

FOUNDATIONS OF MACROECONOMICS UNIT

CIRCULAR FLOW MODEL

IB CORE CONCEPTS AND NOTES SPECIFICALLY RELATED TO THIS VIDEO

<i>IB Core Concept</i>	<u>Standard Level and High Level Concept</u>
Level of Overall Economic Activity	<p>The Circular Flow Model</p> <ul style="list-style-type: none"> • Explain, using a diagram, the circular flow of income between households and firms in a closed economy with no government. • Identify the four factors of production and their respective payments (rent, wages, interest and profit) and explain that these constitute the income flow in the model. • Outline that the income flow is numerically equivalent to the expenditure flow and the value of output flow. • Explain, using a diagram, the circular flow of income in an open economy with government and financial markets, referring to leakages/ withdrawals (savings, taxes and import expenditure) and injections (investment, government expenditure and export revenue). • Explain how the size of the circular flow will change depending on the relative size of injections and leakages. <p style="text-align: right; font-size: small;">Source: IB Economics Subject Guide</p>

Circular Flow of Income Model

- The circular flow model of income represents a very simple model for *how* a nation's economy works.

Circular Flow Model: Two-Sector Economy

- In this very simple model, there are two sectors: households and firms.
- Households:
 - Are the people who *buy* the nation's output of goods and services.
 - Are the *owners* of all factors of production.
 - *Supply* the factors of production to the firms and, in turn, *receive payments* for their factors.
- Firms:
 - *Hire* the factors of production from households.
 - *Use* the factors of production *to produce* the nation's output of goods and services.
- Factors of Production and Factor Payments made simple...

Factor of production (provided by firms)	Payment to the factor (provided by households)
Labour	Wages
Land	Rent
Capital	Interest
Entrepreneurship	Profits

Table 13.2 Payment to the factors of production

- This is the basis for the circular flow of income two-sector model.
- Households provide the factors of production (1) and receive income (2). They buy the goods and services (3) produced by the firms by using the income received (4) and this is the way the income circulates throughout the economy.

Circular Flow Model: Two-Sector Economy

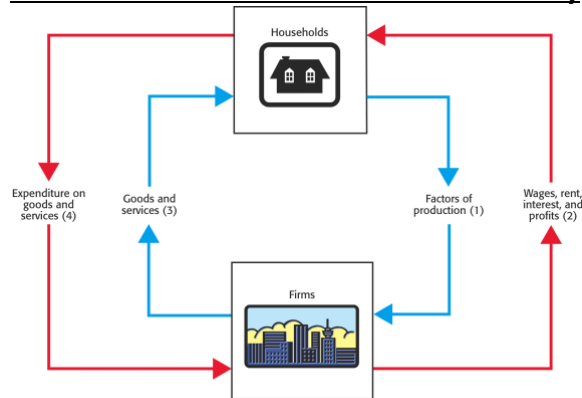


Figure 13.1 Two-sector circular flow of income model

Leakages and Injections

- Leakages
 - *Definition:* In the circular flow of income model, refers to the withdrawal from the income flow of funds due to savings, taxes or imports.
 - *Examples:* consumer savings, taxes, buying imports.
- Injections
 - *Definition:* In the circular flow of income model, refers to the entry into income flow of funds due to investment, government spending, or exports.
 - *Examples:* *government spending, investment, purchase of exports*
- Transfer payments
 - *Definition:* Transfer payments are payments to individuals that are not the result of an increase in output.
 - *Examples:* pensions, unemployment benefits, child allowance payments.
 - Governments tax the income of some households and transfer this income to others through the payments.
→ *As this is a transfer of income, and not an exchange for output, this spending does not represent an injection.*

Circular Flow Model: Four-Sector Economy

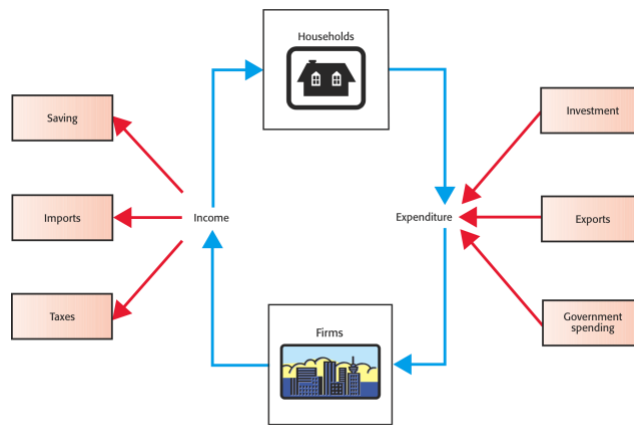


Figure 13.2 Four-sector circular flow with leakages and injections

- The economy stays in equilibrium where leakages are equal to injections.
- If leakages rise, without a corresponding increase in injections, then national output will fall to a new equilibrium, as there will be less income circulating.
- If injections rise with no corresponding rise in leakages, then the economy will move to a new equilibrium.

Source: Jocelyn Blink and Ian Dorton. IB Economics: Course Companion, Second Edition.