03: Circular Flow of Income

What Is the Circular Flow Model?

The circular flow model demonstrates how money moves through society. Money flows from producers to workers as wages and flows back to producers as payment for products. In short, an economy is an endless circular flow of money.

That is the basic form of the model, but actual money flows are more complicated. Economists have added in more factors to better depict complex modern economies.

These factors are the components of a nation's gross national product (GDP) or national income. For that reason, the model is also referred to as the circular flow of income model. Its key points are given below:

- The circular flow model demonstrates how money moves from producers to households and back again in an endless loop.
- The models can be made more complex to include additions to the money supply, like exports, and leakages from the money supply, like imports.
- When all of these factors are totaled, the result is a nation's gross domestic product or the national income.

Circular Flow of Income – In Two Sector Economy :

The circular flow model in the two-sector economy is a hypothetical concept which states that there are only two sectors in the economy, household sector and business sector (business firms).
The household sector is the source of factors of production who earn by providing factor services to the business sector. The business sector refers to the firms that produce goods and services, and receive income by supplying the produced goods to the household sector.

The state of equilibrium in the two-sector economy is defined as a situation in which no change occurs in the levels of income (Y), expenditure (E), and output (O).

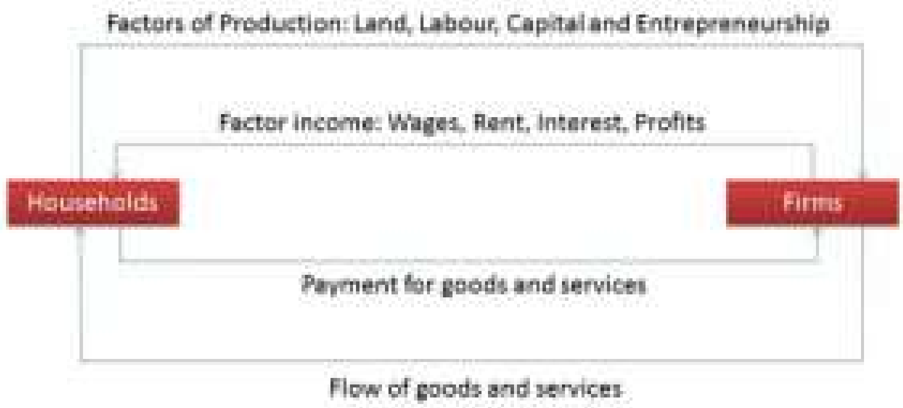
i.e. Y=E=O

Assumptions :

The two sector economy has the following assumptions:

1. There are only two sectors in the economy; household sector and business sector.
2. No government interventions over the economic activities.
3. Business sectors do not carry out any import or export activities, creating a closed economy.

On the basis of the assumptions, the two sector economy is explained with the help of the following diagram:



The outer circle represents real flow and the inner circle represents the monetary flow. Real flow indicates the factor services flow from household sector to the business sector, and goods and services flow from business sector to the household. Monetary flow illustrates that, in terms of money, factor rent, wage, interest and profit flows from the business sector to household sector. On the other hand, the consumption expenditure made by households flow to the business sector as revenue for the firms.

This means that the expenses made by the households become the source of income for the business sector or the firms and vice versa. The firms provide payment to the factory owners for procuring factors of production. Further, the factor owners spend this income on goods and services produced by the business sector, which becomes revenue for the business sector.

Since the households spend their income, the total monetary receipts of business sector will be equal to the income and consumption expenditure of the household sector. This means, monetary receipts of the producers = income of the households = consumption expenditure of the households. In this way, an equilibrium state exists in the economy where total demand equals total supply.

Thus the circular movement of income and expenditure in the economy continues, leading to equalization in the gross national product and gross national income.

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