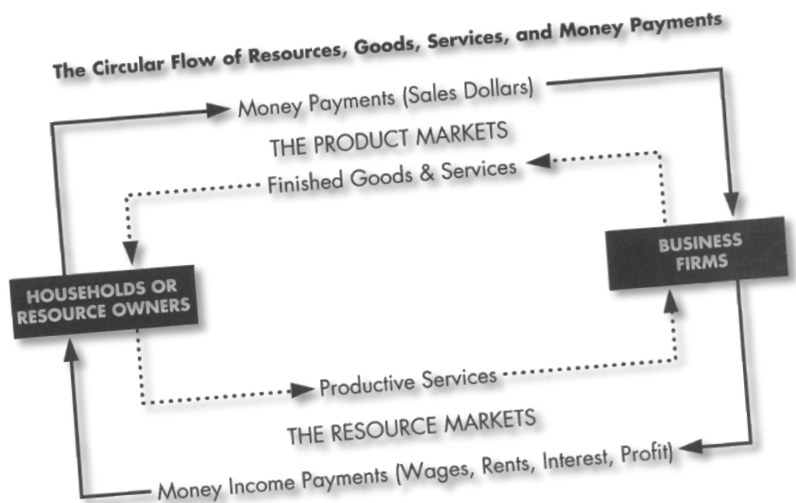


The Circular Flow Revisited

One way to illustrate the overall operation of a market economy is through a circular-flow diagram such as the one to the right. This diagram presents a highly simplified overview of how a market economy operates. Households (families and individuals) supply the services of their land, labor, entrepreneurship, and capital to business firms in exchange for money income payments in the form of wages, salaries, rents, interest, and profits. Households then use these income payments to purchase the finished goods and services supplied by the business firms. Business firms then use the proceeds from these sales to pay the households for the services the firms receive by employing the resources. This is how the circular flow of resources, goods, services, and money payments is established and maintained.



The circular-flow diagram shows the interdependence of a market economy. Consumers are also producers. Households receive income from businesses. Businesses can pay households for resources because businesses sell goods and services to households. Households are both buyers and sellers. Business firms are both buyers and sellers. Money always flows in one direction while resources and products always flow in the opposite direction. Every action in the circular flow has a reaction. Prices of resources are determined by supply and demand. Let's take a closer look.

The Resource Markets

The bottom loop of the circular flow represents the resource markets. There are four kinds of resources. First, human resources consist of the work or labor we provide as employees. Second, natural resources are the gifts of nature such as water, minerals, land, and timber. Another important resource is capital goods, including buildings, tools, machines, and other manufactured goods used in production. The fourth type of resource is entrepreneurship. This is not a physical resource like a machine or an acre of land. Instead, entrepreneurship is the willingness to take the risk of operating a business and the ability to organize that business to produce what consumers want.

Each resource produces income. Most people receive wages and salaries for their labor. About 75 percent of the income earned in the United States consists of wages and salaries. The rest of the income comes from profits, rents, and interest. Some households own corporate stock and receive dividends or profits. Some households own bonds and savings accounts, which produce interest. Households that provide buildings and equipment to businesses receive rents.

The Product Markets

The top loop of the circular flow represents the product markets. In the product markets, businesses sell goods and services to households. Goods are physical things that can be bought and sold—such as pizzas, books, and computers. Services are intangible. Examples of services are concerts, medical care, and education. Businesses are able to produce and sell these goods and services to households because businesses purchase resources from those households. And so on, round and round, the process continues.

An Example

Jennifer works at Jeans World as a sales associate. Jeans World pays Jennifer for the work she does. Jennifer is in the bottom loop of the circular-flow. In the resource markets, she sells her labor for a wage. The business receives a scarce resource (labor) from Jennifer. Jennifer is a seller in the resource markets, and the owners of Jeans World are buyers in the resource markets. Jennifer now has income. She spends some of her income on a jacket, a movie, and lunch. Jennifer is a buyer in the product markets where the jacket store, movie theater, and restaurant are sellers.

Traveling Dollars

By trading dollars in resource markets and in product markets, businesses and households cause dollars to flow in a circular fashion. First, the dollars flow through resource markets from businesses to households. Then the dollars flow through product markets from households back to businesses. With many households, resources, businesses, and products, the cycle repeats itself again and again. No wonder a market economy is described as a circular flow.

Questions for Discussion

Answer the following questions about the circular flow of resources, goods, services, and money payments.

1. What is a household? What is a business firm?
2. What is a product market?
3. Give three examples of transactions you made this week in a product market.
4. What is a resource market?
5. Give an example of a transaction you or your family made this month in the resource markets.
6. What determines the prices of goods and services in the product markets?
7. What determines the prices of land, labor, capital, and entrepreneurship in the resource markets?
8. Where do households get the money to buy goods and services in the product markets?
9. Where do business firms get the money to pay households for their land, labor, capital, and entrepreneurship in the resource markets?
10. Why is it important to know that a market economy is characterized by interdependence?

Clean Teeth and a Healthy Economy

"Don't forget to brush your teeth!" said Mike's mother from the other room. "I know that brushing my teeth is a good investment," thought Mike as he squeezed the tube of toothpaste. Mike stopped and wondered why he had thought of the word investment. Perhaps it was because at school that day his class had discussed investment. Whatever the reason, the word seemed to fit.

Mike thought again of the class discussion that day. The teacher had explained that people must first save in order for businesses to invest. "Saving," remembered Mike, "applies to money. In class the teacher defined saving as setting aside today's money for future use. But doesn't saving also apply to time? I could be watching TV right now instead of brushing my teeth," Mike thought, "so I'm now giving up time when I could be having fun. And I'm investing that time in brushing my teeth in order to have healthier teeth in the future. So in a way I'm saving and investing right now."

"Come to think of it," thought Mike, "I saved and invested in my part-time business. I saved money in my bank account for a long time in order to buy the electric buffer for polishing cars. I could have spent the money on food and clothes, but I saved it instead. And when I bought the electric buffer, I was investing in my business. It paid off, too," he thought. "With the new machine I now polish more cars and earn more money."

Financial Markets

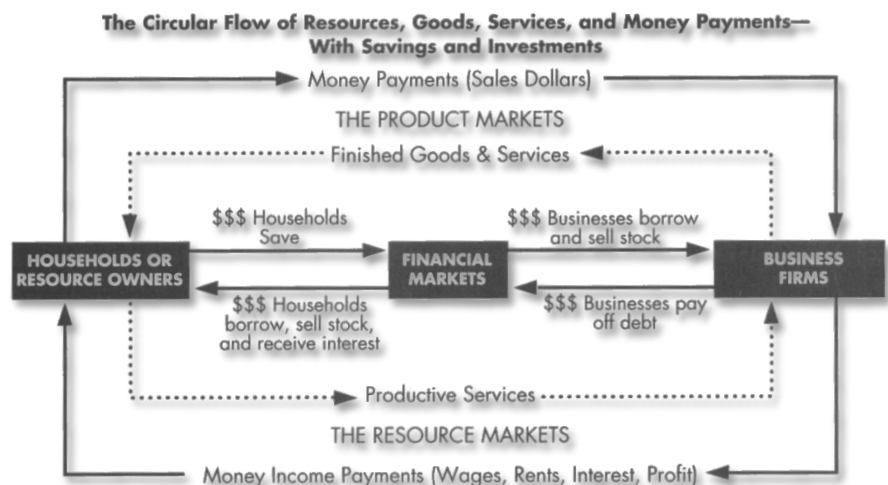
Like Mike, many other people in our economy save money. You are saving whether you put some of your income in a piggy bank or in a real bank somewhere in your community. Your choice to save is an important one, too. By saving money, you are giving up spending the money on goods and services now. You consume less today so you will have more money to spend in the future. But your savings not only help you; they can also help make money available for business spending on new machines, buildings, and other capital goods. Capital goods are manufactured items used to produce goods and services. Just as Mike's new electric buffer helped him polish more cars and earn more money, other new capital tools help businesses increase their production. That means more goods and services, more jobs, and more income for people in our economy.

In Mike's business, Mike was the one who saved and invested the money. But in our economy, most of the people who save are not the same ones who invest. So savings must somehow be transferred to those who want to invest in new capital. To make this important transfer, we depend on special markets called financial markets. Here's how the transfer works. When most people save, they open a bank account, purchase stocks, or buy some other asset that rewards them for saving. Generally, the bigger the reward, the more they save; the smaller the reward, the less they save.

For example, the money you put into a savings account at a bank can be loaned to someone who pays the bank interest for the use of that money. From that person's payments, the bank is able to pay interest to you. The borrowed money might then be used to buy capital goods. In this way, banks, brokerage houses, pension funds, and other companies in the financial markets allow people to transfer their savings to others who are willing to pay for using them.

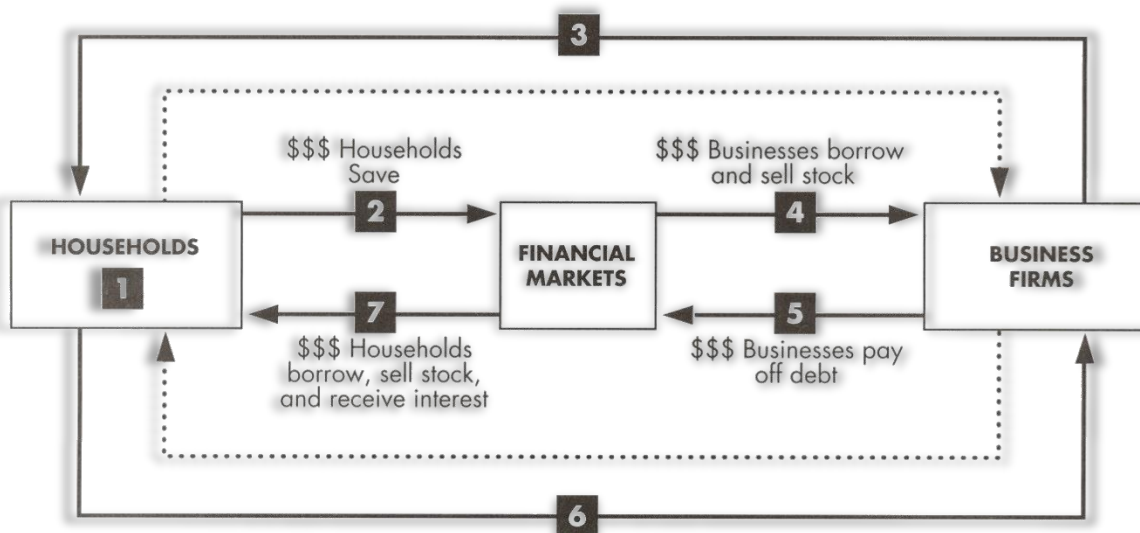
Investment in Capital Goods

The diagram summarizes the important role of financial markets in channeling savings to businesses. The diagram is similar to a simple circular flow, but it has an additional box in the middle to show financial markets.



Pick a Channel

The following diagram contains seven black boxes numbered 1 through 7. Each box identifies a part of the circular flow. Read each of the events, labeled A through J, at the bottom of the page. Decide where in the circular flow each of these events would occur. Then, in the space provided after each event, write the number of the black box that corresponds to that place in the circular flow where the event occurs. You will use some of the numbers in the black boxes more than once.



- a. A bakery pays employees for their work. ____
- b. A restaurant chain sells bonds to borrow money for expansion. ____
- c. A family borrows money from a savings and loan to buy a new home. ____
- d. Tony Lopez buys \$2,000 of common stock through a broker. ____
- e. Marie Brown sells \$2,000 of common stock through a broker. ____
- f. A computer company sells 1,000,000 shares of common stock through an investment banker to raise funds for a new factory. ____
- g. A student uses \$50 of savings from a part-time job to open a savings account at a bank. ____
- h. Terri Lawson uses \$20 of her earnings to take her friends to see a popular movie. ____
- i. An auto repair shop buys a new computerized scope from a manufacturing company to diagnose problems on its customers' cars. ____
- j. An airplane manufacturer buys new computerized robots from a robot manufacturer for use on its assembly lines. ____