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Circular Flow of Income – Chapter 1

Introduction

The **circular flow of income** is a fundamental economic model illustrating how money, goods, and services circulate between different sectors of the economy. It shows the interdependence between production, income generation, and expenditure.

Key Concepts

- **Flows:** Continuous movement of money, goods, and services between entities.
- **Real Flow:** Movement of goods and services.
- **Money Flow:** Flow of income and expenditure.
- **Equilibrium:** Occurs when total leakages = total injections.

Two-Sector Model (Households & Firms)

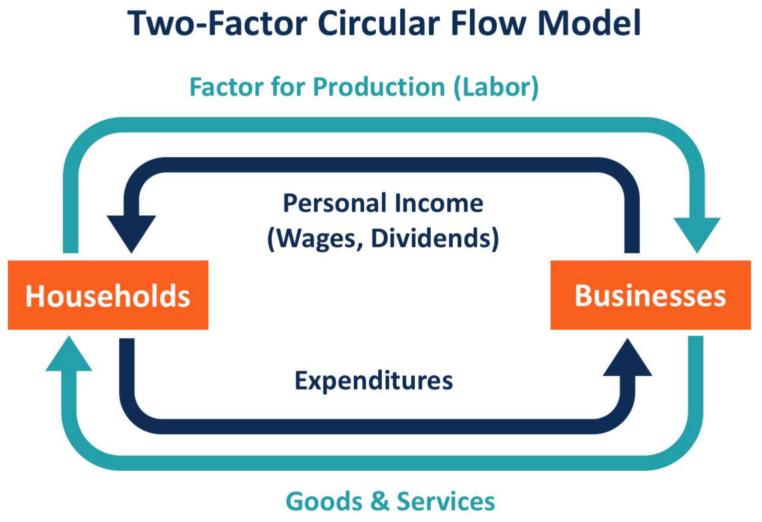

Figure 1: Two-Sector Circular Flow of Income

From	To	Flow
Households	Firms	Factors of production (land, labour, capital, entrepreneurship)

From	To	Flow
Firms	Households	Goods and services + factor payments (wages, rent, interest, profit)

Three-Sector Model (Adding Government)

- Government collects **taxes** (leakage).
- Government provides **public goods/services** and welfare (injection).
- Government influences redistribution of income.

Four-Sector Model (Adding Foreign Sector)

In an open economy, exports bring money into the economy (injection) while imports send money out (leakage).

- **Exports (X):** Domestic goods/services sold abroad → inflow of money.
- **Imports (M):** Goods/services bought from abroad → outflow of money.
- **Net Exports:** X – M.

Leakages and Injections

Leakages	Injections
Savings (S)	Investment (I)
Taxes (T)	Government Spending (G)
Imports (M)	Exports (X)

Real-World Applications

> For instance, when the Indian government increases infrastructure spending, it acts as an injection, boosting demand for materials (cement, steel) and creating employment. This, in turn, generates income for households, which then increases consumption — feeding back into the circular flow.

Limitations of the Model

- Assumes no savings in the basic model (unrealistic in practice).
- Does not capture informal/black economy transactions.
- Ignores price level changes and inflation effects.

Conclusion

The circular flow of income is a simplified yet powerful tool for understanding macroeconomic activity. It demonstrates how disruptions in one sector ripple through the economy and why policy measures target balancing leakages and injections.