

Circular flow of National Income

Economics honours, 1st Semester

Instructor: Ananya Sinha, Asst.Professor, Women's College

Meaning of Circular flow of income

Production generates income which in turn is the source of spending (purchasing power) through which the value of production is realized. And the loop repeats itself over and over. Thus the basic macroeconomic identity of production, income and expenditure is represented by the concept of Circular Flow of Income.

There are actually two flows moving in opposite directions. These flows are : real flow and money flow. It is important to note that income, production and expenditure are flow concepts. They are measured over a period of time.

In an economy, there are mainly four economic sectors: Households, Firms, Government, External or foreign trade.

Role of various economic agents

Households: Consume and save , provide factor services of land, labour, capital and entrepreneurship and earn factor income in the form of rent, wages, interest and profit respectively, pay taxes to the Government

Firms: Produce and invest, hire or employ factors services in lieu of factor payments which constitute rent, interest, wages, profits., pays taxes to the government.

Government: Spends on welfare, administration, defence, law and order, levies taxes

External sector: exports and imports with rest of the world.

Financial sector: Acts as conduit between savers and investors.

Markets

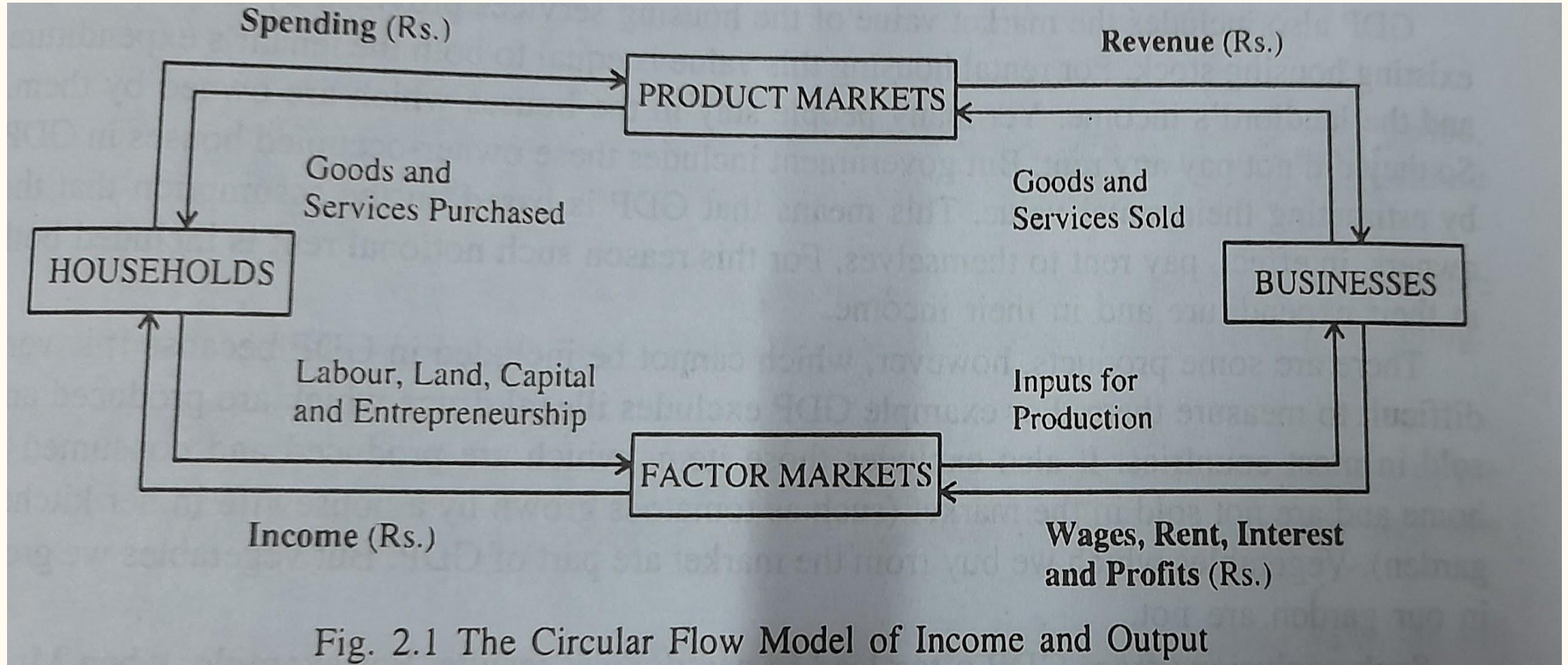
Product

Factor

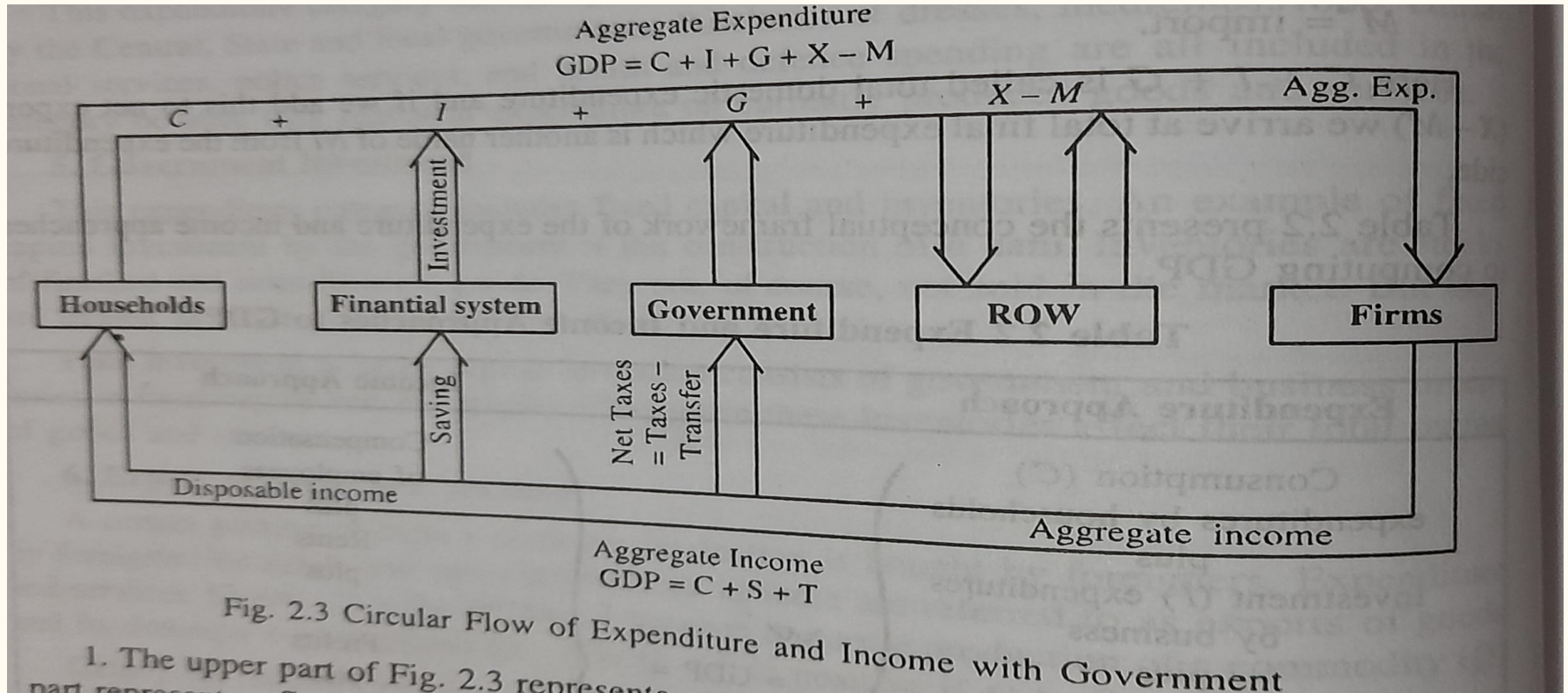
Financial

International

Circular flow of income: 2 sector economy



Circular flow: Diagram (4 sector)



Injection and Leakage

Savings, Net Taxes, Imports are leakages from the income flow. They reduce aggregate expenditure on domestic goods and services.

Investment, Government purchases of goods and services, exports are injections into the income stream. They increase aggregate expenditure on domestically produced goods and services.

Injections increase or expand the income flow and leakages contract it.

When injections are equal to leakages, the National income is in equilibrium.

Importance of the concept

Helpful in understanding how the various sectors of an economy are related to each other.

Helps in National income accounting/ measurement approaches