THE CIRCULAR FLOW OF ECONOMIC ACTIVITY

Circular Flow Concepts

Product Market – where goods and services are exchanged

Households – suppliers of the factors of production & demanders of goods and services

Government – providers of public goods and services & demanders of both private goods and services and the factors of production

Businesses / Firms – suppliers of goods and services & demanders of the factors of production

Factor Market – where the factors of production are exchanged

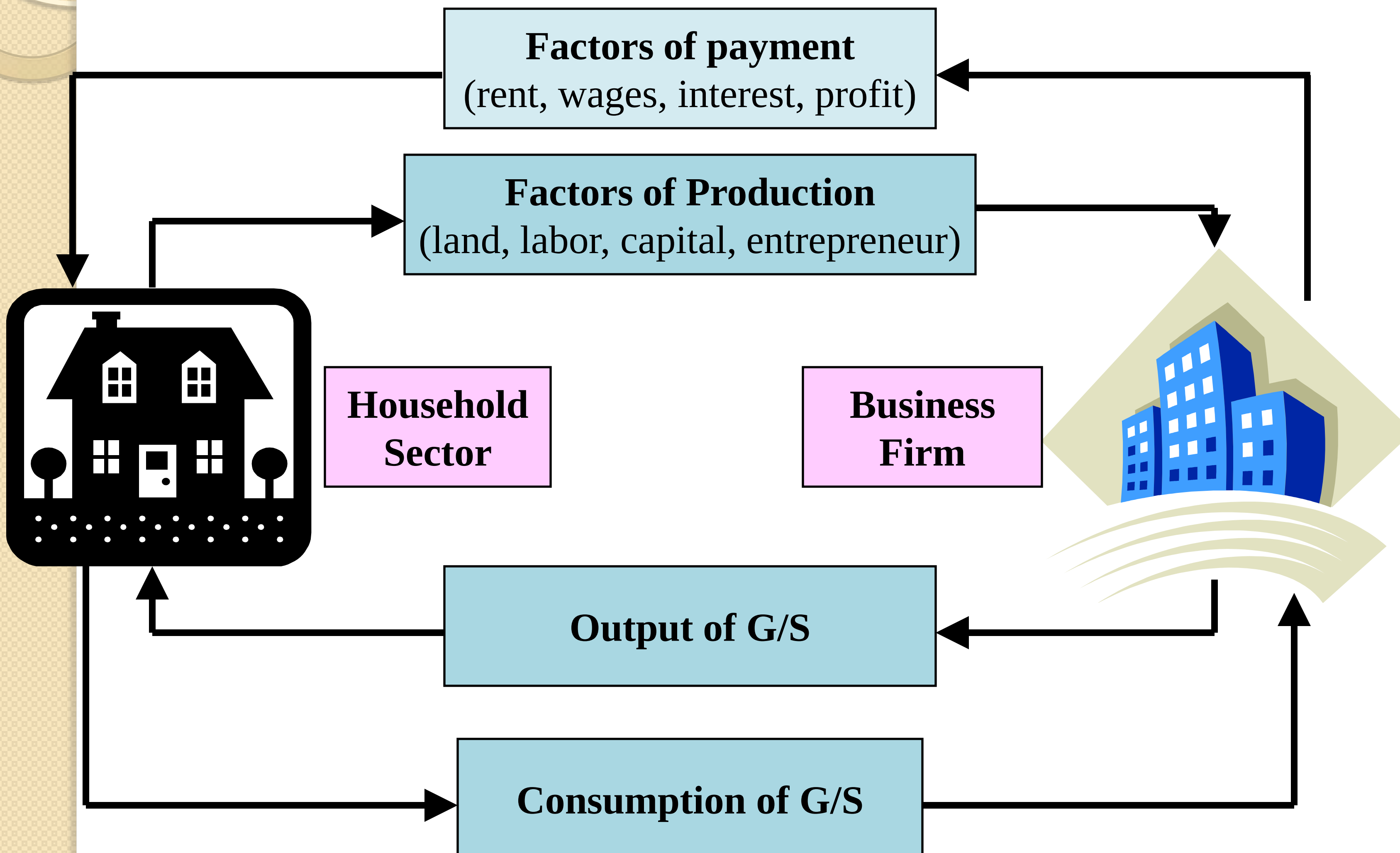
- The **circular-flow diagram** is a model that represents the transactions in an economy by flows around a circle.

- Two sectors models
  - a.) savings economy
  - b.) non-savings economy

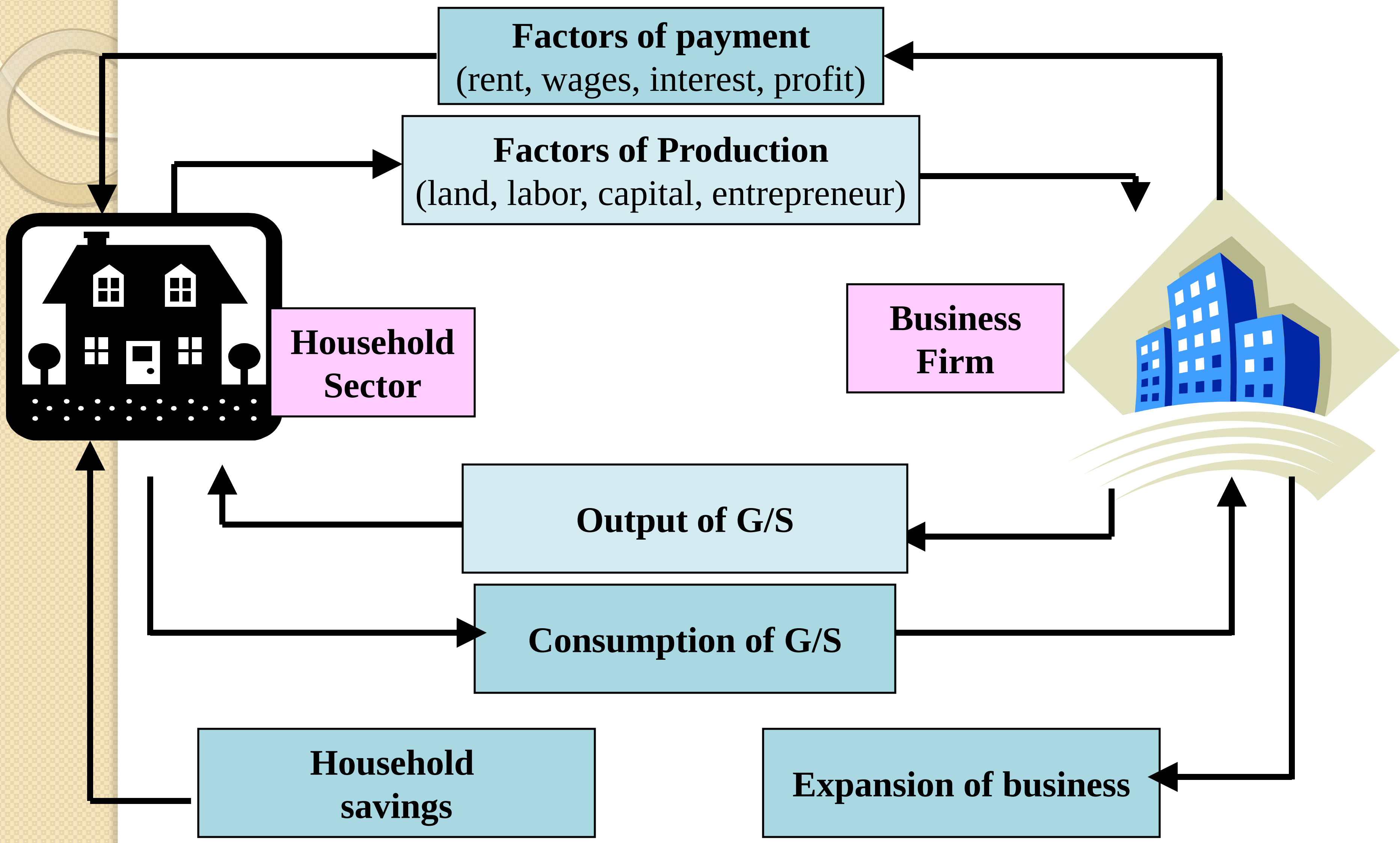
- Three sectors models
- Four sectors models

Two sectors model

(no savings economy)

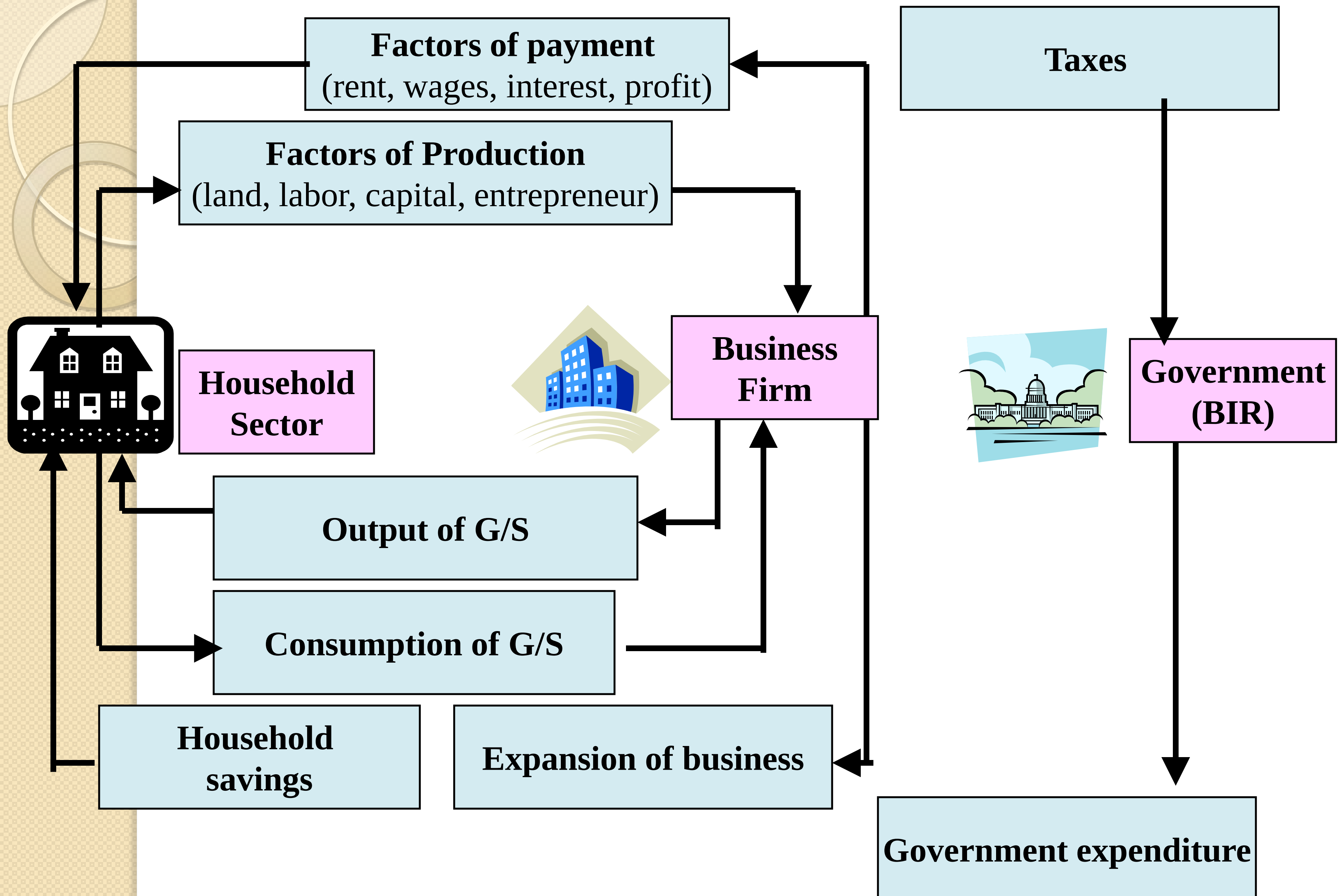


(savings economy)



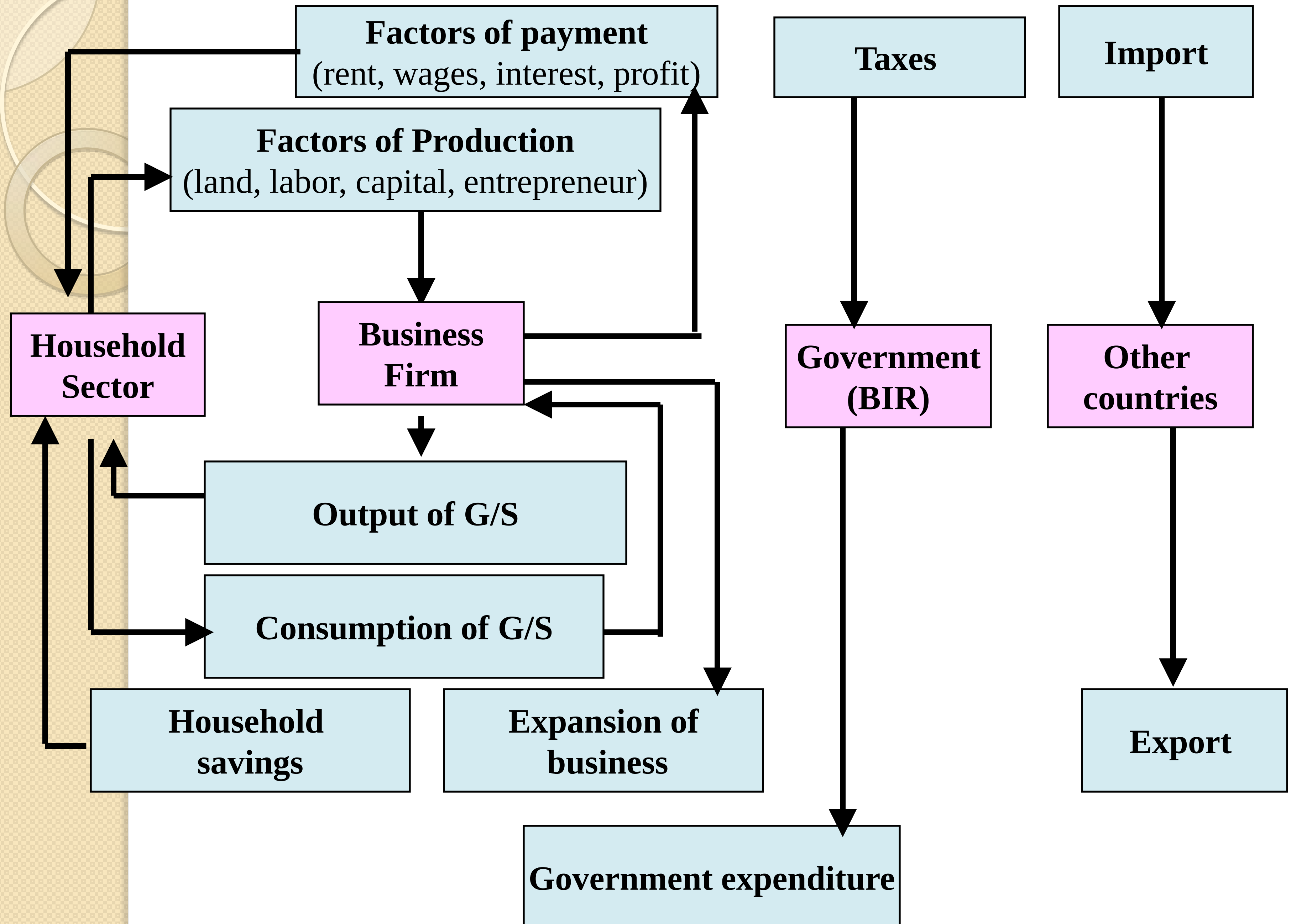
➢Three sectors models

It includes household sector, producing sector and government sector. It will study a circular flow income in these sectors excluding rest of the world i.e. closed economy income. Here flows from household sector and producing sector to government sector are in the form of taxes. The income received from the government sector flows to producing and household sector in the form of payments for government purchases of goods and services as well as payment of subsides and transfer payments. Every payment has a receipt in response of it by which aggregate expenditure of an economy becomes identical to aggregate income and makes this circular flow unending.


Factors of payment
(rent, wages, interest, profit)
Taxes
Factors of Production
(land, labor, capital, entrepreneur)
Household
Sector
Business
Firm
Government
(BIR)
Output of G/S
Consumption of G/S
Household
savings
Expansion of business
Government expenditure

Four sectors models

- A modern monetary economy comprises a network of four sector economy these are- 1.Household sector 2. Firms or Producing sector 3. Government sector 4. Rest of the world sector. Each of the above sectors receives some payments from the other in lieu of goods and services which makes a regular flow of goods and physical services. Money facilitates such an exchange smoothly. A residual of each market comes in capital market as saving which in turn is invested in firms and government sector. Technically speaking, so long as lending is equal to the borrowing i.e. leakage is equal to injections, the circular flow will continue indefinitely. However this job is done by financial institutions in the economy.



Factors of payment
(rent, wages, interest, profit)
Taxes
Import
Factors of Production
(land, labor, capital, entrepreneur)
Household Sector
Business Firm
Government (BIR)
Other countries
Output of G/S
Consumption of G/S
Household savings
Expansion of business
Export
Government expenditure

3 Classification of countries

- LDCS- Low Developed Countries
- IMCS- Intermediate Developed Countries
- HDCS- Highly Developed Countries

LCDS- Low developed countries

Country whose state of economic development is characterized by a low national income, a high rate of population growth and unemployment, and dependence on commodity exports. The majority of nations in Asia, Africa, and Latin America, fit this model, which is why they are known collectively as developing countries or third world countries. LDCs generally pay more for the goods they import from more economically advanced nations than they receive in payments.

IMCS- Intermediate Developed Countries

HDCS- Highly Developed Countries

- It is a sovereign state that has a highly developed economy and advanced technological infrastructure relative to other less developed nations.
- e.g Afghanistan, Pakistan, Eastern African Countries (almost all of them)