

# **The Circular Flow of Economic Activity**

**A lesson in Market  
Economic Systems**

1. Households own and control resources and sell them to businesses.

**H  
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S**

**Capital**



**Human**



**Natural**



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S**



## 2. Businesses use the resources to make finished products.

# B U S I N E S S



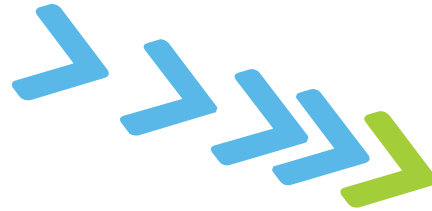
## Econo's



Econo's



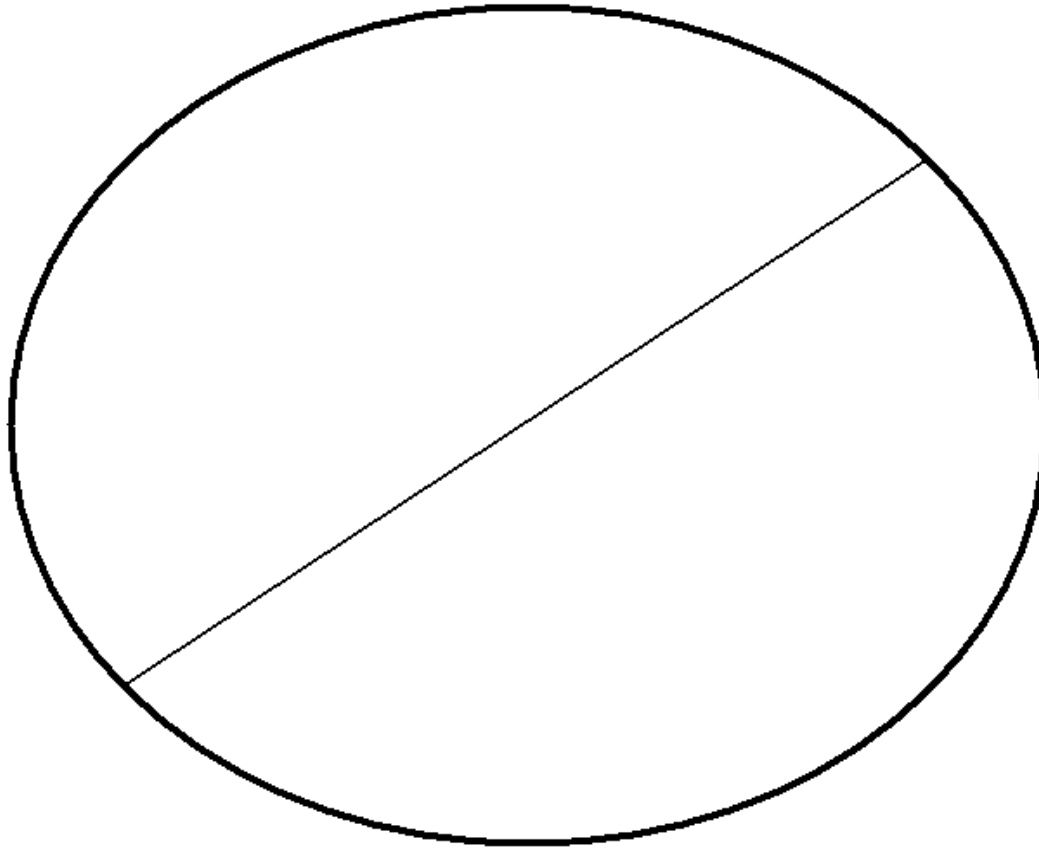
3. Businesses take finished products and sell them to households.



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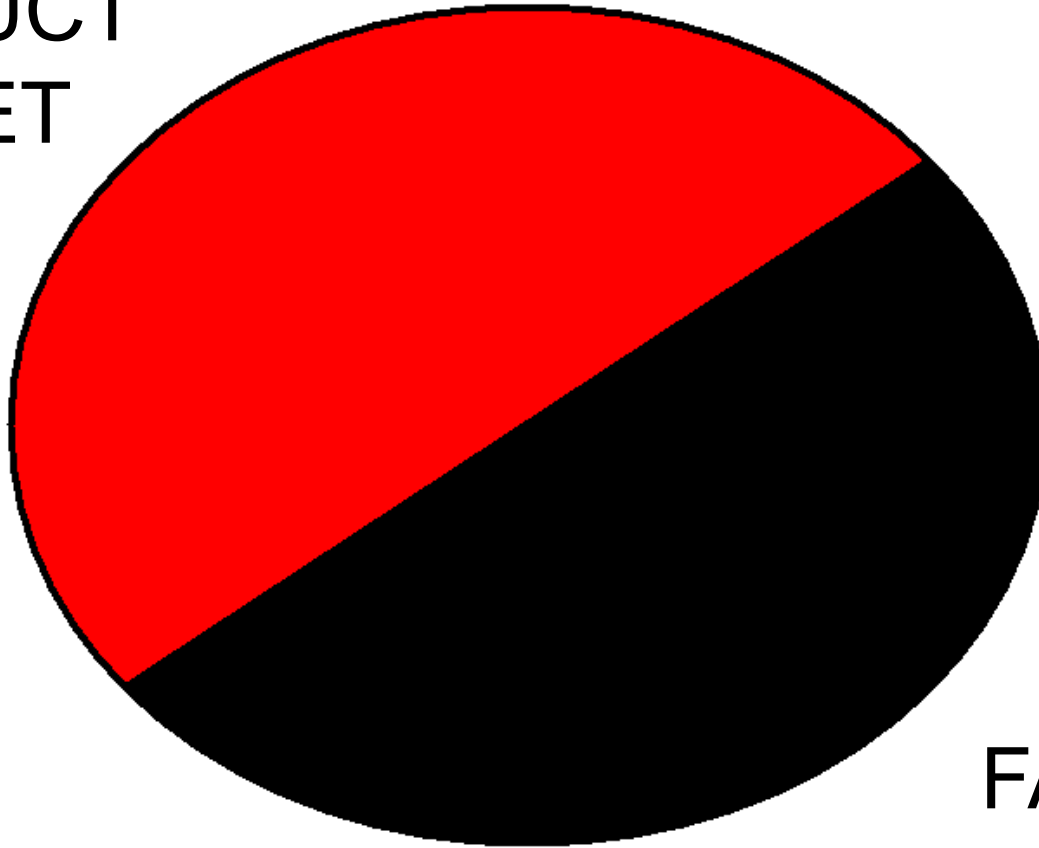
**H  
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# The Circular Flow of Economic Activity



# The Circular Flow of Economic Activity

PRODUCT  
MARKET

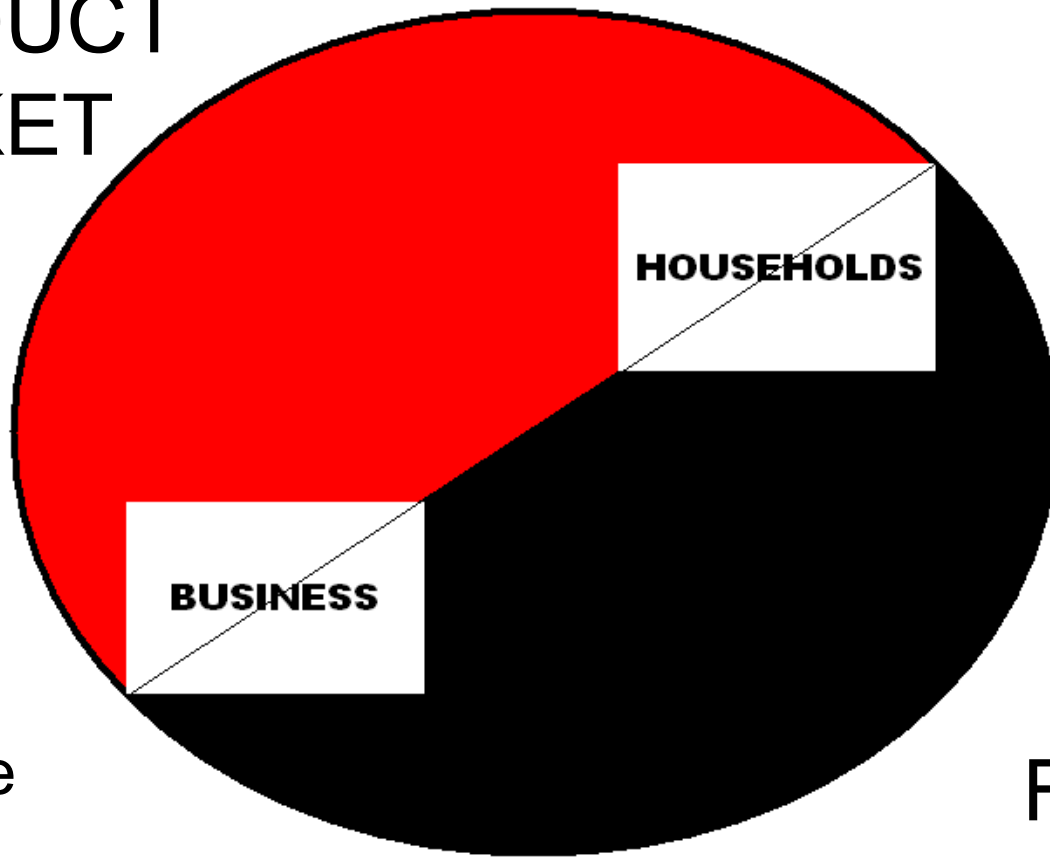


Two  
markets  
exist in the  
circular  
flow

FACTOR  
MARKET

# The Circular Flow of Economic Activity

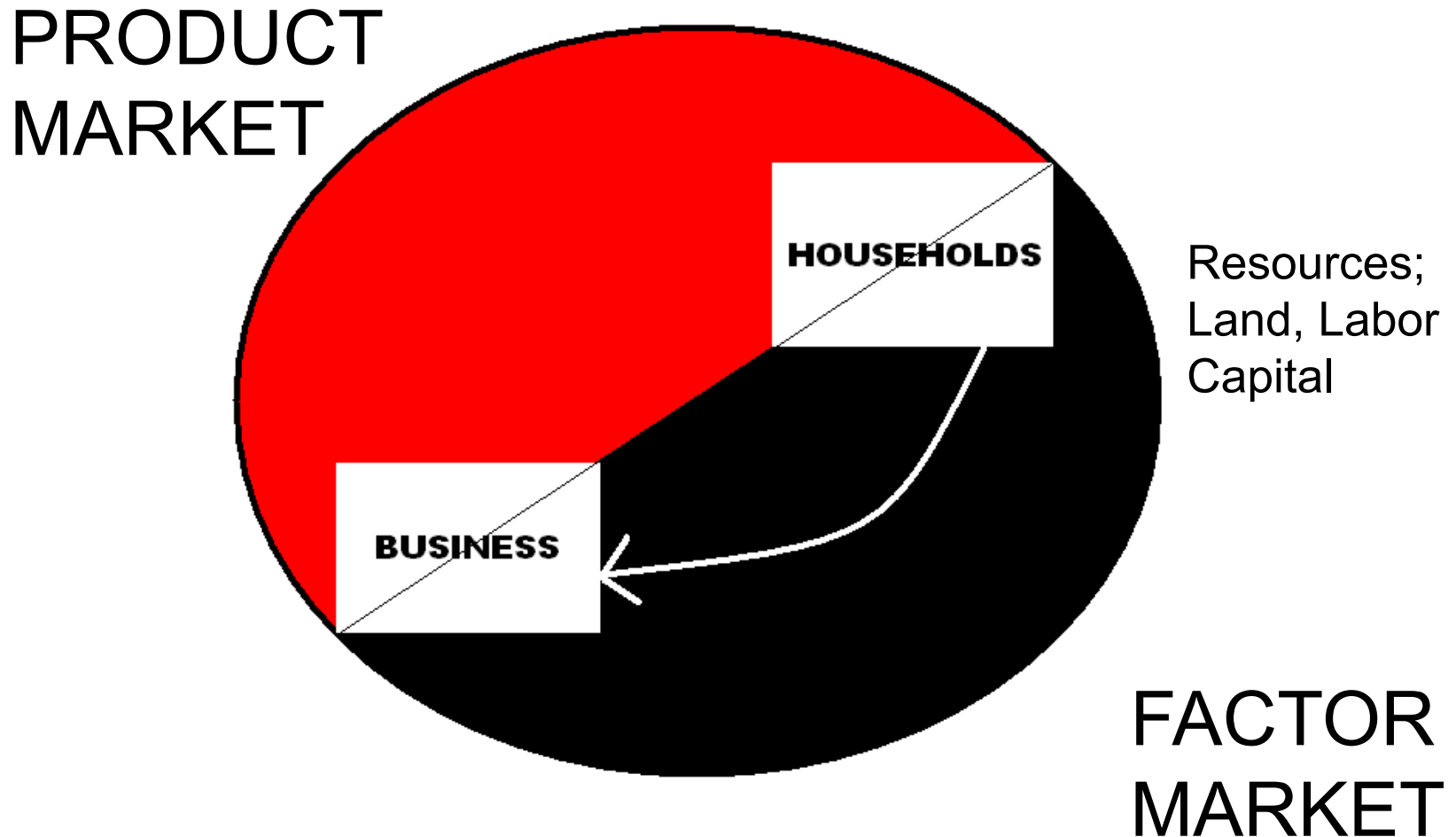
PRODUCT  
MARKET



Two  
markets  
exist in the  
circular  
flow

FACTOR  
MARKET

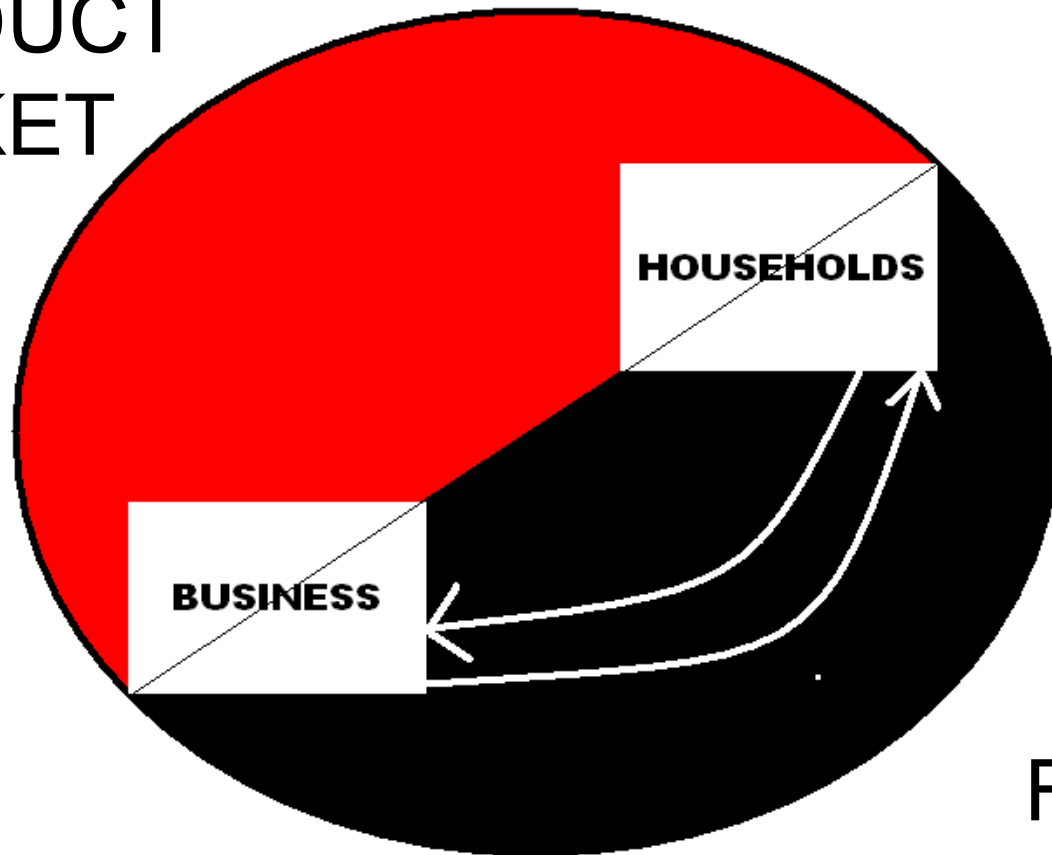
# The Circular Flow of Economic Activity





# The Circular Flow of Economic Activity

PRODUCT  
MARKET



Resources;  
Land, Labor  
Capital

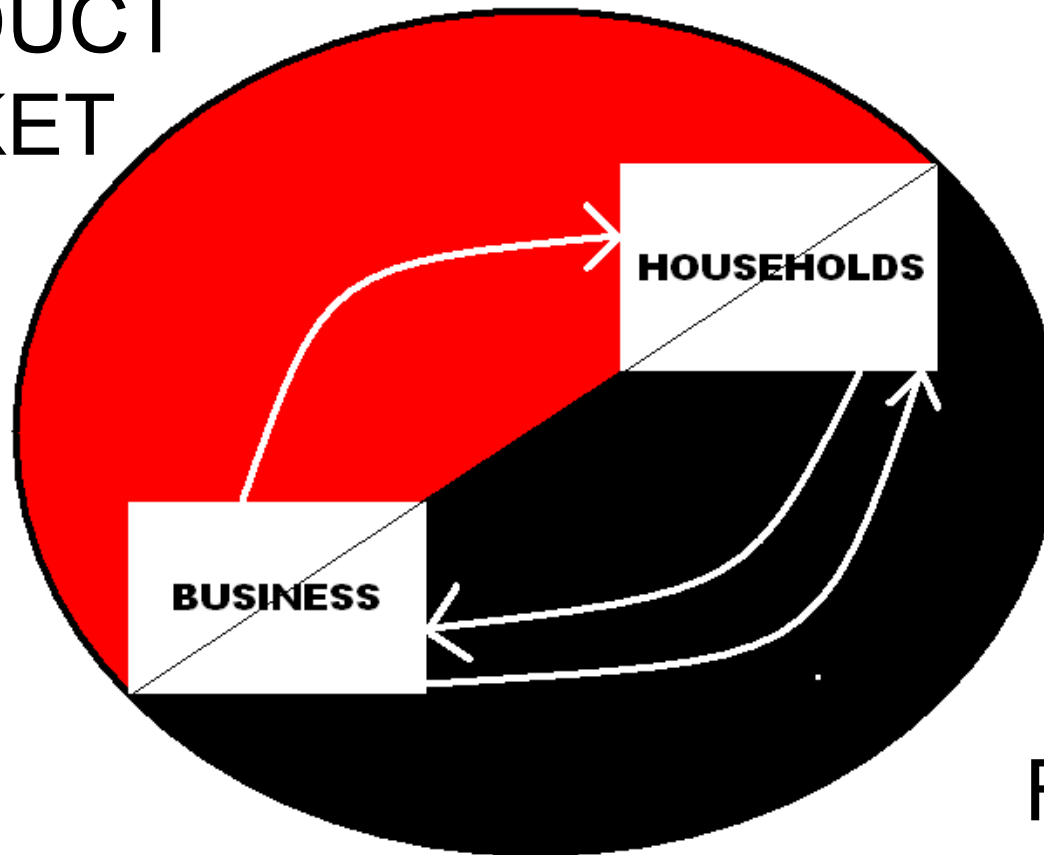
\$\$\$ pay for  
Resources

FACTOR  
MARKET

# The Circular Flow of Economic Activity

PRODUCT  
MARKET

Finished  
Goods  
and  
services



**HOUSEHOLDS**

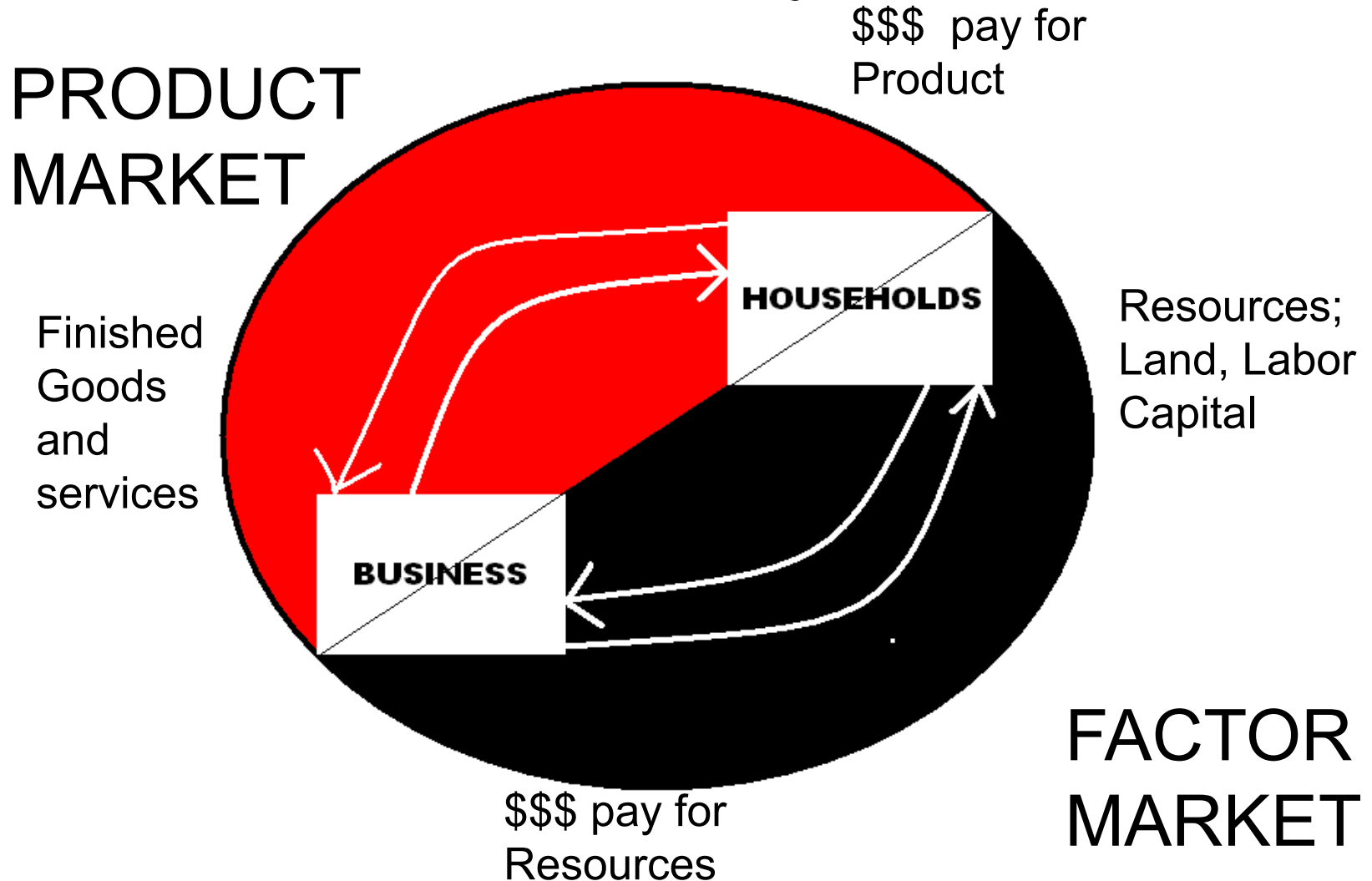
Resources;  
Land, Labor  
Capital

**BUSINESS**

\$\$\$ pay for  
Resources

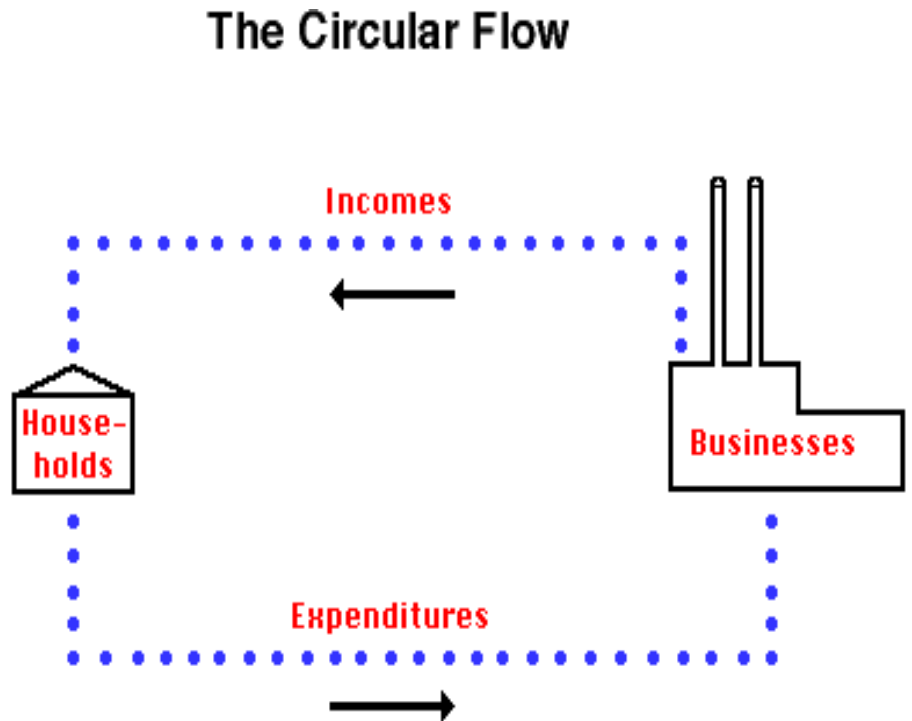
FACTOR  
MARKET

# The Circular Flow of Economic Activity



# The Circular Flow

Describe how you  
have been  
involved in the  
flow over the last  
week of your life.



# The Circular Flow of Economic Activity

- **The flow of payments in an economy is a circular flow.**
- **Individuals--people living in households--work for businesses, rent their property (or their capital) to businesses, and manage and own the businesses.**

# The Circular Flow of Economic Activity

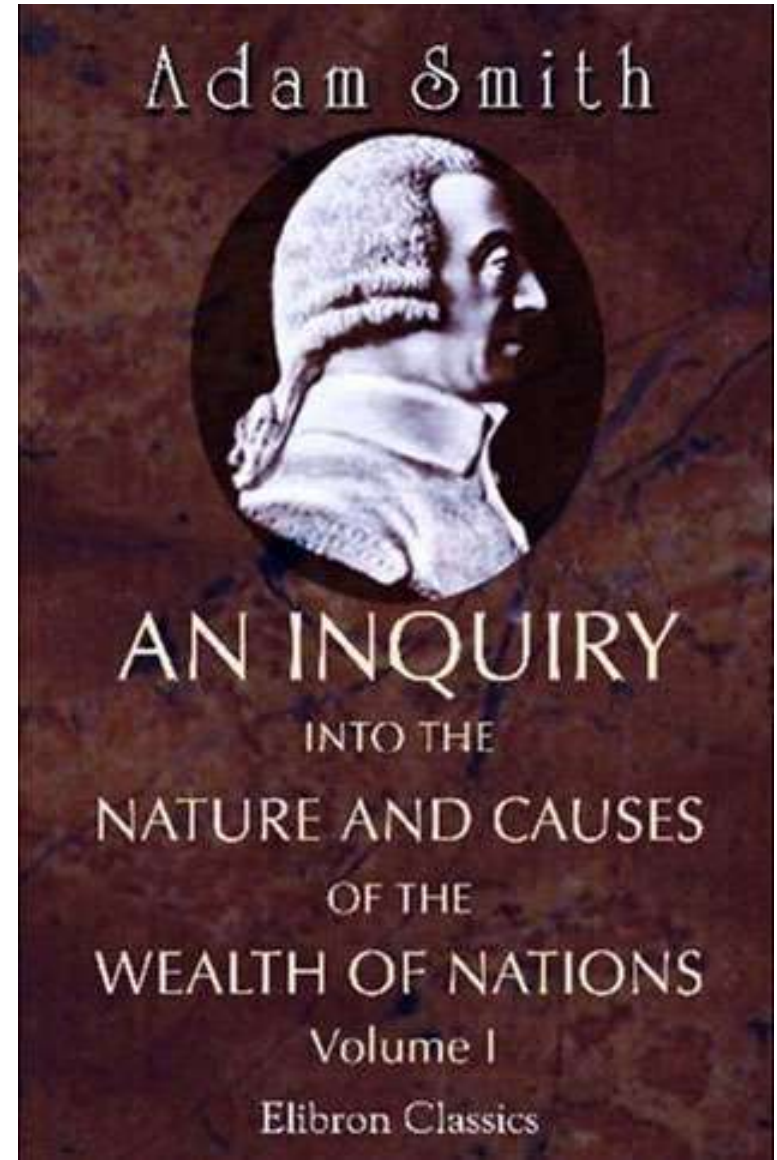
- **All these activities generate incomes--flows of payments from businesses to households.**
- **But households then spend their incomes--on consumption goods, in taxes paid to governments, and on assets like stock certificates and bank CDs that flow through the financial sector.**

# The Circular Flow of Economic Activity

- **The two flows--of incomes and of expenditures--are equal: all expenditures on products are ultimately someone's income, and every piece of total income is also expended in some way**

# ADAM SMITH

- It is an account of economics at the dawn of the Industrial Revolution, as well as a rhetorical piece written for the generally educated individual of the 18th century - **advocating a free market economy** as more productive and more beneficial to society.

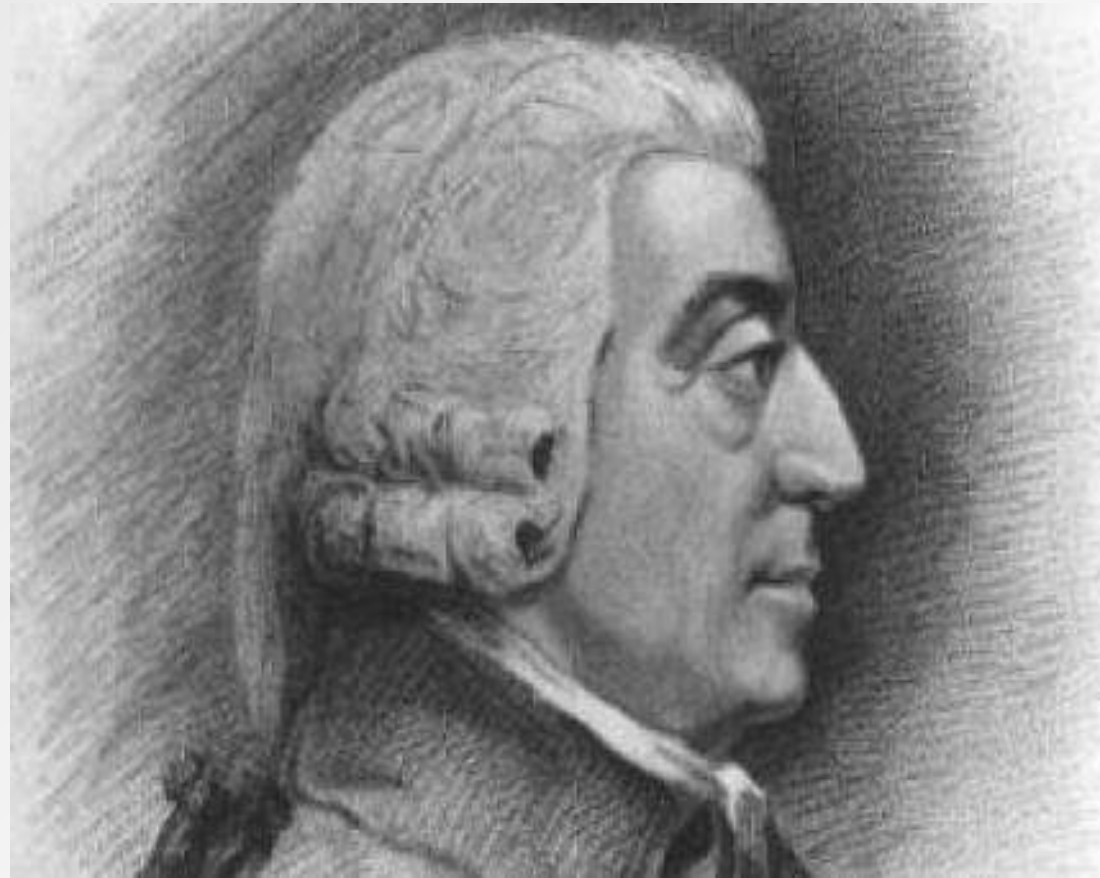




# ADAM SMITH

**“Invisible Hand of the Market”**

- **The self-regulating nature of the market-place.**



# **“Invisible Hand of the Market”**

- **"It is not from the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard to their own self-interest... Every individual intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end which was no part of his intention. By pursuing his own interest, he frequently promotes that of society more effectually than when he really intends to promote it."**

# “Invisible Hand of the Market”

- The natural force that guides free market capitalism through competition for scarce resources. According to Adam Smith, in a free market each participant will *try to maximize self-interest*, and the interaction of market participants, leading to exchange of goods and services, enables each participant to be better off than when simply producing for himself/herself.

# “Invisible Hand of the Market”

- Another misconception is that the invisible hand is a form of *individualism*. It would be hard to call the actions of a baker who spends all day baking bread for strangers "individualism."



# **“Invisible Hand of the Market”**

- It is simply untrue that personal greed will always result in society's best interest: crime is a devastating counter-example.**
- The very reason we have police and criminal justice systems is to prevent the harm caused to society by individuals seeking to enrich themselves at the expense of the group.**