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Circular Flow Of Income and Expenditure

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Introduction

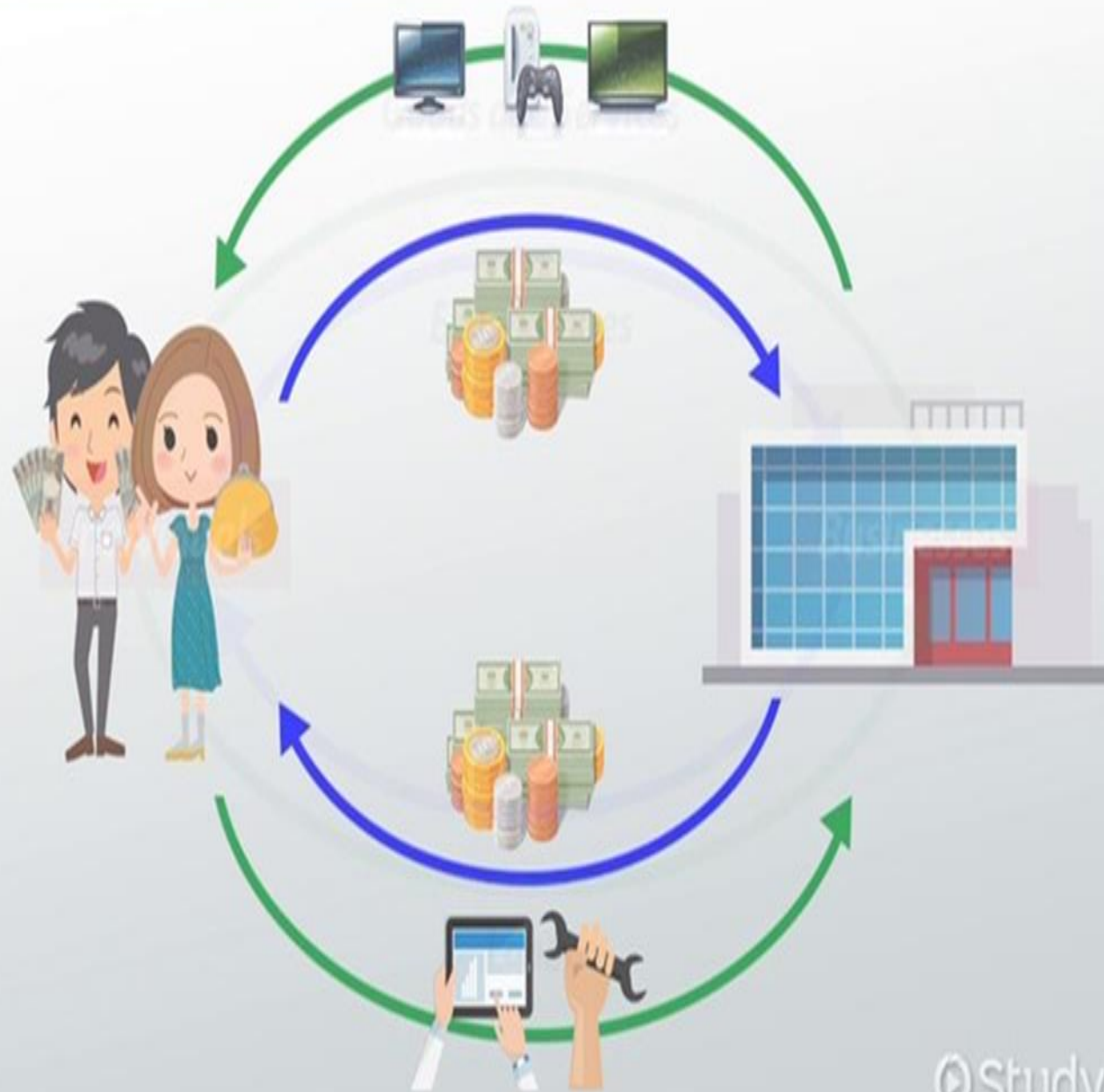
- **Circular Flow-** Simple economic model which describes the reciprocal circulation of income between producers and consumers.
- The basis of Circular flow is the interdependence of consumers and sellers.



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KEY TERMS AND CIRCULAR FLOW





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- Economic transactions generate two kinds of Flows-
- Real Flow and Money Flow.
- Real Flow- In a simple economy, the flow of factor services from households to firms and corresponding flow of goods and services from firms to households known to be as real flow.



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Circular Flow in a Two Sector Economy

- It is the simplest form of economic activities
- Two players in the economy-Households and Firms
- Households are the owners of the factors of production and the consumers of all consumer goods
- Firms are units which provides consumers with goods and services



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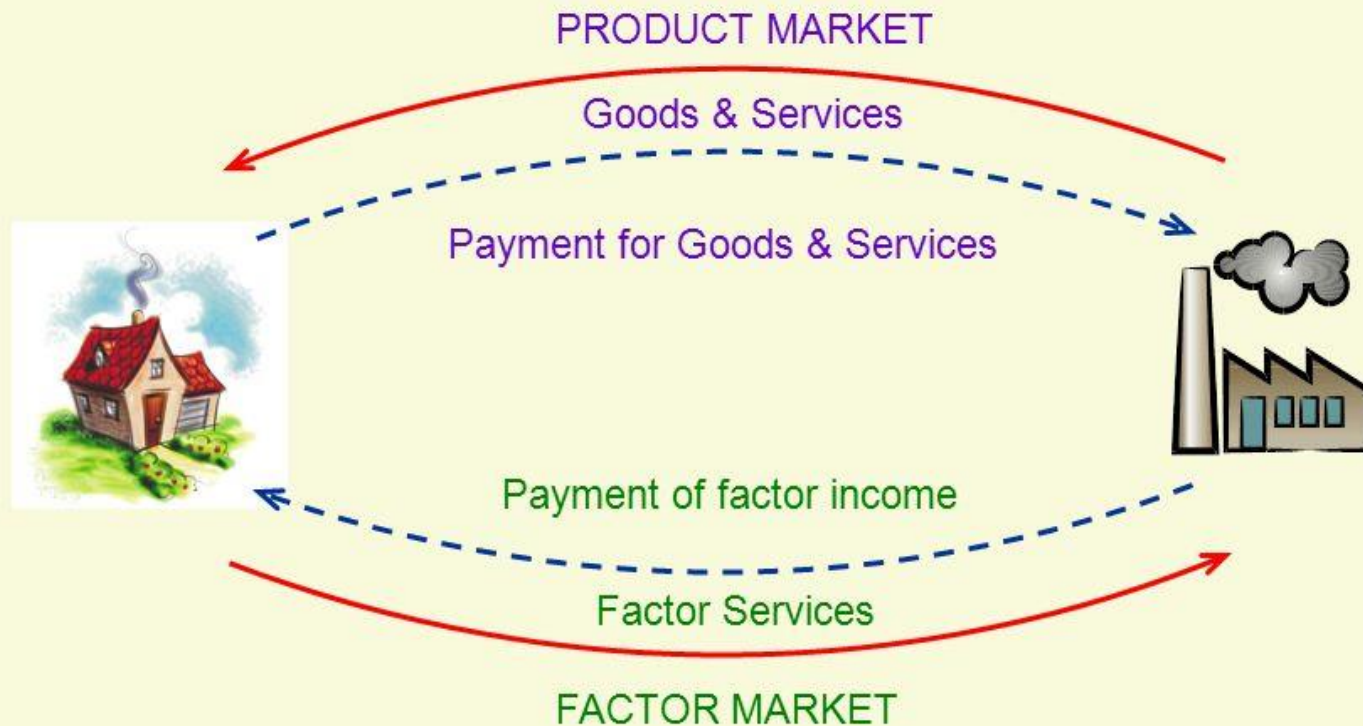
- The assumptions are
1. Households spend their total income
 2. Firms produce as much as demanded
 3. Firms make factor payments in terms of rent, wages, interest, and profits
 4. There is no inflow/outflow of income/goods and services from any outside source



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The Circular Flow of Income – 2 Sector Model



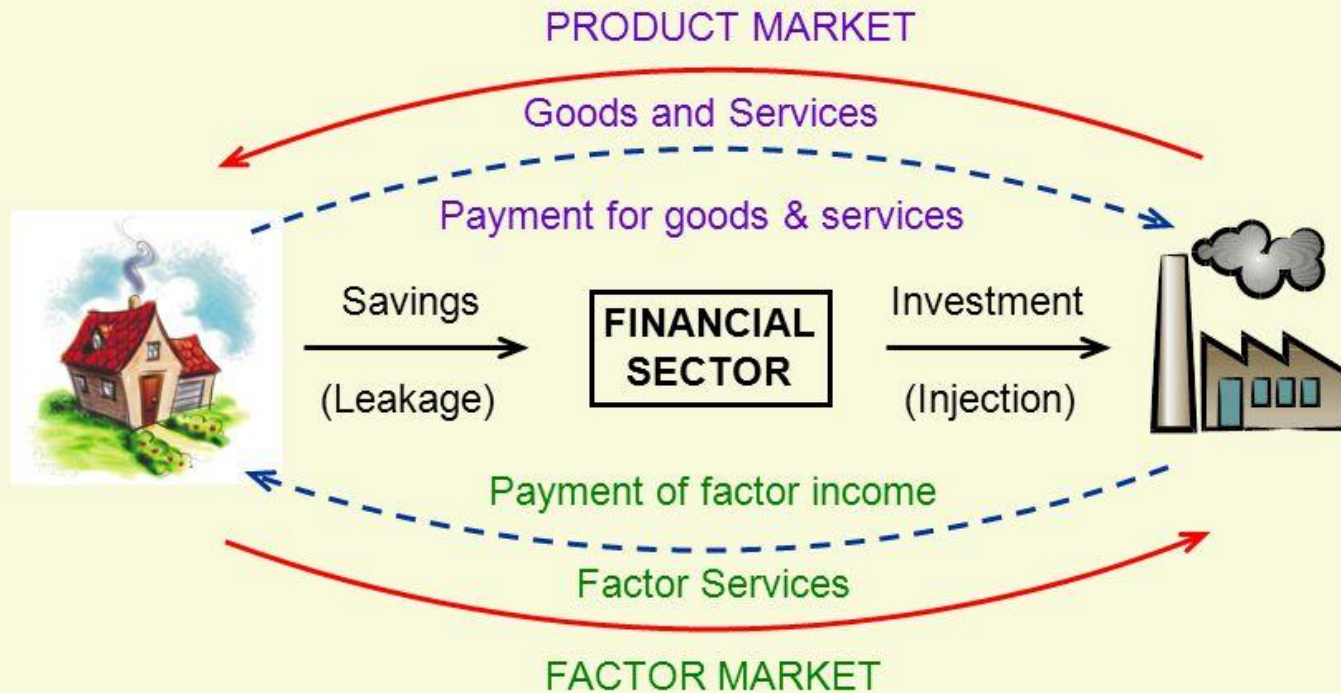


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The Two Sector Model with Savings

Two Sector Model with Financial Sector



Savings : Residual income that households do not use to purchase goods and services

Investment : Expenditure on capital goods



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Circular Flow in a Three Sector Economy

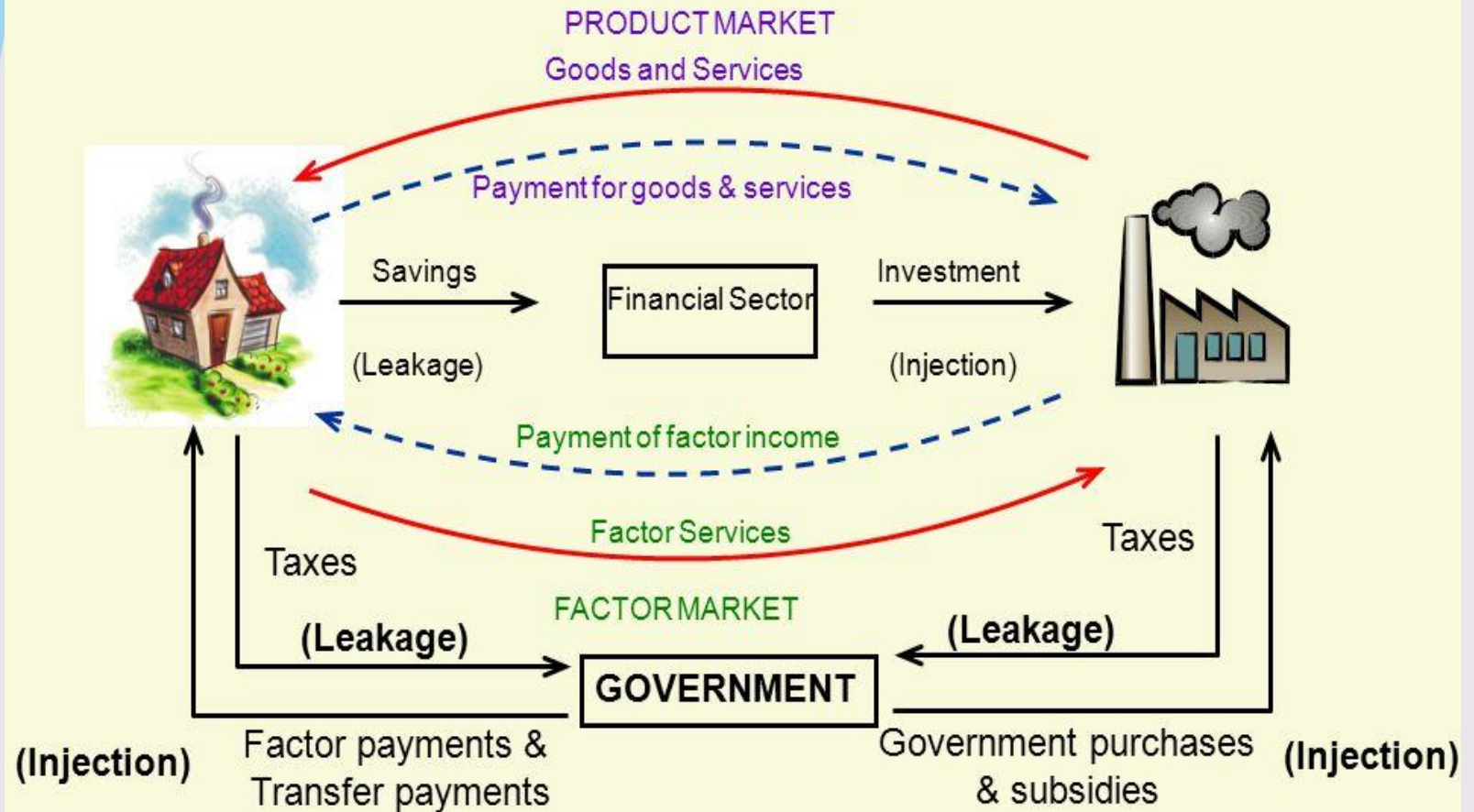
- Government is added to the two sector model
- Govt. creates basic infrastructure and thus total expenditure is $E=C+I+G$
- Total Income $Y=C+S+T$



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Three Sector Model



Equilibrium is achieved when leakages = injections

$$\text{Savings} + \text{Taxes} = \text{Investment} + \text{Govt. Purchase} + \text{Payments}$$



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Circular Flow in a Four Sector Economy

- Foreign Sector is added in the Three Sector Model
- External Sector consists of Exports and Imports of goods and services
- The export and import of goods and non-labour services are made only by the firms
- The households export only labour

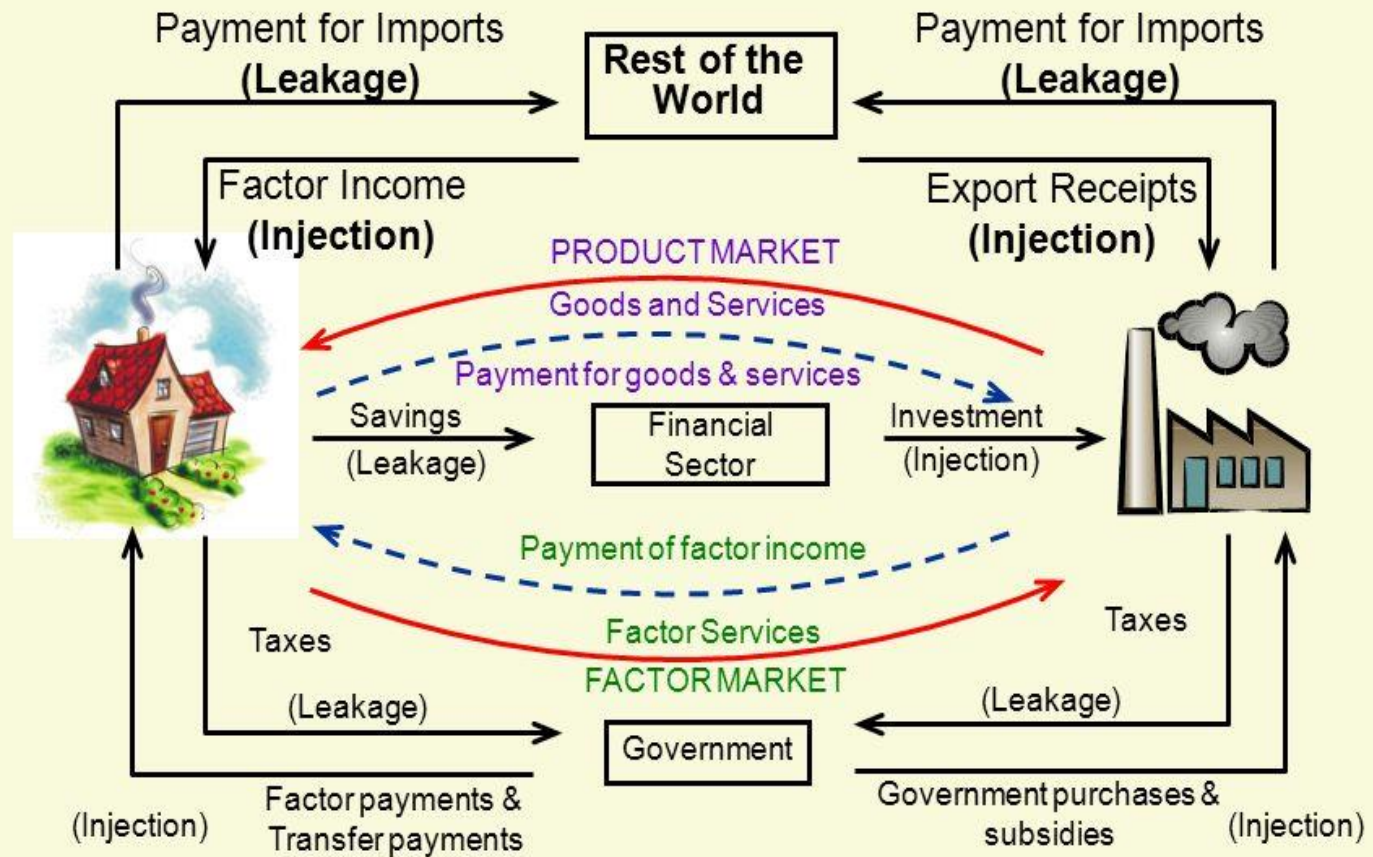


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Four Sector Model



In Equilibrium : Leakages = Injections

Savings + Taxes + Imports = Investment + Govt. Expenditure & Transfers + Exports



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THANK YOU