



Circular Flow Model

Notes

TWO BRANCHES OF ECONOMICS

- 1) **Microeconomics:**
Study of individual markets, decisions and interactions between individual economic agents
- 2) **Macroeconomics:**
Study of economy as a whole; how decisions of multiple economic agents determine aggregate outcomes like output

CIRCULAR FLOW OF INCOME MODEL

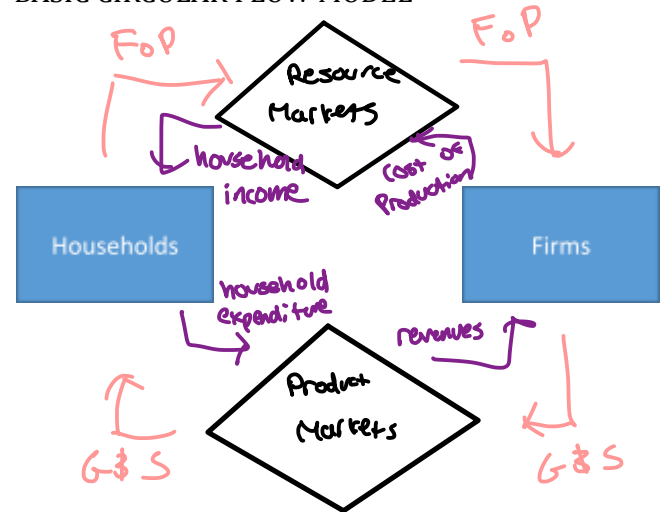
The **circular flow of income model** is a very simple model of a nation's economy showing how national income moves through the economy and output is created.

ASSUMPTIONS OF THE BASIC MODEL

There are four assumptions for the model:

- 1) There is a **closed economy**, which is...
no link to other countries
no international trade
no govt intervention
- 2) The only decision makers are households and firms.
- 3) Households are the owners of the four factors of Production
- 4) Firms sell goods & services

BASIC CIRCULAR FLOW MODEL



WHY THE CIRCULAR FLOW MODEL IS IMPORTANT

The circular flow model shows us that the value of output produced is equal to the total income generated in producing that output, which is also equal to the expenditures made to produce that output.

In other words:

$$\text{income flow} = \text{expenditure flow} = \text{output flow}$$

LEAKAGES AND INJECTIONS

Leakages are a withdrawal from the circular flow and include:

1) Savings (s)

2) Taxes (t)

3) Imports (M)

Injectors are... an entry of income into the circular flow

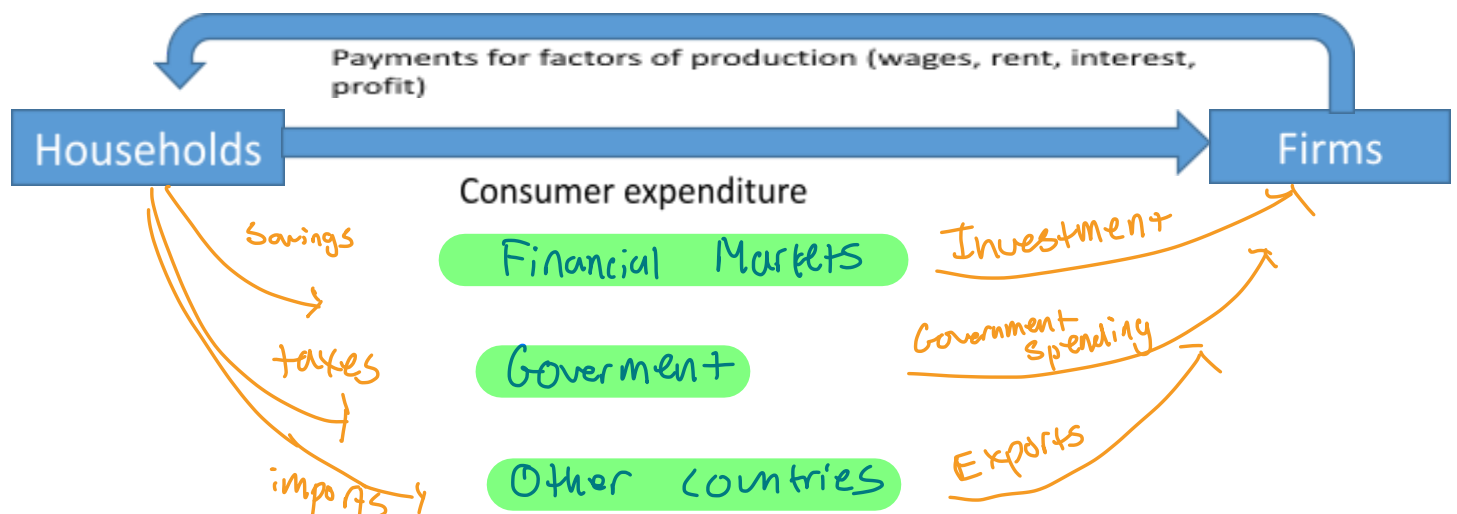
and include:

1) Investment (I)

2) Government spending (G)

3) Exports (X)

OPEN ECONOMY CIRCULAR FLOW MODEL (



- 1) A basic circular flow begins with payments for the factors of production and consumer expenditure
- 2) Leakages indicate a loss from the circular flow and can "flow" out of production of an economy

- 3) The money from the leakages is "collected" by various markets or third parties
- 4) Leakages often become injections into the circular flow through these groups.

Circular Flow of Income Activity Set

Part I: Micro or Macro?

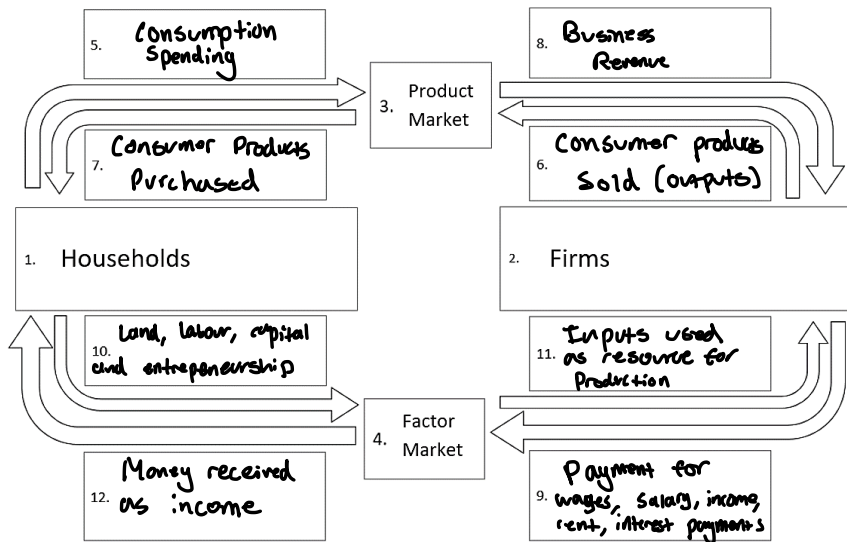
1. Review the definition of microeconomics and macroeconomics. What branch of economics does the circular flow of income model fall into? Why?

Macroeconomics- concerns whole economy

Part II: Identifying the Components of the Circular Flow

2. Use the word bank to fill in the blanks in the circular flow diagram below.

| | | | |
|--|--|------------------------------------|---------------------------|
| • Land, labour, capital, entrepreneurial ability | • Payment for wages, salary, income, rent, interest payments | • Money received as income | • Consumption spending |
| • Inputs used as a resource for production | • Consumer products purchased | • Consumer products sold (outputs) | • Business income/revenue |



Part II: What makes up the flow?

Fill in the blanks below by identifying the following based on your responses to the above circular flow model in the previous question.

| | | | | | |
|---------|----------|------------------|-----------------|-------------|--------|
| • Buyer | • Seller | • Product Market | • Factor market | • Household | • Firm |
|---------|----------|------------------|-----------------|-------------|--------|

3. Milin brings her six-year-old son to Tim Hortons for breakfast this Saturday morning.

Milin is a member of a household and acted as a buyer in the product market for this transaction.

Tim Hortons represents a firm and acted as the seller in the product market for this transaction.

4. Fisher and his brother Hunter own a large family farm where they raise chickens. They sell the chickens to Pardue Chicken Company.

Fisher and Hunter are members of a household, and collectively act as the Seller of chickens in the factor market.

Part 2 cont.: Fill in the blanks below by identifying the following based on the circular flow in question 1.

| | | | |
|-------------|----------------|------------------|-----------------|
| • Buyer | • Seller | • Product Market | • Factor market |
| • Household | • Firm | • Land | • Labor |
| • Capital | • Entrepreneur | • Good | • Service |

5. Matthew owns and operates a local gym. At his gym, he provides fitness training, cycling classes and personal training.

Matthew's business provides a Service. The gym itself and equipment represent capital that Matthew utilizes for his business. Matthew would be considered a (n) entrepreneur that acts as a Seller / firm in the product market.

6. Wesley works retail at the local Fun-Is-Ups, Inc., which sells party products for people who want to throw a birthday party or party.

Fun-Is-Ups is a firm that acts as a Seller of party products, and the business provides a good in the product markets market. Wesley is a member of a household that obtained his job in the factor market and acts as a labour resource for the business.

Part 3: Money Flowing Through the System

Money serves three functions in modern economies. When buyers and sellers engage in voluntary exchanges, they utilize money as a medium of exchange. For each of the following, identify how the money is flowing to the party receiving it. Money will flow in one of the following ways found in the table below. Terms may be used more than once.

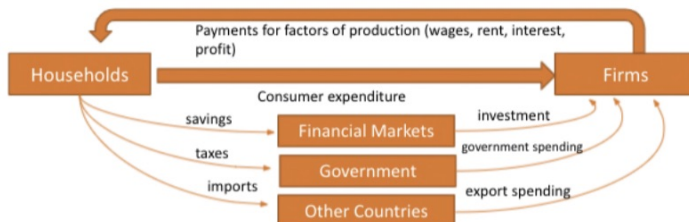
| | | |
|--------------------|------------|----------------------------|
| • Business revenue | • Profit | • Wages, salary, or income |
| • Rent | • Interest | |

| Scenario | Flow of Money |
|--|-------------------------|
| a. Ian purchased flowers for his fiancé on Valentine's Day from Love at a Low Price. | <u>business revenue</u> |
| b. Landon worked at the Home Depot last year and earned | |

| | |
|--|------------------------|
| \$55,000 for his hard work and effort. | Wages salary or income |
| c. Morgan owned and operated a cupcake business that sold custom cupcakes out of a storefront. To produce a cupcake cost her \$1.25, and she sold her cupcakes for \$3.00 per unit. The \$1.75 leftover represents this type of payment. | Profit |
| d. Mitchell recently purchased the new iPhone from the Apple Store at the local mall. The Apple Company received \$1,200 from the purchase of the phone. | Business Revenue |
| e. Bethany worked as a babysitter last week and earned \$20 per hour. | Wages salary or income |
| f. Paul buys a new car for his uber delivery business. | Interest |

Part 4: Opening the Circular Flow

7. Draw the "Open Economy Circular Flow of Income" (5 sector model) in the space below.



8. Differentiate between injections and leakages. Give specific examples of each.

Leakages are withdrawals from circular flow and include: , Injections are \times tries and

- | | |
|-----------|-----------------------|
| - Savings | include: ~ Investment |
| - Taxes | - Government Spending |
| - Imports | - Exports |

9. Explain the relationship between injections, leakages and the circular flow of income.

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Economic growth is a consequence of injections $>$ leakages.

Negative economic growth is a consequence of injections $<$ leakages

When there are more injections than leakages, the circular flow moves faster and there are more goods and services produced, resulting in economic growth.

When there are more leakages than injections, the circular flow slows down, and there are less goods and services produced, resulting in slow or negative economic growth from time to time.