

Chapter 2

How an economy works

Learning intention for students

After studying this chapter, you should understand how an economy works. You will use the circular flow diagram to understand the flows of **spending** and **income** in an economy, and you will know more about how the government, financial and overseas sectors play a part in our economy.



Economic models

Useful words

consumption spending – spending on goods and services

human resource – productive work; labour

income – money earned from work or other sources

labour – productive work; human resource

terminology – the special words and expressions for a particular subject



Many people feel economics is a complicated subject. In order to understand economics in action, we can use a range of economic models.

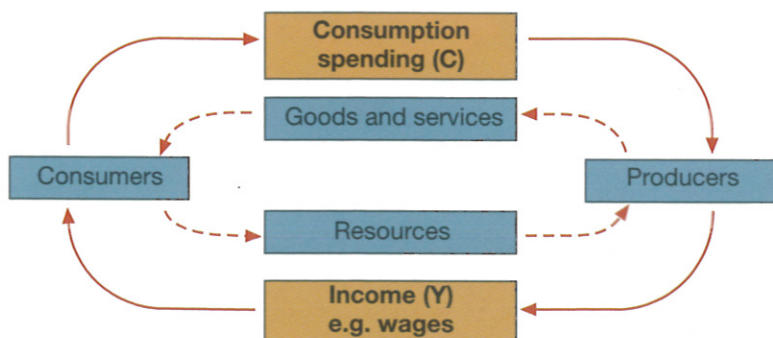
An economic model is a diagram that helps us better understand the economic world. In this chapter, we will introduce you to some simple economic models that will explain to you how an economy works.

Using a circular flow diagram

Let's use a circular flow diagram to look at how an economy works. First, we need to apply the economic terms introduced in Chapter 1 to Kiwiville and the Pihama family.

Like most other people, the Pihama family earn their money from working at jobs. They sell their **labour** or productive work (this is also called human effort or **human resource**) for wages, or **income**. Labour is one of a range of resources used by producers in the production of goods and services.

Jo Pihama works as a builder in a construction company. Josie works as a cleaner. As consumers, they can spend their income on buying their groceries or other goods and services from producers. This is called **consumption spending**.



This cycle can be shown in an economic model we call the circular flow diagram. In the diagram, the arrows represent the flow of money through the goods and services and resources in the economy.





ACTIVITY

See if you can apply the circular flow diagram on page 10 to Kiwiville. Refer to the cartoon map of Kiwiville on the inside back cover of this book, and then try to answer the questions below.

- 1 Who are the consumers in Kiwiville?
- 2 Who are the producers in Kiwiville?
- 3 Give an example of a resource.
- 4 Give an example of a good or service.
- 5 Give an example of consumer spending.
- 6 Name one type of income, and give an example that applies to Kiwiville.

Useful words

borrowers – those who use other people's money to finance their spending

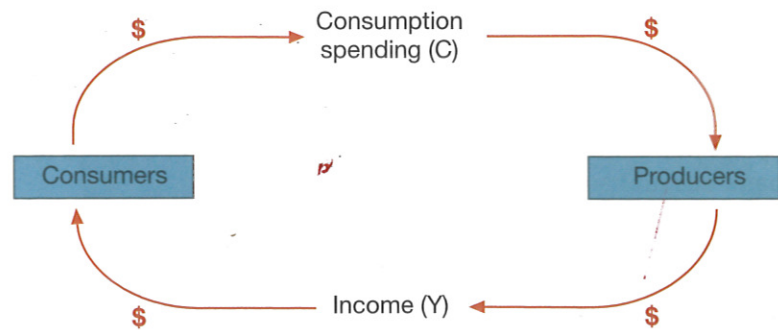
interest – the cost of borrowing or the reward for saving

investor – a person or group who has invested money in an enterprise to gain profit in return

saving – income not spent

sector – a part of society

We can make the circular flow diagram easier to understand by focusing only on the money flows.



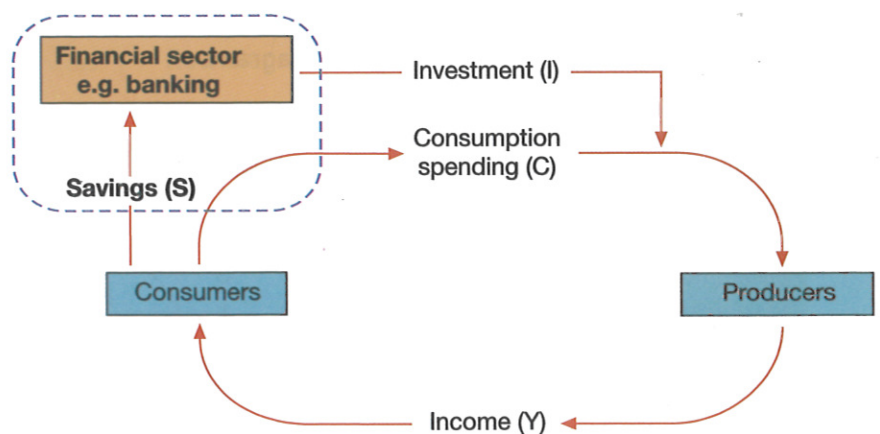
From the first circular flow diagram, we can identify consumption spending (C) and income (Y). What happens when we don't spend all of our income?

How do we use the financial sector?

The financial **sector** consists of a range of organisations that deal with the management and transfer of money – for example, banks, the stock market, and private sector finance companies and brokers. Most people (that is, the general public) use the financial sector in three primary ways:

- saving
- investing
- borrowing.

Let's develop the circular flow diagram to include the financial sector.



Saving

Consumers may not end up spending all of their income, because they might choose to save some of it. **Saving** (S) is income not spent. This income is saved so that it can be used at some time in the future.

Consumers can save their income with the financial sector. For example, Nanny deposits her savings in a bank account and, in return, receives **interest** payments. These interest payments can be added to her income from the government so she can spend more as a consumer, or the payments can be added to the money already in her bank account so she can save even more.

Borrowing

The banks use savers' money to lend to other people, who are called **borrowers**. The banks charge the borrowers interest on the monies they have borrowed.

Like many New Zealanders, Jo and Josie Pihama are borrowers, because they needed to borrow money to buy their house. They got a mortgage (loan) from the bank and they must pay interest on this borrowed money every month. As well as paying interest to the bank, Jo and Josie also pay back a small portion of their actual loan.

How do banks work?

Banks channel money from savers to borrowers. They make income by charging borrowers a higher rate of interest than they pay to savers (investors).

For example, the Bank of New Zealand will pay Nanny 3.00 per cent interest on her money in her savings account. Jo and Josie are paying 5.75 per cent on the money they have borrowed (their mortgage). The bank makes 2.75 per cent each month on the difference.

INTERESTING TO KNOW...

Paying for a house loan

A house loan is usually paid for in two ways. First, the bank charges you interest on the money you borrowed in the first place. Second, money is paid off the actual loan – this is called 'repaying the principal'.

Useful words

deduct – subtract

GST – goods and services tax

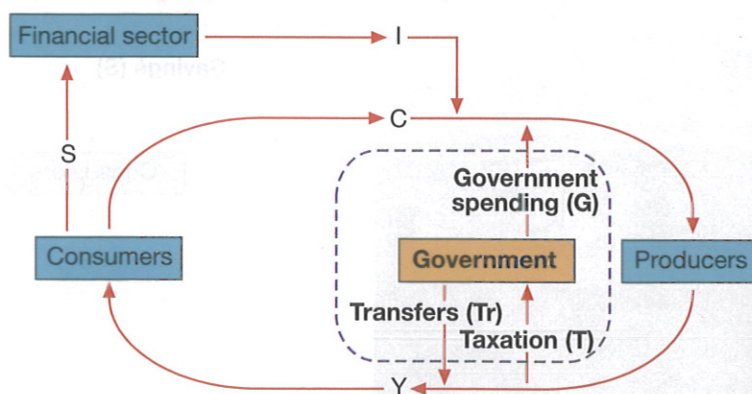
tax – compulsory payment to the government

taxation – the main source of income for the government

transfers – benefits paid by the government to citizens who are unable to support themselves

How does the government pay for its spending?

Let's add another component, government, to our circular flow diagram.



The government is an important sector of the economy. **Government spending** (G) is used to provide many of our public services, such as hospitals (health) and schools (education).

The government provides assistance, known as government benefits, to particular groups in society – for example, those who cannot provide for themselves, or who are unemployed. The sickness benefit, or superannuation for anyone over the age of 65, are types of government benefit.

Economists call these payments **transfers** (Tr). The money required for this government spending comes mainly from **taxation** (T). Once we start paid work, we should all pay income **tax**. Companies pay company tax on their profits. All of us pay goods and services tax (GST) on all our spending.

Jo and Josie's employers **deduct** the income tax from their pay before they receive it. Their employers pay this income tax to the government. Whenever Jo and Josie buy goods and services, they pay GST.

In return for paying their taxes, Joe and Josie and their family get to use services such as roads and schools. When they retire, they should receive superannuation, just like Nanny.



INTERESTING TO KNOW...

GST

GST is a tax placed on most goods and services in New Zealand, most imported goods, and certain imported services. GST is added to the price of taxable goods and services at the current rate of 15 per cent.

- Consumers pay GST on their total shopping bill whenever they buy.
- Businesses pay GST on sales and income to the government, but can claim GST back for their purchases and expenses.

Useful words

export – sell goods or services to an overseas country

export receipts – payments received for goods and services sold overseas

import – buy goods or services from an overseas country

import payments – payments owed for goods and services bought overseas

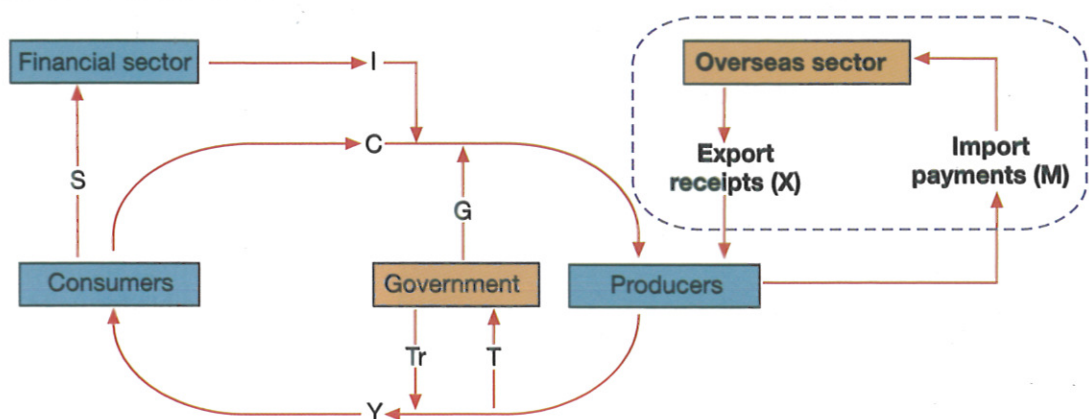
receipt – money received from the sale of goods or services



How do imports and exports affect our economy?

New Zealand has many trading links with the rest of the world.

Let's add the overseas sector to our circular flow diagram.



New Zealand depends on its ability to **export** goods and services to markets overseas in order to be able to **import** goods and services from overseas producers.



Jo's employer needs to buy some cedar building materials from Canada. When products are brought in from overseas, these products are classed as imports.



New Zealand also sells services such as tourism and education to foreigners. In money terms, the funds coming into the country from the sale of exported goods and services overseas are called **export receipts** (X on the circular flow diagram). These receipts make it possible for us to pay for the goods and services imported from overseas. These payments are called **import payments** (M on the circular flow diagram).



ACTIVITY

Read this article on Diane Foreman, who was named Ernst & Young Entrepreneur of the Year.

Ice-cream queen named New Zealand's top entrepreneur

by Anamika Vasil

The international success of her New Zealand Natural ice-cream brand stands out as the jewel in the crown of the formidable business empire created by Diane Foreman – this year's Ernst & Young Entrepreneur of the Year.

Foreman is CEO of the Emerald Group, which runs Emerald Foods, a company with a stable of six ice-cream brands, including New Zealand Natural. She says winning the award has not only been a personal triumph but good for business too, with many people approaching her since the awards.

'The exciting part is that many of these contacts have been international, which will stimulate further growth particularly for Emerald Foods.'

Earlier this year Emerald Foods was also named 'Best Business Operating Internationally with an annual turnover between \$10 million to \$50 million' in the New Zealand Trade and Enterprise (NZTE) 2009 New Zealand International Business Awards.

In the food industry, the New Zealand Natural brand has the distinction of being the food sector's biggest franchise operation, having expanded into 21 countries with nearly 700 franchised ice-cream parlours.

The premium ice-cream is made here and also sold overseas through supermarkets and hotel chains. It is exported to 29 countries.

For Foreman, the business is about much more than making and selling ice-cream.

'People think ice-cream is simply ice-cream,' she says. 'The way I see it, while we are committed to making the best-tasting ice-cream, what I am more interested in doing is raising the bar so we make ice-cream no one has ever tasted before.'

'That's what being an entrepreneur is all about, setting the standard that others will then follow.'

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- 1 In small groups, discuss why you think Diane Foreman might be so successful at what she does. What makes her different from other exporters who might be making the same product but not experiencing so much success?

Now imagine you are the sales manager for Borich Orchards and it is your job to find new customers for your produce. You believe you could sell your fruit to New Zealand Natural for their ice-creams.

- 2 Write a letter to Diane Foreman explaining why you think New Zealand Natural should use your fruit for their ice-creams. Remember to write the letter in such a way that it will catch Diane Foreman's attention and appeal to her.





ACTIVITY

Create a circular flow model based on Kiwiville, giving clear instructions as to what aspects of Kiwiville life fit into the circular flow diagram (for example, 'The Borich orchard exports fruit to Japan').



Reflection

At this point, you will understand that an economy works in a flow of spending and income between consumers and producers, and between the financial, government and overseas sectors.

Before you read this chapter, did you feel differently about income tax than you do now? Explain.

Before you read this chapter, did you consider yourself part of New Zealand's economy? Do you feel differently now? In what ways do you think you participate in our economy?

EXTRA FOR EXPERTS

- 1 Complete an inquiry into one of New Zealand's major exports. For example, you can look at the dairy or forestry industry.
- 2 Produce an illustrated marketing booklet that you could send to potential customers. Ensure you cover the following areas:
 - Where is the product produced?
 - Where is it currently exported to?
 - How much does this product contribute to New Zealand's economy annually?
 - Why is this product successful?
 - Why should a potential customer be interested?
 - Who is the end consumer of this product?

