

The Market System and the Circular Flow

INSTRUCTIONAL OBJECTIVES

After completing this chapter, you should be able to:

1. Highlight the main features of a market economy and a command economy.
2. List and explain the important characteristics of the American market system.
3. State the Five Fundamental Questions faced by any economic system.
4. Describe how the market system answers each of these five fundamental questions.
5. Explain how the consumer influences the “What goods and services will be produced?” question.
6. Explain how a market system achieves economic efficiency.
7. Explain how markets answer the “Who will get the output?” question.
8. Describe how prices drive the movement of resources in a market system.
9. Describe how the market system promotes technological improvements and capital accumulation.
10. Explain the role of self-interest and “invisible hand” in promoting economic efficiency.
11. Explain why the command systems of the Soviet Union, Eastern Europe, and China failed.
12. Identify the decision makers and the markets in a market system using the circular flow diagram.
13. Identify the two roles each that households and businesses play using the circular flow diagram.
14. Differentiate between product and resource markets.

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Chapter 2 Study Questions

HOMEWORK

Directions. Read Chapter 2 and complete the following. Your responses must be typed, printed out, and placed in the homework section of your binder.

Terms. For each term listed below, provide 1) a textbook definition, and 2) a one-sentence explanation of its importance in economics.

- Command System
- Market System
- Private Property
- Freedom of Enterprise
- Freedom of Choice
- Self-Interest
- Competition
- Market
- Specialization
- Division of Labor
- Medium of Exchange
- Consumer Sovereignty
- Dollar Votes
- Creative Destruction
- “Invisible” Hand
- Resource Market
- Product Market

Questions. Respond to each question in a short answer format (e.g. a topic sentence and a two to three sentences of explanation – or more when required).

1. Contrast how a market system and a command economy try to cope with economic scarcity.
2. How does self-interest help achieve society’s economic goals? Why is there such a wide variety of desired goods and services in a market system? In what way are entrepreneurs and businesses at the helm of the economy but commanded by consumers?
3. Why are private property, and the protection of property rights, so critical to the success of the market system?
4. What are the advantages of using capital in the production process? What is meant by the term “division of labor”? What are the advantages of specialization in the use of human and material resources? Explain why exchange is the necessary consequence of specialization.
5. In market economies, firms rarely worry about the availability of inputs to produce their products, whereas in command economies input availability is a constant concern. Why the difference?
6. In what way are businesses and households both sellers and buyers in this model? What are the flows in the circular flow model?
7. Go to the Internet auction site eBay at www.ebay.com and select the category Jewelry and Watches and then Loose Diamonds and Gemstones.
 - a. How many loose diamonds are for sale at the moment? Note the wide array of sizes and prices of the diamonds.
 - b. In what sense is there competition among the sellers in these markets?
 - c. How does that competition influence prices?
 - d. In what sense is there competition among buyers?
 - e. How does that competition influence buyers?