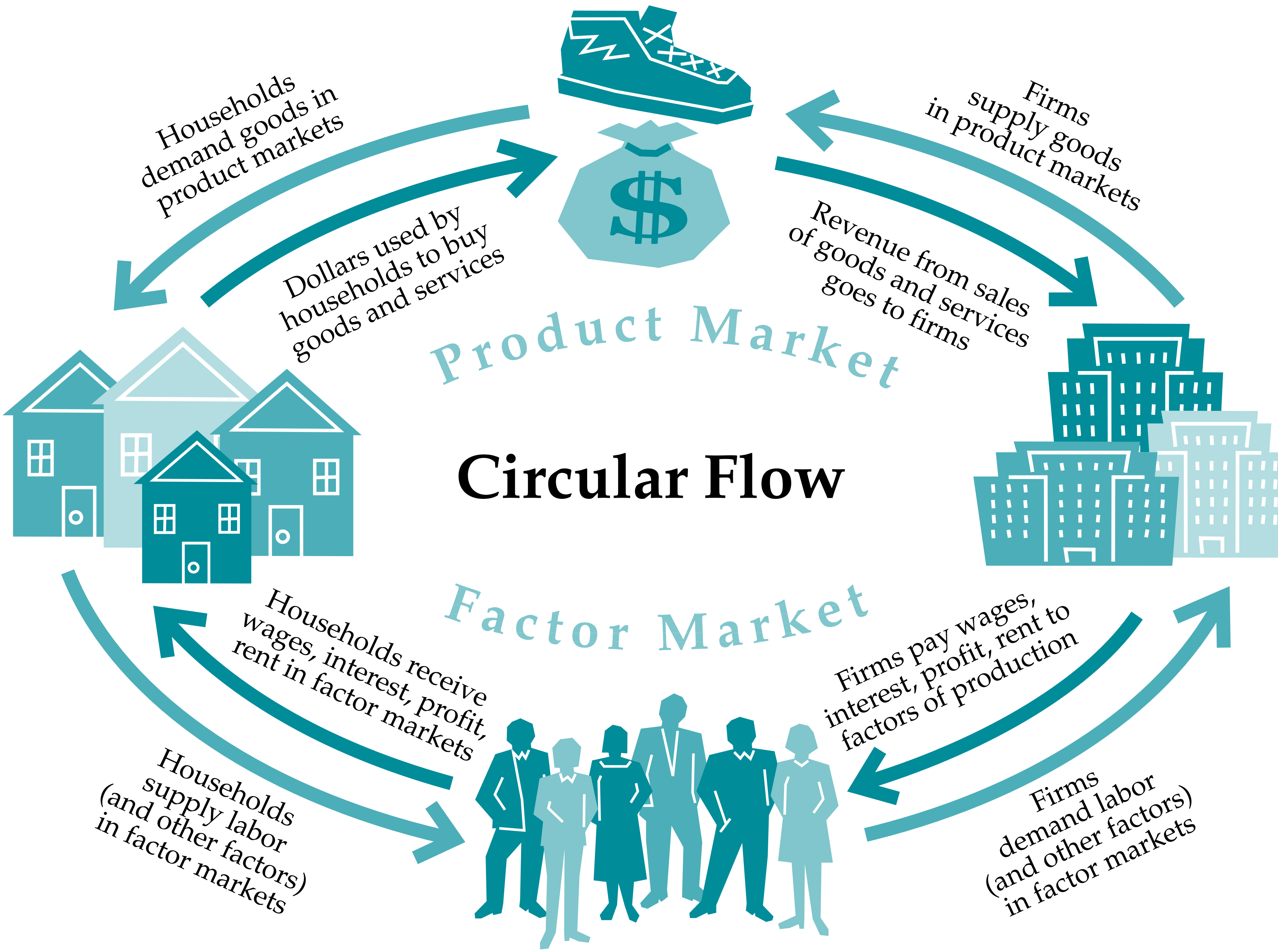
Circular Flow
Product Market
Factor Market
Households demand goods in product markets
Dollars used by households to buy goods and services
Firms supply goods in product markets
Revenue from sales of goods and services goes to firms
Households receive wages, interest, profit, rent in factor markets
Households supply labor (and other factors) in factor markets
Firms pay wages, interest, profit, rent to factors of production
Firms demand labor (and other factors) in factor markets

Economics Review

Circular Flow

Market System

The basic coordinating mechanism of a capitalist economy is a market (and the price system). Capitalism is a market economy. Decisions are made by buyers and sellers of products (in the product market) and resources are turned into products via the exchange of resources (in the factor market). In our problem, the product market is the market in which shoes are bought and sold and the (primary) factor market is the market in which labor is hired and paid wages.

The preferences of sellers and buyers are registered on the supply and demand sides of the markets. The outcome of these choices is a system of product (e.g. shoes) and resource (e.g. labor) prices. These prices provide households (as resource owners and consumers) and firms (as resource purchasers and producers) with information to make and revise decisions in furthering their self interests.

The market system is an elaborate communication system through which innumerable individual choices are recorded, summarized, and weighted against each other. Prices are the means of communication. Firms and households who pay attention to the market's signals (i.e. prices) are rewarded while those who ignore the market's signals are penalized. Through the price communication system and individual responses to it, society decides what the economy should produce, how production is organized, and how rewards and penalties are distributed. That is, the market system is the mechanism through which society decides how to allocate resources and distribute output as well as the system through which these decisions are carried out. In societies that are not grounded in capitalism, these decisions are made through non-market mechanisms (e.g. government, tradition).

Operation of a Market-Based Economy

In a free market, money-based economy, households, as resource owners, sell their resources to firms for money income. As consumers, households spend their money income buying goods and services. Firms must spend money in order to buy the resources used to produce goods and services. Their finished products are then sold to households in exchange for money. The net result is a counter clockwise real flow of economic resources and finished goods and services and a clockwise money flow of income and consumption expenditures (see diagram in Appendix IV). These flows are simultaneous and repetitive.

The Circular Flow diagram illustrates the flow of real resources and money in a market-based economy. In this economy, there are two groups of decision makers—households and firms.

The coordinating mechanism that brings the decisions of households and firms into alignment with one another is the market system.

Factor Market

The bottom half of the diagram shows the Factor Market. In this market consumers (households), who directly or indirectly (through their ownership of business corporations) own all economic resources, supply resources to producers (firms). Producers, of course, demand resources because they are the means by which goods and services are produced. [Note: the interaction of demand and supply for resources in the factor market establishes the price of each resource]. The payments that firms make in obtaining resources are their costs, but simultaneously constitute flows of wages, rent, interest, and profit income to the households supplying these resources.

Labor is used as the primary example of a resource in this problem but renting or buying the robotics is also an example. Resource scarcity in this market can best be illustrated by the fact that firms must pay for resources. If resources were unlimited (e.g. air), firms would not have to pay to obtain them. Anthony Beckett is the most dramatic example of a scarce resource. Because there are limits to the number of individuals with his skills, shoe companies bid up the price to pay for his endorsement. In contrast, air, because it is virtually unlimited, carries no price and would be costless as a resource in the production of shoes.

Potential Hurdle: Students often have difficulty seeing that households supply resources other than labor to the factor market. It is fairly easy for students to see that labor is paid wages to enter the "factor market." Students can also be shown that households get interest on monies they loan to firms for purchase of capital that is used in the factor market, rent on land that is used in the factor market, and profit to savvy entrepreneurs.

Product Market

The top half of the diagram shows the Product Market. The money income received by households from the sale of resources does not, as such, have real value for them. Consumers cannot eat or wear coins and paper money. Hence, through the expenditure of money income in the product market, households express their demand for a vast array of goods and services. Simultaneously, producers combine the resources that they have and supply goods and services in the same market. The interaction of these demand and supply decisions determines product prices. Note that the flow of consumer expenditures (money) on goods and services constitutes sales revenues for producers.

Circular Flow of Resources

As the diagram implies, a complex, interrelated web of decision making and economic activity exists within a market economy. Both consumers and producers participate in both markets, but on different sides of each. Producers are on the buying (demand) side of the factor markets, and consumers (as resource owners) are on the supply side. In the product market, these positions are reversed. Households, as consumers, are on the buying (demand) side of product markets and firms, as producers, are on the selling side.

Scarcity

Scarcity underlies all of the transactions portrayed in this diagram. Because households have only limited amounts of resources to supply to firms (e.g. limited time, abilities), the household's money income is limited. This means that each consumer's income will go only so far in the purchasing of goods and services. A limited number of dollars clearly will not permit the consumer to buy all of the goods and services desired. Similarly because resources are scarce, there are limits to the number of goods and services that can be produced. Scarcity and choice should permeate the entire discussion of the flow of resources.

Money

Although money performs many functions in an economy, its most important function is that of a medium of exchange. Consumers must trade or exchange their labor (for example) for goods and services desired. Because consumers want a wide variety of products, they would have to provide their resources to diverse types of firms to obtain variety in goods consumed unless money is used to facilitate exchange. For example, without money if a person wanted only food, clothes and shelter, s/he would have to provide labor for a farmer, cloth maker, and construction contractor to obtain these goods in payment. This would be quite inconvenient. Instead, the consumer can provide labor to any firm and be paid in money that can be used to purchase a wide variety of goods and services.