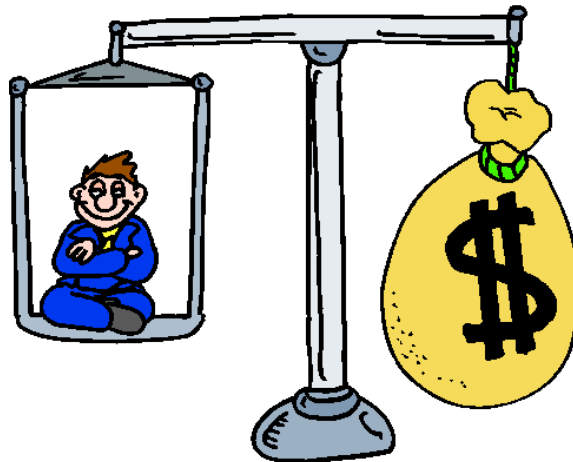
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## *Next Chapter Preview...*

# Demand, Supply, and the Market Equilibrium



# Chapter 3

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