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How an economy operates

- 2.1 The factors of production
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Every economy must find ways to organise its resources to meet the needs and wants of its people. This chapter explores how economies operate by examining the key building blocks and decisions that shape economic activity. At the core are the **factors of production** – land, labour, capital and entrepreneurship – which are used to produce goods and services.

Because resources are limited, all economies must answer the **key economic questions**: what to produce, how much to produce, how to produce and how to distribute what is produced. Societies answer these questions in different ways, resulting in different **economic systems**, including traditional, planned, free market and mixed economies.

The chapter also examines the **importance of money** in enabling economies to function efficiently. Money supports exchange, specialisation and economic activity over time. Together, these ideas provide a foundation for understanding how economies operate.

2.1 The factors of production

A **factor of production** can be defined as any resource that can be used in the production of goods and services. A factor of production is simply another name for a resource or input. The quantity and quality of an economy's factors of production (or resources) can influence how wealthy or poor that country will be. People who live in a country with abundant, high-quality resources will usually be better able to satisfy their wants and have a much higher **standard of living**, or quality of life, than people in a country with fewer, poorer-quality resources.

As outlined in chapter 1, the supply of these resources is limited. Therefore, producers face opportunity costs when they are deciding how to use resources in the production process. Over time, these decisions can be affected by the availability of the factors of production. For example, the size and quality of the labour force may change as educational standards improve, and more investment in technology and machinery will lead to increased availability of capital. On the other hand, environmental damage may reduce the quantity of natural resources that can be used in the production process.

There are four factors of production in an economy: natural resources, labour, capital and enterprise. The income received by the owners of these resources are rent, wages, interest and profit respectively.

Factor	Natural resources	Labour	Capital	Enterprise
↓	↓	↓	↓	↓
Income	Rent	Wages	Interest	Profit



Natural resources

Natural resources include all naturally occurring materials that are used in the production process (sometimes also called *land* as shorthand for all natural resources). They are classified as renewable (i.e. they can regenerate over time – for example, forests, fish stocks) or non-renewable (fixed in supply and exhaustible – for example, mineral deposits). Renewable resources can be depleted if extracted faster than they regenerate, while quality can be damaged through pollution or degradation regardless of type. It is important therefore for economies to manage their natural resources, to ensure they remain available to future generations.

The income received by the owners of natural resources is called **rent**. Rent goes beyond the idea of renting property. It covers all the income rewards derived from the productive use of natural resources.

Labour

Labour is human effort, both physical and mental, used to produce goods and services. The supply of labour for production depends on a number of factors, and these can change over time. The size of a country's population is obviously important in determining how much labour is available. Population size will be influenced by a country's birth rate, life expectancy and levels of immigration. Other factors that influence the availability and quality of labour resources include the school-leaving age, the retirement age, social attitudes towards the role of women in the workforce, the availability of childcare, population health, educational outcomes and the availability of on-the-job training.

Wages are the return to the owners of labour. Again, economists use this term in a wider sense than its common usage. As well as regular payments for a standard working week, the term wages includes executive salaries, commissions, fees for professionals and the earnings of self-employed people.

Capital

Capital is the “produced means of production”. This means that capital goods are not produced for immediate consumption, but to be used in the production of other goods and services. Examples of physical capital include machinery, tools, factories and computers. These types of capital goods are generally owned privately by individuals or firms. **Infrastructure** (or social overhead capital) is another form of capital that is usually owned by the community as a whole. Infrastructure includes roads, railways, bridges, telecommunications networks and schools. Even where infrastructure is not owned by businesses, it is vital to their operations – for example, roads are necessary for the transport of goods, and a reliable power supply is necessary to operate machinery.

In addition to physical capital, modern economies increasingly rely on **intellectual capital**, which includes assets such as patents, trademarks, copyrights, software and brand value. These forms of intellectual property (IP) represent ideas and innovations that can be used in production and can provide firms with a competitive advantage. For example, a patented technology or well-known brand can increase a firm's productivity and profitability, even though it is not a physical asset. It is important to note that economists' definition of capital does not include financial assets such as money, shares and bonds, but it does include these intangible productive assets.

Capital equipment, including both physical and intellectual capital, can greatly increase the **productivity** of other resources – that is, how much output they can produce per unit of time. Using capital goods can increase the level of production from the existing workforce and natural resources, enabling economies to satisfy more wants than would otherwise be possible. The amount and quality of capital available can therefore have a significant effect on the future earning capacity of an economy.

When households do not spend all their income, the resulting saving can be channelled through financial institutions to businesses and entrepreneurs, who use it to purchase capital goods. In effect, consumer saving shifts resources away from the production of consumer goods and towards the production of capital goods.

In the simplified factor-income model, **interest** is treated as the return to capital. More precisely, interest is paid to savers or lenders who provide funds that businesses use to purchase capital goods. Alternatively, for firms and entrepreneurs who invest their own surplus funds in capital equipment or intellectual property, the interest those funds could have earned elsewhere is an opportunity cost of investing them in capital.

Enterprise

Enterprise involves organising the other factors of production (natural resources, labour and capital) for the purpose of producing goods and services. It is the vital ingredient that brings the production process together. The entrepreneur makes the management decisions concerning all aspects of production and bears the risk that these decisions may not be the correct ones. The right decisions can make a business successful, while the wrong ones may result in failure.

Profit is the return to enterprise. This is not merely revenue earned minus actual expenses. Entrepreneurs are entitled to receive rent for the use of any land that they own in the production process, wages as a return for their work effort and interest for any capital invested into the business. Profit is the income received over and above these other rewards. It is earned because the entrepreneur sets up and runs a successful business despite the considerable risk of failure.

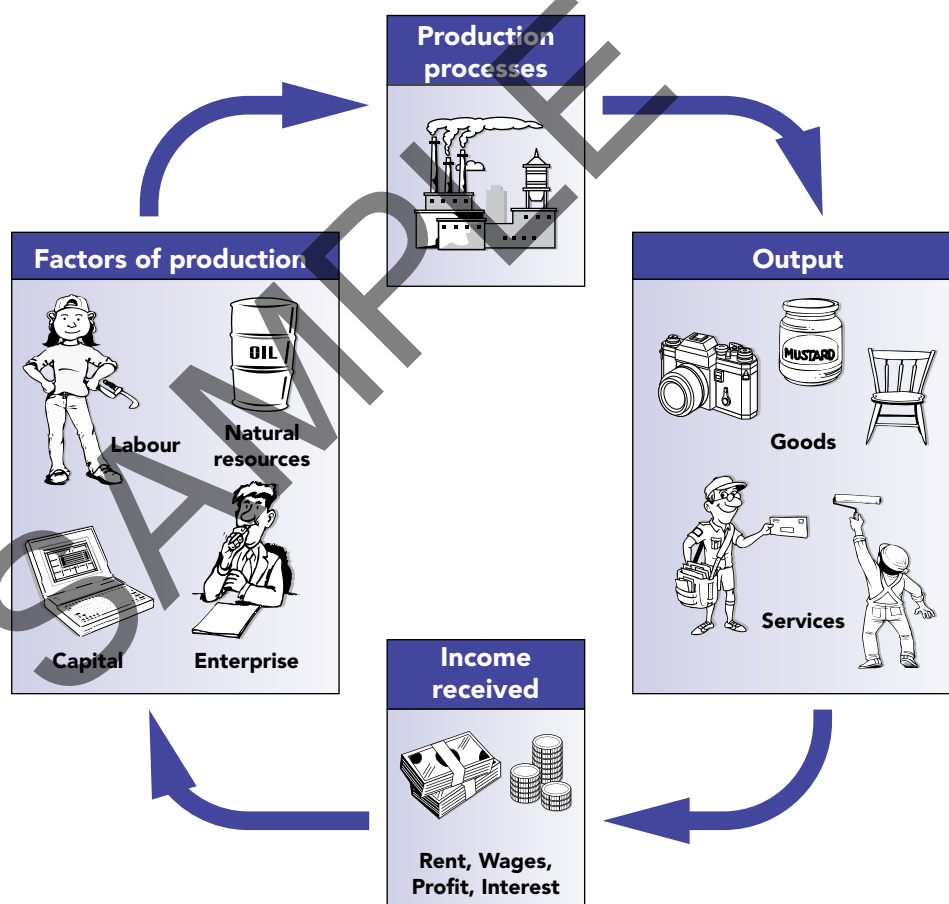


Figure 2.1 ♦ The combination of natural resources, labour, capital and enterprise and the income they each receive in return

Each of the four factors of production is limited in its supply, reflecting the **problem of scarcity** in economies:

- There are limits to the natural resources available for production, including land, fossil fuels or even clean air and water.
- Our supply of labour is limited by several factors such as population size, labour market skills and people's willingness to work.
- The supply of capital is limited by the willingness of governments and the private sector to invest and by the amount of domestic or overseas saving available to finance investment.

- The supply of entrepreneurial skills is also limited by the size of the population and a range of other cultural and economic factors, including the ability and willingness of individuals to innovate and take risks.

The availability, quality and combination of the factors of production determine how much an economy can produce and how efficiently it operates. Understanding these factors and their returns provides a foundation for analysing how resources are used and how income is generated within an economy.



REVIEW QUESTIONS

- 1 Identify the major factor of production used in each of the following activities:
 - a providing childcare
 - b production of cricket bats
 - c managing a small business
 - d emu farming.
- 2 Identify the type of income received after participating in the following activities:
 - a A fishery pays for permission to fish in a protected coastal area.
 - b A café owner buys a new coffee machine that boosts their sales and earnings.
 - c A tech firm releases a new app for making AI-generated videos.
 - d A lifeguard is paid for supervising swimmers at the local pool.
- 3 Describe ONE example of a capital good that would increase the productivity of labour.
- 4 Outline how the problem of scarcity affects the supply of natural resources, including land.
- 5 Explain how a small business owner could receive all four types of factor income.

2.2 Key questions for an economy

Every economy, no matter how simple or advanced, must make decisions about how to use its limited resources. Resources such as land, labour, capital and entrepreneurship are scarce, meaning there is not enough to produce everything that people want. As a result, individuals, businesses and governments must make choices about how these resources are allocated. These choices are important because they determine what is produced, how efficiently production occurs and how goods and services are shared across society. Economists summarise these decisions using four **key economic questions**, which provide a framework for understanding how any economy operates.

The first question is **what to produce**. This refers to the types of goods and services an economy chooses to create. For example, an economy must decide how much to produce of essential goods such as food, housing and healthcare, compared with non-essential items like entertainment or luxury products. It also includes decisions about how much to focus on producing goods (such as cars or clothing) versus services (such as education or tourism). Because resources are limited, producing more of one good usually means producing less of another. This trade-off introduces the concept of **opportunity cost**, which is the value of the next-best alternative that is given up when a choice is made.

The second question is **how much to produce**. Once an economy decides what goods and services to produce, it must also determine the appropriate quantity. Producing too little of essential goods can lead to shortages and unmet needs, while producing too much can result in waste and inefficiency. For example, overproducing food may lead to spoilage, while underproducing housing can create shortages and rising prices. Economies aim to find a balance, with resources used efficiently to meet the needs and wants of the population. This often involves responding to changes in demand, population growth and available resources.





The third question is **how to produce**. This focuses on the methods and processes used to create goods and services. Producers must decide whether to use more labour (human workers) or more capital (machines and technology). For example, a factory might choose to automate production using advanced machinery, or it might rely on workers to complete tasks manually. These decisions affect costs, productivity and employment levels. In modern economies, there is also an increasing focus on producing goods in ways that are environmentally sustainable and socially responsible, even if these methods are more expensive.

The fourth question is **how to distribute what is produced**. After goods and services are produced, they must be allocated among individuals and groups in society. This raises important questions about fairness, equity and access. In some systems, goods are distributed based on the ability to pay, meaning those with higher incomes can access more goods and services. In others, governments play a role in redistributing income and providing essential services to ensure that everyone has access to basic needs such as healthcare, education and housing. How goods and services are distributed has a major impact on living standards, inequality and overall wellbeing.

Together, these four key economic questions – what to produce, how much to produce, how to produce and how to distribute production – form the foundation of all economic decision making. Different economic systems answer these questions in different ways, depending on their values, institutions and level of development. By studying these questions, we can better understand how economies function, why outcomes differ between countries and how economic decisions affect people's everyday lives.



REVIEW QUESTIONS

- 1 Identify ONE factor that influences what goods or services a society chooses to produce.
- 2 Identify a consequence of producing too much of a good.
- 3 Discuss the considerations that influence the question of how to produce for an economy.
- 4 Outline the impact of income inequality on distribution of goods and services.

2.3 Different economic systems

Every society must decide how to use its limited resources to meet people's needs and wants. To do this, economies develop different systems, known as economic systems, which guide decision making. The four main types are pre-industrial (traditional), planned (command), free market and mixed economies. Each system has its own way of organising production and distribution. No matter their type, all economies must answer the same four key economic questions: what to produce, how much to produce, how to produce and how to distribute what is produced. The way these questions are answered shapes how resources are used, how goods and services are shared and how people live. By comparing different economic systems, we can better understand the strengths and weaknesses of each approach.

Pre-industrial (traditional) economies

A pre-industrial or traditional economy is one in which economic activity is based on customs, traditions and long-established ways of life rather than formal markets or government planning. Traditional economic systems predate industrialisation and continue in some communities, often alongside market and government institutions. Before European colonisation, Aboriginal and Torres Strait Islander peoples maintained diverse economic systems shaped by customary law, kinship, trade and detailed environmental knowledge.



In pre-industrial economies, people usually live in small groups and focus on producing what they need to survive, often using local resources and knowledge passed down through generations. Economic roles are usually stable, with children learning the same skills and occupations as their parents. There is little use of advanced technology, and production is typically small-scale and labour-intensive.

What to produce: Decisions are guided by tradition and basic needs. Communities produce goods such as food, clothing and shelter because these are essential for survival. What is produced tends to change very slowly over time, as customs and environmental conditions remain relatively constant.

How much to produce: Production is usually limited to what is needed for daily life, with perhaps a small surplus for emergencies or local trade. There is little focus on growth or profit, and output is constrained by available resources, seasons and labour.

How to produce: Goods are made using handmade tools, manual labour and traditional techniques. Farming, hunting, fishing and craft-making are common, and knowledge is shared informally within the community. Pre-industrial economies nevertheless often developed production methods finely tuned to local environmental conditions. The Brewarrina fish traps in New South Wales, for example, are a network of stone weirs built by Aboriginal communities to channel and harvest fish as river levels rose and fell, demonstrating a detailed understanding of aquaculture developed over many generations.

How to distribute what is produced: Distribution is based on customs, family roles and community needs. Goods may be shared or consumed directly by producers, or among family members or exchanged through barter or local markets. Cooperation and social responsibility are often more important than individual gain.

Planned (command) economies

A planned economy, also known as a command economy, is one in which the government makes most of the key economic decisions. Instead of relying on markets, a central authority decides what goods and services will be produced, how they will be produced and who will receive them. This system has been used in countries such as the former Soviet Union and is still present in modified forms in some parts of the world. The goal is often to achieve control over important industries, rather than relying on profit or competition. However, it requires a large amount of information and coordination, which can be difficult to manage.

What to produce: The government decides what goods and services are needed, often focusing on essentials like food, housing, healthcare and infrastructure. National priorities, such as industrial development or defence, strongly influence these decisions.

How much to produce: Production levels are set through targets or quotas. Planners estimate how much of each good is required, but mistakes can lead to shortages (not enough goods) or surpluses (too much of something).

How to produce: The government controls resources such as labour, land and capital and directs how production takes place. Factories and farms follow state plans, and efficiency is often pursued through large-scale production.

How to distribute what is produced: Goods and services are distributed by the state, sometimes using rationing systems or government-run shops. While the aim is to ensure everyone has access to basic goods, distribution may not always match people's preferences.

Free market economies

A free market economy is one in which individuals and businesses make most economic decisions with minimal government involvement. Prices are determined by demand and supply, and competition between producers plays a central role. Consumers signal what they want through their spending, and businesses respond



by producing goods and services they believe will be profitable. While no country is a completely free market, many economies, such as the United States, place a strong emphasis on free market principles, such as limited government intervention and private property rights. This system encourages innovation, efficiency and choice, but can also lead to inequality and uneven access to resources.

What to produce: Businesses decide what to produce based on consumer demand. If people are willing to pay for a product, firms will supply more of it. Products that are not profitable are usually discontinued.

How much to produce: Production levels are influenced by market prices and demand. High demand and rising prices encourage firms to increase output, while low demand leads to reduced production.

How to produce: Producers choose the most efficient and cost-effective methods to maximise profit. This often involves using new technology, improving productivity and finding ways to reduce costs.

How to distribute what is produced: Goods and services are distributed through the price system. People who can afford to pay the market price receive the goods, which can reward effort and innovation but may also result in unequal outcomes.

Mixed economies

A mixed economy combines elements of both free market and planned systems. Mixed economies are the most common form of modern economic system; Australia is one example. In a mixed economy, the private sector plays a major role in producing goods and services, but the government also intervenes to provide essential services, regulate markets and reduce inequality. The aim is to balance the efficiency and innovation of markets with the fairness and stability provided by government involvement. This allows societies to benefit from economic growth while also addressing social, environmental and equity concerns.

What to produce: Most goods and services are produced by businesses responding to consumer demand. However, governments also play both direct and indirect roles in deciding what is produced. They provide public goods and merit goods such as defence, infrastructure, healthcare and education, which may not be adequately supplied by the market alone. Governments can also influence production through subsidies, tax incentives and regulations. For example, they may encourage renewable energy or restrict harmful goods and services through laws and regulations.

How much to produce: Production levels are largely determined by market forces such as demand and supply, but governments can influence the scale of production. They may encourage greater production of desirable goods such as education and the arts – known as merit goods – through subsidies or funding. At the same time, governments may limit production in certain areas – for example, by regulating industries or restricting activities that create social or environmental harm. Policies such as tariffs, quotas or support for domestic industries can also affect how much is produced.

How to produce: Businesses generally choose the most efficient methods of production to minimise costs and maximise profits. However, governments influence how goods and services are produced through regulations. Laws relating to workplace safety, minimum wages, environmental protection and fair competition aim to ensure that production is not only efficient but also safe, ethical and sustainable. These rules may increase costs but help protect workers, consumers and the environment.

How to distribute what is produced: Goods and services are mostly distributed through markets, where people access goods based on their ability to pay. However, governments play an important role in redistributing income to promote fairness. This is done through progressive taxation and welfare payments, which support lower-income individuals and households. Governments may also intervene in factor markets – for example, by setting minimum wages – to influence income distribution.



United States of America

The United States is often described as a **free market economy**, where most decisions are made by individuals and businesses. It is the world's largest economy, with a GDP of over US\$32 trillion, and is characterised by strong competition and innovation.

Businesses decide what to produce based on consumer demand, and prices help guide how much is produced. Firms choose production methods that maximise efficiency and profit, often using advanced technology. The private sector plays a dominant role, with **over 85 per cent of economic activity driven by private enterprise**.

Goods and services are distributed through markets, meaning access depends largely on income. While this system promotes efficiency and choice, it can also lead to inequality. The United States has a relatively high **Gini coefficient of around 0.41**, indicating income inequality compared to other developed countries. Although the government regulates markets and provides public goods, the economy remains strongly market-driven.

United Kingdom

The United Kingdom is an example of a **mixed economy**, combining market forces with government intervention. Most goods and services are produced by private businesses, but the government plays a significant role in providing public services and regulating the economy. Government spending accounts for around **45 per cent of GDP**, reflecting its role in healthcare, education and welfare.

Market forces largely determine what and how much is produced, while firms choose efficient production methods. However, government regulations ensure safety, environmental protection and fair working conditions.

The UK also redistributes income through taxation and welfare. For example, the National Health Service (NHS) provides healthcare free at the point of use. As a result, the UK has a **lower Gini coefficient of around 0.35** after taxes and transfers, showing the impact of redistribution.

This combination of market efficiency and government support makes the UK a typical modern mixed economy.



Cuba

Cuba is a well-known example of a **planned (command) economy**, where the government plays a central role in economic decision-making. After the 1959 revolution, the state took control of major industries and key services such as healthcare and education. Government spending accounts for a large share of economic activity, with **public sector employment exceeding 70 per cent of the workforce**.

The government decides what and how much to produce, often focusing on essential goods and services. Production is guided by national plans, and resources are allocated according to state priorities. Basic goods are distributed through state systems, including rationing.

Cuba has achieved strong social outcomes, including a **literacy rate of around 99 per cent**, reflecting its investment in education. However, the system also faces challenges such as inefficiency, shortages and limited consumer choice. In recent years, some market reforms have been introduced, but government control remains central to the economy.

Papua New Guinea

Papua New Guinea (PNG) has many features of a **pre-industrial (traditional) economy**, particularly in rural and remote areas. While some sectors are linked to global markets, most people rely on subsistence farming, fishing and local trade. Around **80 per cent of the population lives in rural areas**, and a large share depends on agriculture for their livelihoods. Economic activity is guided by customs, traditions and community relationships rather than formal markets.

People mainly produce goods for their own consumption, with small surpluses traded locally through barter or informal exchange. Production methods are labour-intensive and based on traditional knowledge. Distribution is shaped by kinship and social obligations, with an emphasis on sharing.

At the same time, PNG has many elements of a modern economy, with **natural resources accounting for around 70 per cent of export earnings**, particularly from mining and energy. This highlights how traditional and modern economic systems can coexist within the same country.

Figure 2.2 ♦ Economic systems around the world

As a result, mixed economies aim to combine market outcomes with policies that reduce inequality and improve access to essential goods and services. Figure 2.3 summarises how the four economic systems answer the key economic questions.

Economic system	What to produce?	How much to produce?	How to produce?	How to distribute?	Example economies
Pre-industrial (traditional)	Based on customs and tradition	Based on basic needs	Simple, labour-intensive methods	Shared by community or barter	Australia before European settlement; rural subsistence economies (e.g. Papua New Guinea)
Planned (command)	Decided by government	Set by government quotas	Directed by the state	Distributed by government (e.g. rationing)	North Korea, Cuba
Free market	Decided by consumer demand	Determined by demand and supply	Chosen for efficiency and profit	Based on ability to pay	United States, Singapore
Mixed economy	Mostly market-based, some government provision	Market-driven with government influence	Efficient methods within regulations	Market distribution and government redistribution	Australia, United Kingdom

Figure 2.3 ♦ Different economic systems

Intervention or interference?

The role of government in the economy is hotly debated. If you listen to the language of people opposed to government intervention, you may hear it described as *bureaucratic interference*, *the nanny state*, *a red tape nightmare* and *socialism*. On the other hand, those who support the role of government may speak of *giving people a fair go*, *decent minimum standards*, *basic rights* and the need to protect individuals from the structural inequality and marginalisation created by the market economy. This language reflects the very different perspectives that different people and groups bring to the debate on what role governments should play in a market economy.



REVIEW QUESTIONS

- Identify the economic system which aligns with the following examples:
 - A restaurant extends its opening hours due to customer demand, but must follow government rules on staff wages and working conditions.
 - A small farming village grows crops using simple tools and traditional methods, producing mainly enough food for their own families.
 - A nation's central planning agency sets production targets for steel, wheat and electricity.
 - A café adds a popular drink to its menu because customers request it, without any government involvement or regulations.
- Identify FOUR examples of government intervention in a mixed economy.
- Explain how each economic system differs in the way goods and services are distributed to consumers.

2.4 The importance of money

Money plays a central role in the functioning of modern economies. It is something people use every day, often without thinking about how important it really is. At its simplest, money allows people to buy and sell goods and services more easily. Without money economies would rely on barter, which is slow and inefficient. Money allows individuals to specialise in particular jobs and trade their output for what they need. This specialisation increases productivity and improves living standards over time. Money also makes it easier to compare the value of different goods and services, with prices providing clear information that helps people make decisions. Businesses rely on money to calculate costs, set prices and measure profits, while governments use it to collect taxes and provide public services. Financial systems are built around money, enabling saving, borrowing and investment.

For money to perform these roles effectively, people must have confidence that it will hold its value and be widely accepted. Stable monetary systems, supported by trusted institutions such as the Reserve Bank of Australia, help maintain this confidence. When stability breaks down, such as during periods of high inflation or financial crisis, money can lose its value and people may lose trust in the system. This can lead to reduced spending, disrupted trade and serious economic hardship. In extreme cases, people may turn to barter or alternative currencies, making economic activity more difficult. Money also allows economic activity to take place across time, linking present decisions with future outcomes and supporting long-term planning. Understanding the role of money is essential for understanding how economies operate.

The functions of money

To understand why money is so important, it is helpful to look at the specific roles it performs in an economy. Economists describe these roles as the **functions of money**, and they explain how money supports everyday transactions and broader economic activity. Rather than being valuable in itself, money is useful because of what it allows people and businesses to do. It makes exchange easier, provides a way to measure value, allows people to save for the future and supports borrowing and lending. These functions work together to reduce uncertainty, improve efficiency and enable complex economic systems to operate smoothly. By examining each function in detail, we can better understand how money underpins modern economic life.

THE FOUR FUNCTIONS OF MONEY

1

A medium of exchange

Goods, services and resources are exchanged for money.

2

A measure of value

Money provides a common unit for expressing and comparing the value of goods, services and resources.

3

A store of value

Money can be held over time and used predictably for future exchanges of goods, services or resources.

4

A method of deferred payment

Money allows the development of a system of lending and borrowing.

Money serves as a **medium of exchange**, allowing goods and services to be traded without the need for a direct barter match. In a barter system, for an exchange to take place there must be a “double coincidence of wants”, where each party wants what the other offers. Money removes this constraint by acting as an intermediary: individuals can sell their labour or goods for money and then use that money to purchase entirely different goods from others. This dramatically reduces transaction costs, enables markets to function smoothly and underpins the high levels of specialisation seen in modern economies.

Money also functions as a **measure of value**, providing a common measure through which the value of all goods and services can be expressed. Prices denominated in money allow individuals and firms to compare alternatives, calculate costs and assess profitability. Without a standard unit, economic calculation becomes unwieldy, as





values need to be expressed in terms of many different goods. The “unit of account” function is therefore essential for rational decision making, resource allocation and the operation of firms and markets.

A third key role of money is as a **store of value**, enabling individuals to transfer purchasing power over time. By holding money, people can preserve purchasing power earned today for use in the future. This supports planning, investment and financial security. However, this function depends on the stability of money’s value: inflation erodes purchasing power, while extreme instability can undermine confidence in money altogether. In this sense, the effectiveness of money as a store of value is closely tied to broader economic stability.

Finally, money acts as a **standard of deferred payment**, meaning it is used to denominate debts and contractual obligations that are settled in the future. Loans, wages, rents and other financial agreements are typically specified in monetary terms, allowing economic activity to extend across time. This function underpins credit markets and facilitates investment, as individuals and firms can borrow today in anticipation of future income.

The forms of money

Money can take a variety of forms, and these have evolved over time as economies have grown and become more complex. Different forms of money reflect changes in technology, trust and the organisation of economic systems. While these forms differ in how they are created and used, they all perform the same basic functions of facilitating exchange, measuring value, storing wealth and enabling payments over time.

One of the earliest forms is **commodity money**, which consists of goods that have intrinsic value. Examples include gold, silver, salt and even livestock. These items were accepted as money because they were useful, durable and relatively scarce. For instance, gold and silver were widely used because they did not spoil and could be divided into smaller units. However, commodity money has significant drawbacks. It can be heavy to carry, difficult to divide accurately and its supply depends on natural availability, which limits economic flexibility.

To overcome these limitations, **representative money** was developed. This form of money involves paper notes or tokens that represent a claim on a commodity, usually gold or silver. People could exchange these notes for the underlying commodity, which made transactions easier and safer than carrying valuable metals. This system was used under the gold standard, in which notes were convertible into a fixed quantity of gold. Over time, however, maintaining these reserves became restrictive and economies moved away from this system. Australia abandoned its gold standard between 1929 and 1931, and convertibility of currency notes into gold was formally abolished in 1932.

Today, most economies use **fiat money**, which has no intrinsic value and is not backed by a physical commodity. Its value comes from government authority and the trust that people place in it. In Australia, fiat money is issued and managed by institutions such as the Reserve Bank of Australia. Fiat money is flexible because governments and central banks can adjust its supply to respond to economic conditions. However, this also means that its value depends on stability and responsible management.

Another form is **bank or digital money**, which exists as electronic records in bank accounts rather than physical cash. This is the most common form of money used today, as people increasingly rely on cards, online banking and mobile payments. Bank money is created largely through lending and allows for fast, convenient transactions across large distances.

More recently, **cryptocurrencies**, such as Bitcoin, have emerged as a new form of digital money. These operate on decentralised networks and are not controlled by governments or central banks. While they offer new possibilities, they are still evolving and are not yet widely accepted as everyday money due to price volatility and limited use.

How is money measured?

Most people think of money simply as the notes and coins they use every day. However, in economics the focus is much broader. Economists are interested in the **money supply**, which is the total amount of money in an economy that can perform the key functions of money: acting as a medium of exchange, a measure of value, a store of value and a method of deferred payment. Physical currency actually makes up only a small share of the total money supply – around 3 per cent in Australia – because most money exists in digital form within bank accounts.

To better understand the money supply, economists divide it into different measures based on its **liquidity** – how easily the money can be used. The most basic measure is currency, which includes all notes and coins held by households and businesses. While this is the most visible form of money, it is only a small part of the total.

A broader measure is M1, which includes currency plus money held in transaction accounts, such as everyday bank accounts, that can be accessed instantly using cards or online payments. M1 represents the most liquid forms of money, meaning it can be used immediately for spending.

An even wider measure is M3, which includes M1 plus non-transaction deposits, such as term deposits. These funds are less liquid because they cannot be easily accessed without delay or penalty, but they still represent money held within the banking system. M3 is often used as a key indicator of the money supply in Australia.

The widest measure is **broad money**, which includes M3 plus deposits held in non-bank financial institutions, such as credit unions and building societies, with some adjustments. This provides the most comprehensive view of the total money available in the economy.

Another important concept is **credit**, which refers to loans provided by banks and other lenders to households and businesses. Credit is not money itself, but it is closely related because it increases spending power in the economy. Together, measures of money and credit help economists understand economic activity and financial conditions.

Money supply is the total amount of funds in an economy that can be used as a medium of exchange, a measure of value, a store of value and a method of deferred payment.



REVIEW QUESTIONS

- 1 With reference to the four functions of money, explain the importance of money to market economies.
- 2 Outline the different forms of the money supply measured by the Reserve Bank of Australia.
- 3 Explain the difference between money and credit.

CHAPTER SUMMARY

- 1 **Factors of production** are used to produce goods and services while **factor incomes** are the payments earned by the owners of the four factors of production.
- 2 The four main factors of production and their factor incomes are:
 - **natural resources** or land, which earn **rent**
 - **labour**, which earns **wages**
 - **capital**, which earns **interest**
 - **enterprise**, which earns **profit**.
- 3 Each economy must answer the following four basic questions:
 - What to produce?
 - How much to produce?
 - How to produce?
 - How to distribute what is produced?
- 4 **Pre-industrial systems** rely on tradition and local production, using natural resources and simple methods to produce enough for their own survival.
- 5 **Planned systems** have government planners making all major economic decisions, owning all resources and controlling distribution through central planning.
- 6 **Free market economies** allow individuals and private firms to make decisions based on self-interest and consumer demand.
- 7 **Mixed economies** rely on consumer demand to guide most production and pricing decisions, while the government intervenes selectively to influence outcomes.
- 8 **Money** is essential because it enables efficient exchange, supports specialisation and allows modern economies to function smoothly and grow.
- 9 Money performs **four key functions**: it acts as a medium of exchange, a measure of value, a store of value and a method of deferred payment, enabling individuals to buy, compare, save and borrow.
- 10 Money exists in **different forms** – such as commodity, fiat, digital, and cryptocurrency – which have evolved over time to make transactions easier and more efficient. It can be measured by currency (notes and coins) or by broader measures such as M1, M3 and broad money, which reflect different levels of how easily money can be used.

CHAPTER REVIEW

- 1 Explain the economic meaning of the following terms:
 - a natural resources
 - b labour
 - c capital
 - d enterprise.
- 2 Explain how investment in capital can increase an economy's future productive capacity.
- 3 A country experiences a decline in birth rates. Discuss how this might affect its labour supply and future production.
- 4 Discuss the challenges economies face when deciding how to distribute goods and services.
- 5 Outline the factors that influence how much of a good or service should be produced in a free market economy.
- 6 Analyse the reasons modern economies tend to adopt mixed market systems.
- 7 Outline the differences between pre-industrial, planned, free market and mixed economies.
- 8 State the four key features of money.
- 9 Explain why modern economies prefer money over bartering or exchange systems.
- 10 Distinguish between the following forms of money:
 - a commodity
 - b fiat
 - c digital.

Extended response

Compare and contrast how pre-industrial, planned, free market and mixed economies answer the key economic questions. In doing so, assess how effectively each system addresses scarcity and allocates resources to meet societal needs.