



Chapter 2: Economic Systems
Section 2

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ECONOMICS

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Objectives

1. **Explain** why markets exist.
2. **Analyze** a circular flow model of a free market economy.
3. **Describe** the self-regulating nature of the marketplace.
4. **Identify** the advantages of a free market economy.



Key Terms

- **market:** any arrangement that allows buyers and sellers to exchange things
- **specialization:** the concentration of the productive efforts of individuals and businesses on a limited number of activities
- **free market economy:** an economic system in which decisions on the three key economic questions are based on the voluntary exchange in markets
- **household:** a person or group living in a single residence



Key Terms, cont.

- **firm:** an organization that uses resources to produce a product or service, which it then sells
- **factor market:** the arena of exchange in which firms purchase the factors of production from households
- **product market:** the arena of exchange in which households purchase goods and services from firms
- **self-interest:** an individual's own personal gain



Key Terms, cont.

- **incentive:** the hope of reward or fear of penalty that encourages a person to behave a certain way
- **competition:** the struggle among producers for the dollars of consumers
- **invisible hand:** a term coined by Adam Smith to describe the self-regulating nature of the marketplace
- **consumer sovereignty:** the powers of consumers to decide what gets produced



- What are the characteristics of a free market economy?
 - A free market economy is characterized by:
 - Households and firms
 - Factor and product markets
 - Self-interest
 - Competition
 - Economic freedom, efficiency, and equity



The Purpose of Markets

- Checkpoint: Why do markets exist?
 - Markets, like a farmer's market, a sporting goods store, and the New York Stock Exchange, eliminate the need for any one person to be self-sufficient.
 - Markets allow us to exchange the things we have for the things we want.



Specialization

- Rather than being self-sufficient, each of us specializes in a few products or services.
 - Specialization leads to efficient use of land, labor, and capital.
 - Specialization allows businesses to focus on a limited number of related products or services.
- Because of specialization, markets are needed to give people an arena with which to sell their products and to buy products that they don't produce themselves but need.



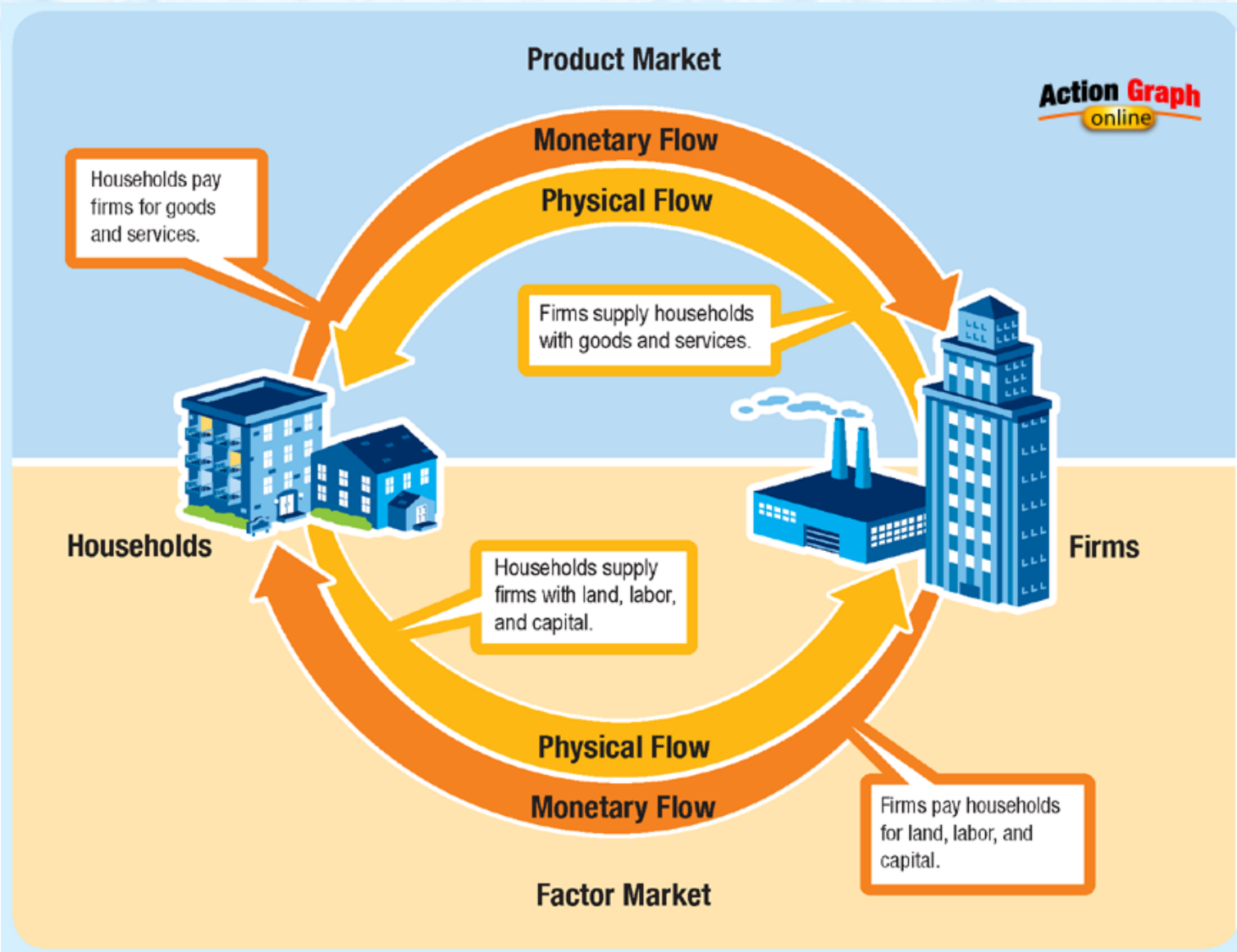
Free Market Economy

- In a free market, answers to the three key economic questions are made by voluntary exchange in the marketplace.
- Choices made by individuals determine what gets made, how it is made, and how much people can consume of the goods and services produced.
- In a free market system, individuals and privately owned businesses own the factors of production.



Circular Flow Model of a Market Economy

Action Graph
online



Factor and Product Markets

- In an arena of exchange known as the factor market, firms purchase factors of production, such as renting land, hiring and paying workers, and borrowing money, from households.
- The arena in which households buy the goods and services that firms produce is called the product market.



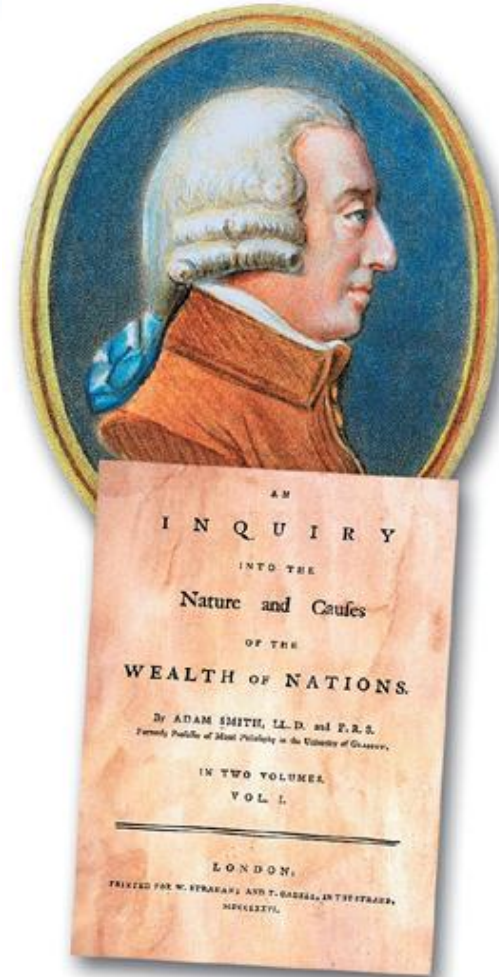
Self-Regulation

- In *The Wealth of Nations*, Adam Smith observes that in the countless transactions that occur in the market, the buyer and seller consider only their self-interest.
 - Self-interest is the motivating force in the free market.
 - Consumers pursuing their self-interest have the incentive to look for lower prices.



Self-Regulation, cont.

- According to Smith, consumers will respond to the positive incentive of lower prices by buying more goods because spending less money on a good lowers the opportunity cost of the purchase.



What are Incentives?

Positive Incentive

- Higher grades make it easier for Andre to get into a good college.
- Andre's parents promise him concert tickets if he improves his grades.



Response

Andre spends more time studying.

Negative Incentive

Andre's parents threaten to ground him if his grades continue to slump.

Positive Incentive

State government offers tax credit for commuters who use public transportation.



Response

Gas consumption drops as many workers take the bus rather than drive.

Negative Incentive

State raises gasoline taxes.



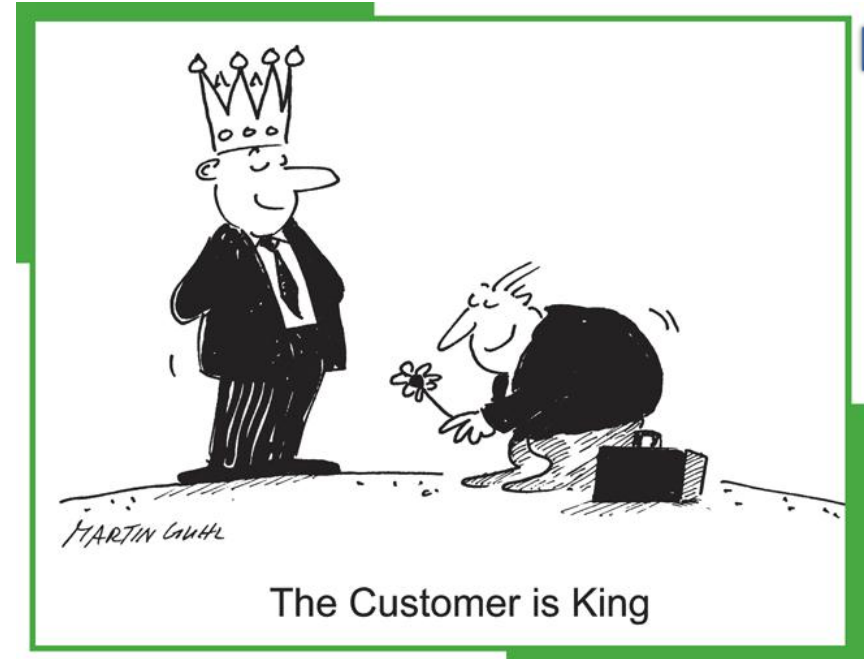
Competition

- Checkpoint: Why is competition important to the free market?
 - Firms seek to make higher profits by increasing sales.
 - Because of competition among other firms, though, increasing sales is not always possible.
 - Self-interest and competition work together to regulate the marketplace.
 - Smith called this self-regulating mechanism “the invisible hand of the marketplace.”



Advantages of a Free Market

- Under ideal conditions, free market economies meet the following economic goals:
 - They respond to rapidly changing conditions.
 - They have a large degree of economic freedom.
 - They encourage economic growth.
 - They lend themselves to consumer sovereignty.



What free market principle does this cartoon illustrate?



Advantages, cont.

- Despite the advantages of a free market economy, no country today operates under a pure, unregulated free market.



Review

- Now that you have learned the characteristics of a free market economy, go back and answer the Chapter Essential Question.
 - How does a society decide who gets what goods and services?

