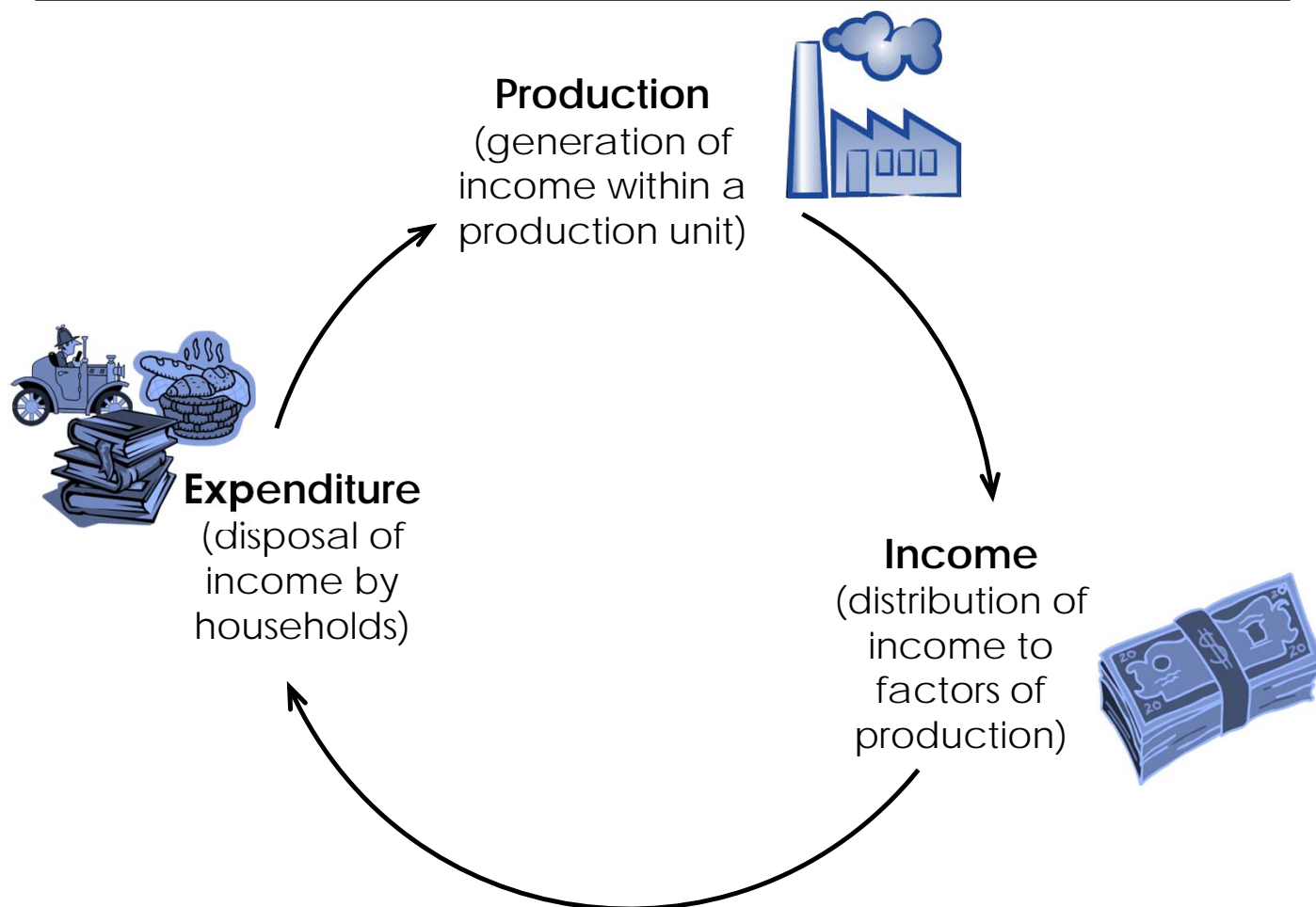




ECONOMICS OF ENTREPRENEURSHIP (EP60008)

Circular Flow Model

Meaning of Circular Flow of Income



History

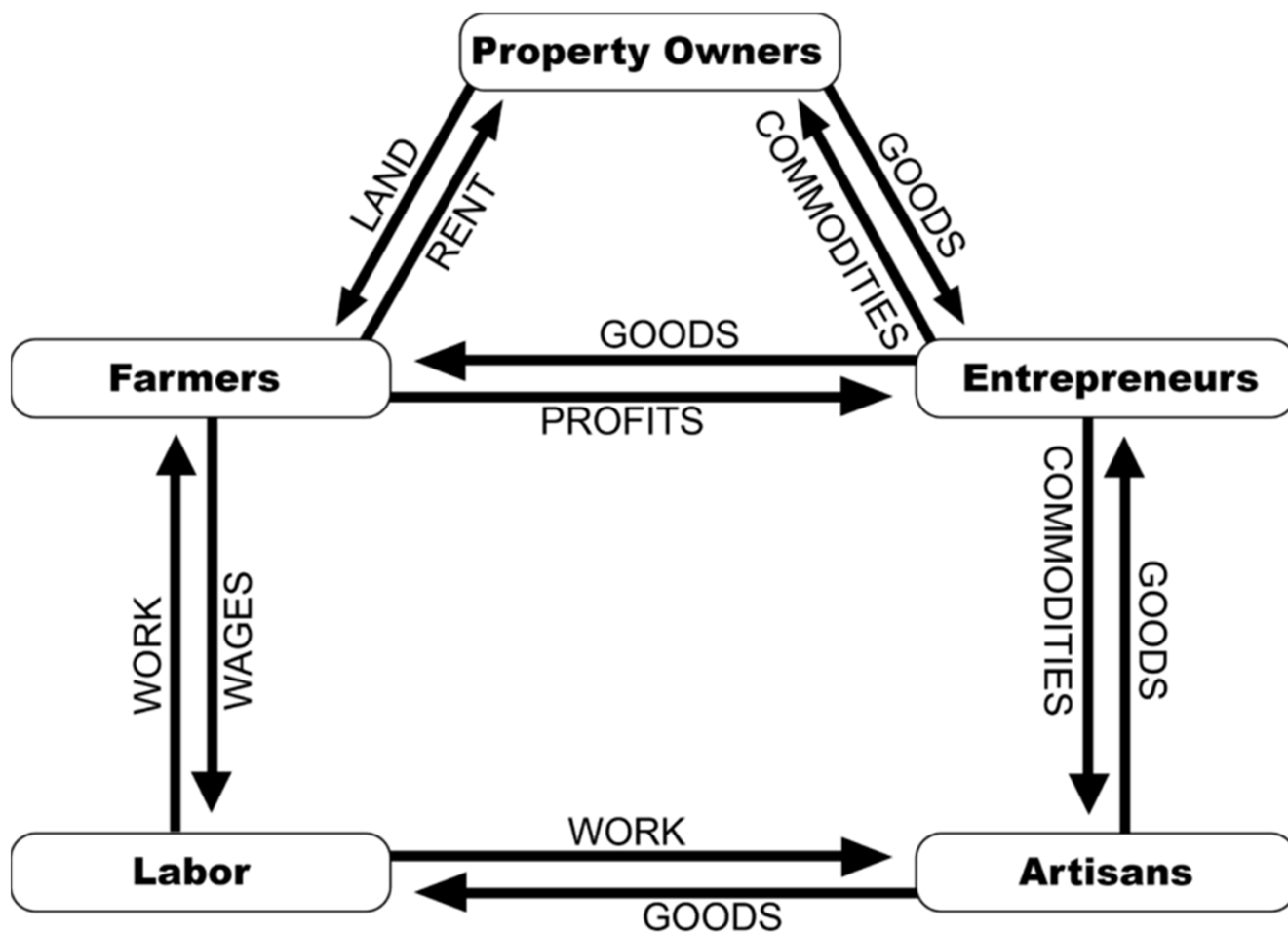


- First mentioned in the work of economist Richard Cantillon after influencing from William Petty
- François Quesnay further validated his idea after reporting the actual transactions of different agents
- Marx also developed the idea a little bit but the major improvement in the idea was done by Keynes
- Keynes published his idea in 1933 publication of General theory of Employment, interest and money
- Current visualisation is done based on Frank Knight's 1933 publication of The economic organization

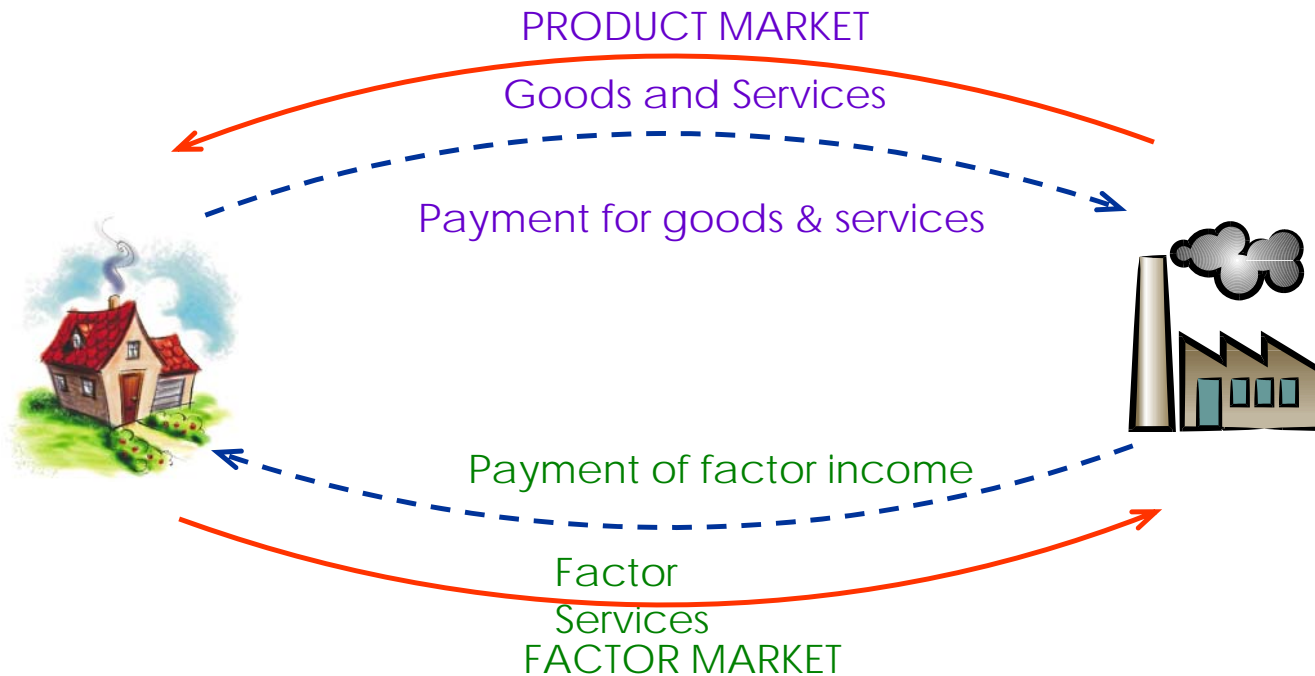
"The general character of an enterprise system, reduced to its very simplest terms, can be illustrated by a diagram showing the exchange of productive power for consumption goods between individuals and business units, mediated by the circulation of money, and suggesting the familiar figure of the wheel of wealth"

-Frank Knight

Cantillon Circular Flow



The Circular Flow of Income – 2 Sector Model



Money Flows

Represent the flow of money in the economy

Real Flows

Represent the flow of goods and services including factor services in the economy

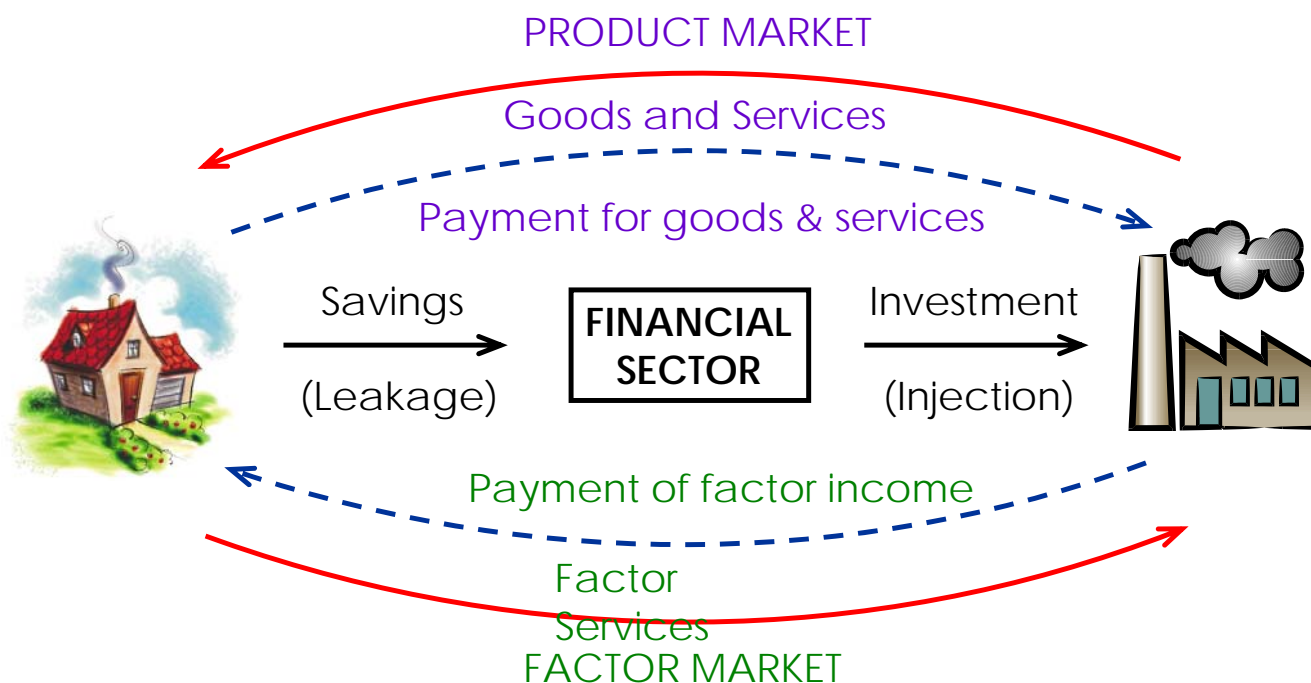
Limitations and Assumptions



- Households spend all of their income (Y) on goods and services or consumption. No savings
- All output (O) produced by firms is purchased by households through their expenditure (E)
- There is no financial sector
- There is no government sector.
- There is no foreign sector

When you come to practicality, you can't neglect the amount of saving people do in their real life. It is a major withdrawal from any economy. You can't even neglect the power of Foreign sector or government sector"

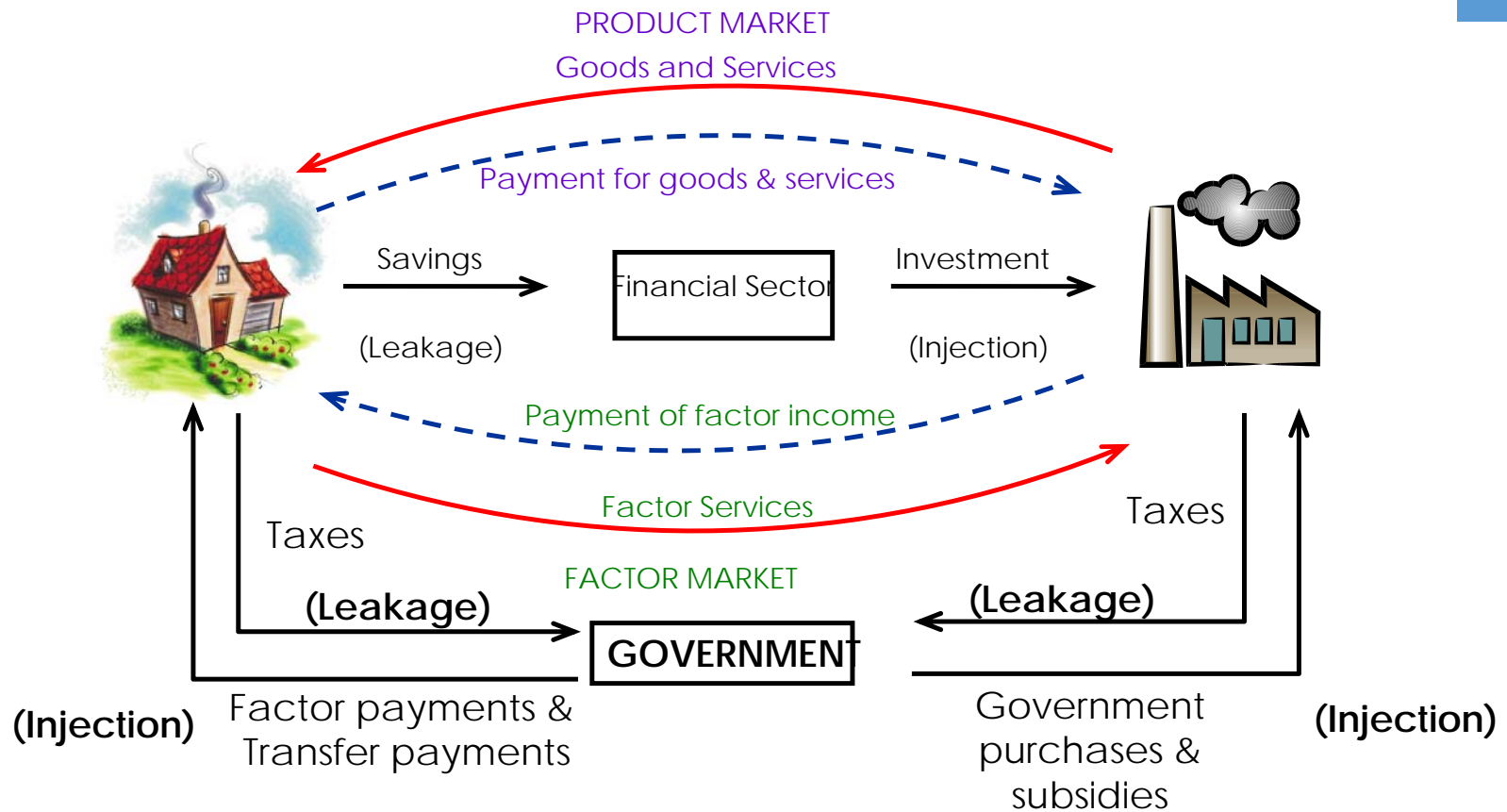
Two Sector Model with Financial Sector



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

Investment : Expenditure on capital goods

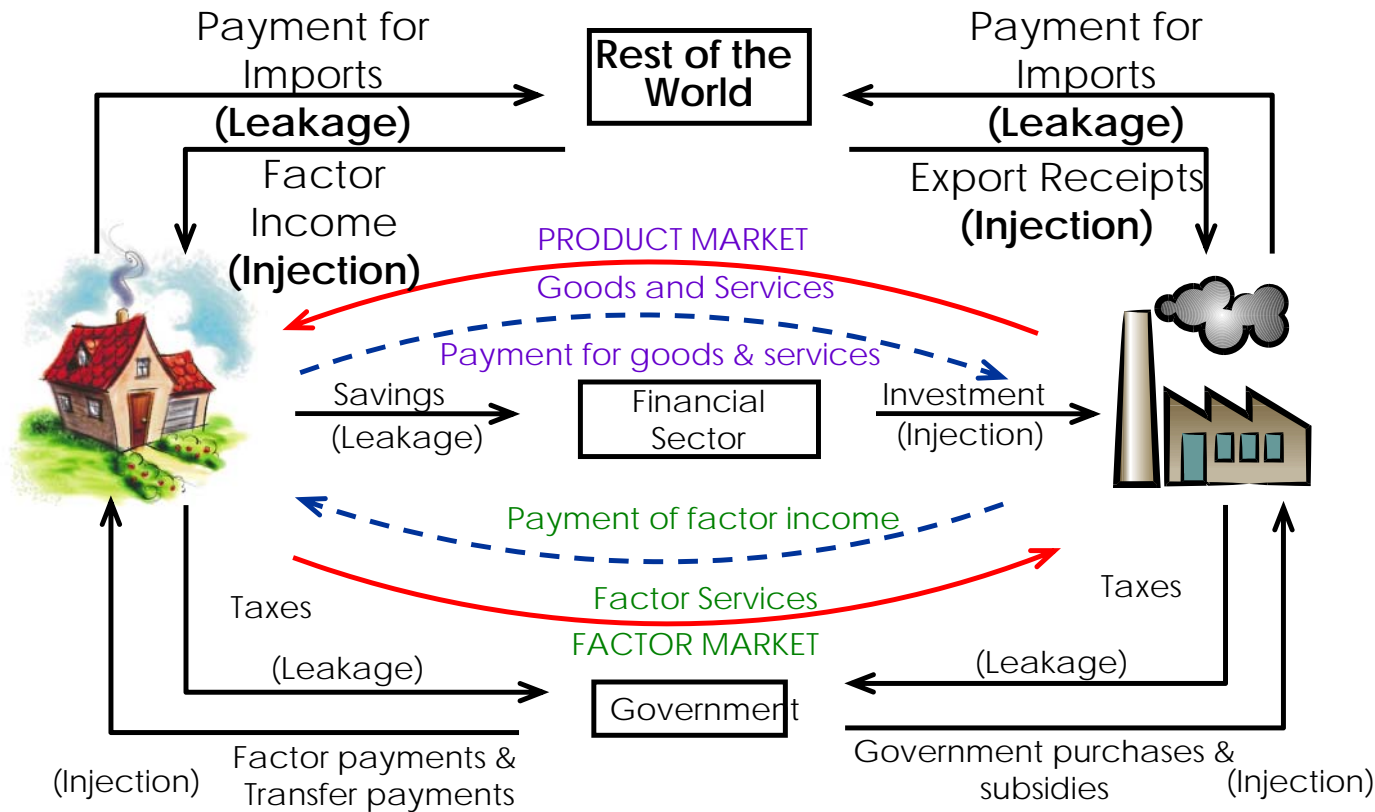
Three Sector Model



Equilibrium is achieved when leakages = injections

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

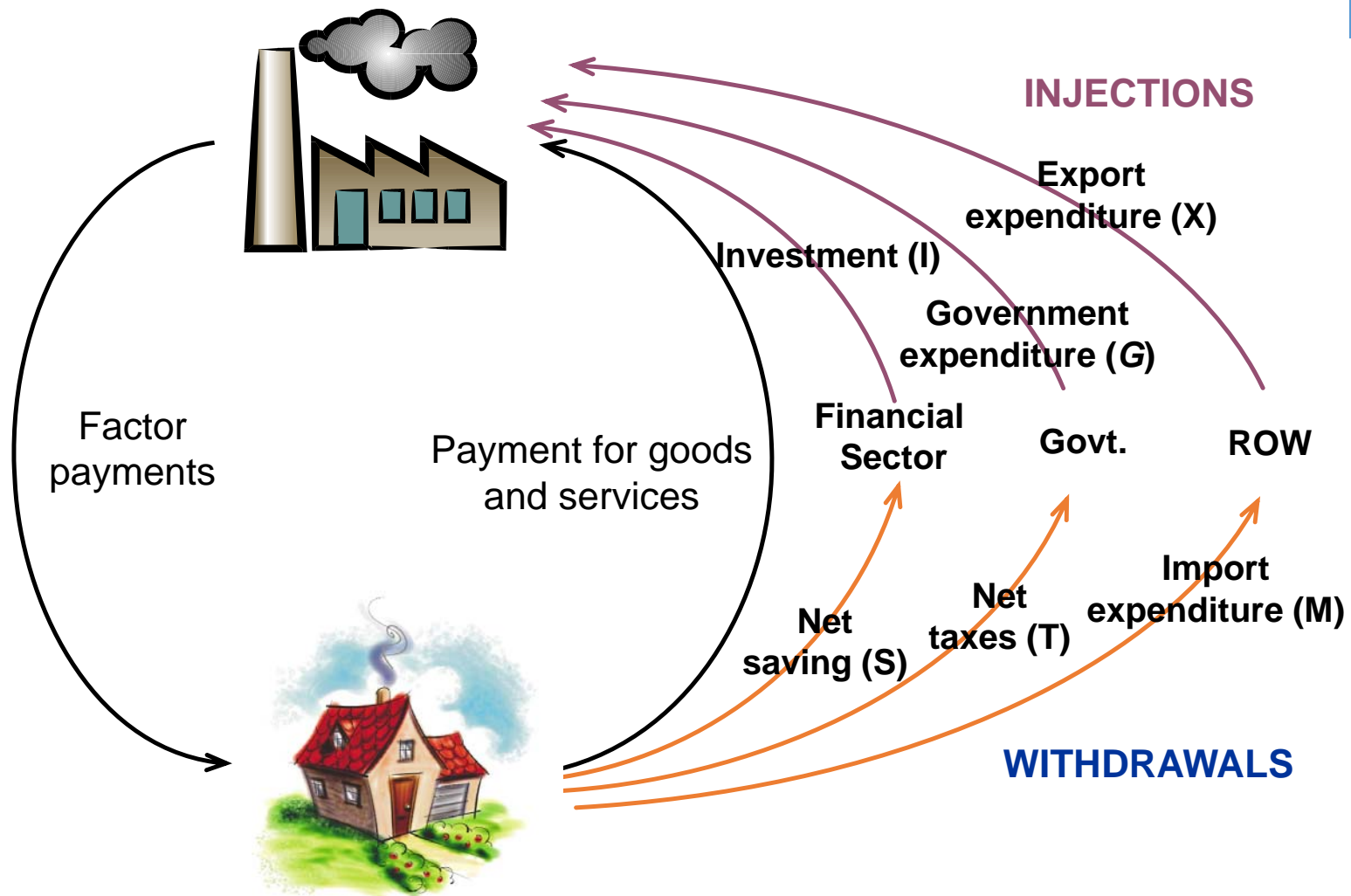
Four Sector Model



In Equilibrium : Leakages = Injections

$\text{Savings} + \text{Taxes} + \text{Imports} = \text{Investment} + \text{Govt. Expenditure \& Transfers} + \text{Exports}$

Circular Flow of Income - Summary



Significance of Circular flow of income



- Measurement of National Income: The national income is an estimation of aggregation of any economic activity of a circular flow.
- Knowledge of Interdependence: A circular stream of income means the interdependence of each of the actions with each other.
- Unending Nature of Economic Activities: Production, incomes and expenditures are endless, therefore economic activity in the economy can never stop.
- Injections and Leakages