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(Macro Economic)

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Module I

Circular Flow of National Income Models

Economic transactions generate two kinds of flows :

1. Real flow i.e. the flow of goods and services, and
2. Money flow.

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Real and Money flows go in opposite direction in a circular fashion.

The goods flow consists of

- (a) factor flow, i.e., flow of factor services, and
- (b) product flow, i.e., flow of goods and services.

In a monetized economy, the flow of factor services generates money flows in the form of factor payments which take the form of income flows. The factor payments and expenditure on consumer goods and services take the form of expenditure flows.

Economies are of closed/ partially open and/ or open economies.

A closed economy is one that has very less or no trading activity with rest of the world. We can define it as an entirely self-sufficient economy, which means very restricted or no imports come into the country and no exports leave the country. The goal of a closed economy is to provide domestic consumers with everything they need from within the country's borders.

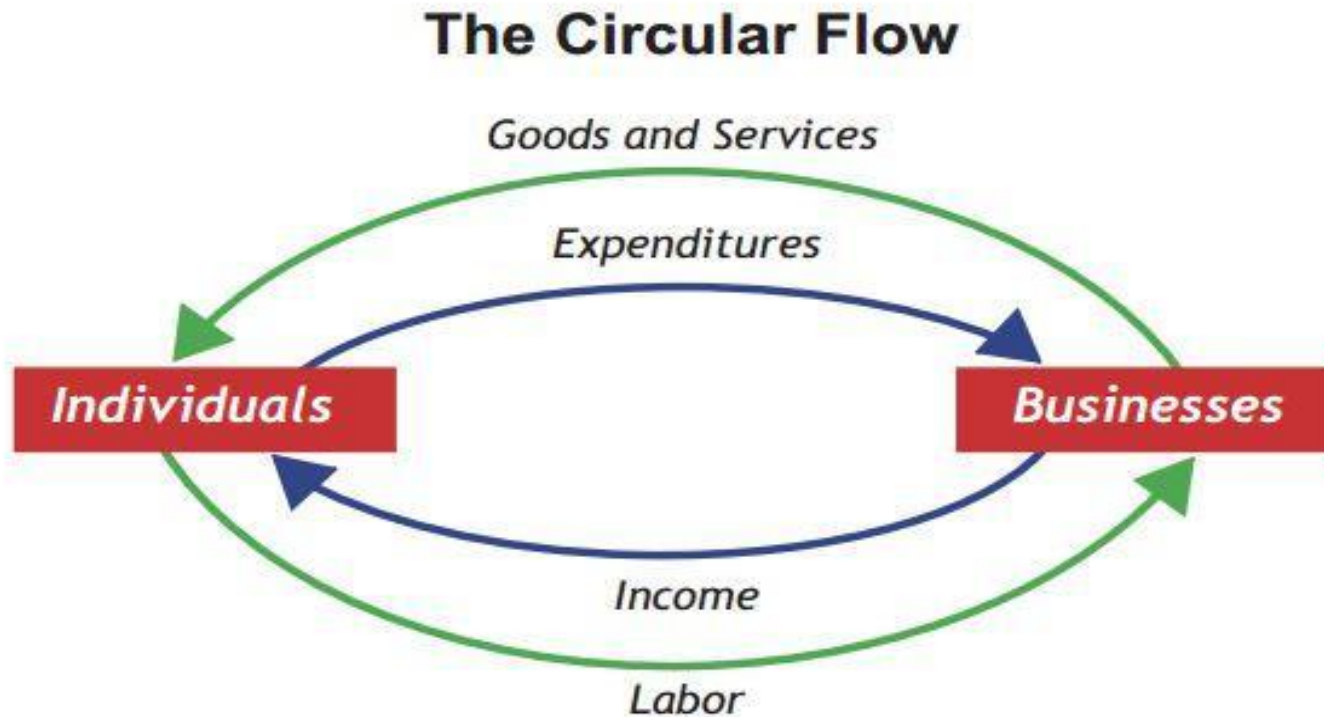
Circular Flow of National Income- Closed and Open economy Contd...

A nation in which freedom to buy and sell goods and services is given with no or very few restrictions is termed as **open economy**. The GDP of such nation is comprised of Net Export. In the present world almost all nations are of open economies to certain extents.

To understand the flows of income and expenditure, the economy is divided into four sectors i.e. household sector, business sector, the firms, government sector and foreign sector. These are combined to make the following three models for the purpose of showing the circular flows.

1. Two sector model including the household and business sectors
2. Three sector model including the household, business/ firms and government sectors
3. Four sector model including the household, business/ firms, government and the foreign sectors.

Circular Flows of National Income in Closed Economy (Two Sector Economy)



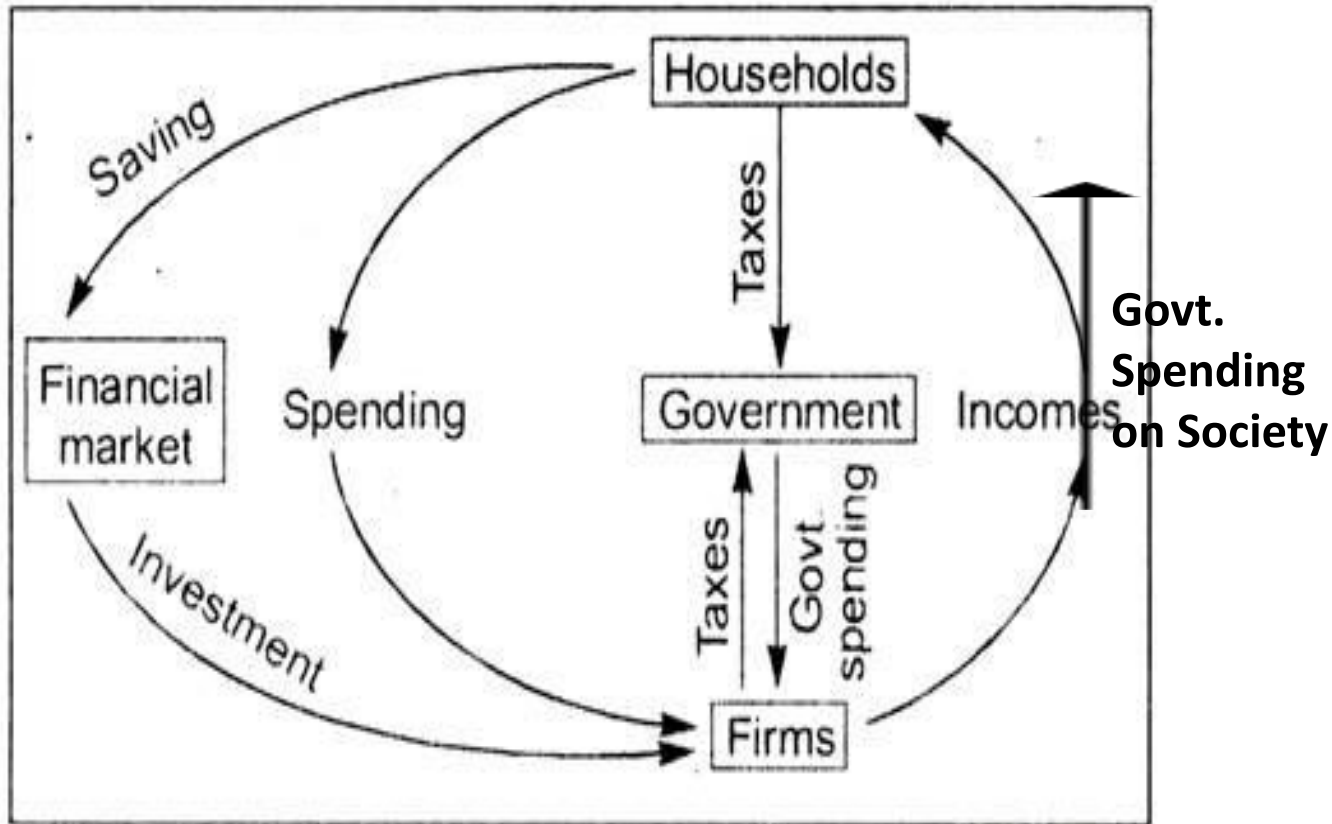
This model represents the flow of payments and receipts for goods, services, and factor services between the households and the firm/ Business sectors of the economy.

- The outer and down loop of the diagram shows the flow of factor services (Labour) from households/Individuals to firms and the corresponding flow of factor payments (Income) from firms to households.
- The Upper loop shows the flow of goods and services from firms to individuals and the corresponding flow of consumption expenditure from households to firms.
- The entire amount of money, which is paid by firms as factor payments, is paid back by the factor owners to the firms.

Source: Google Image

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Circular Flows of National Income in Closed Economy (Three Sector Economy)



This Figure shows closed economy NI circular flows with Saving and Investment parameters.

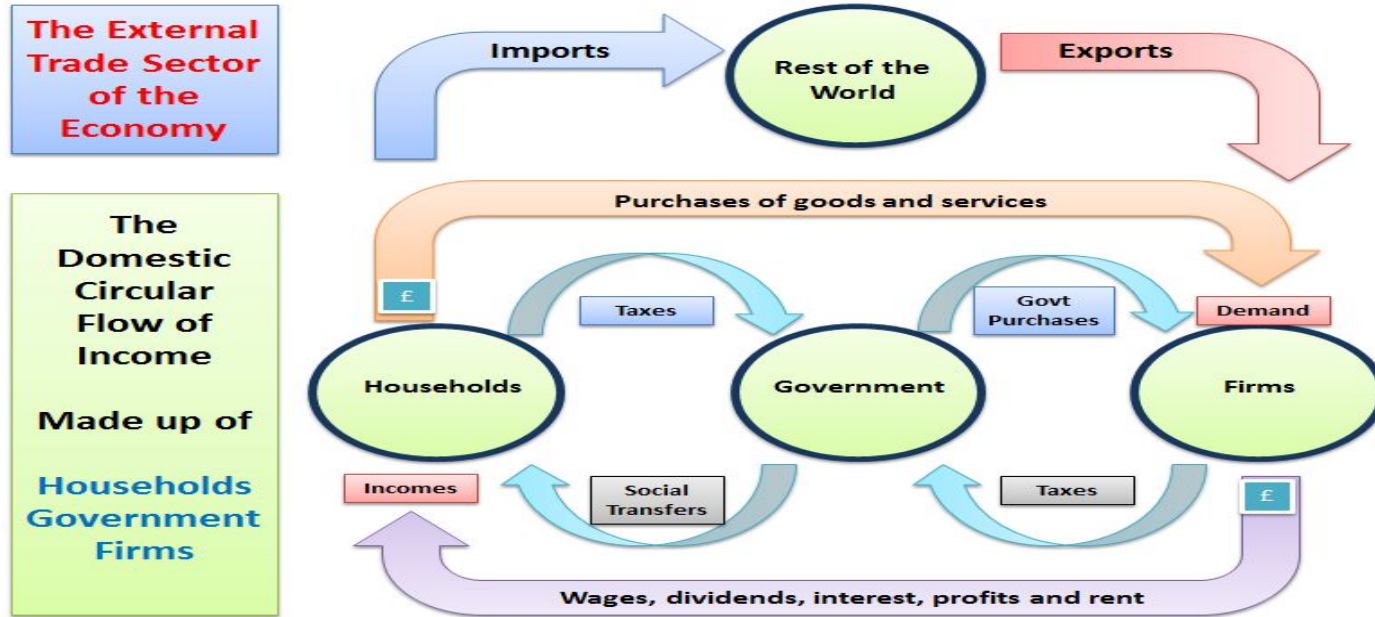
Usually economists consider saving as a leakage into national income flow, but when this saving made by households find its way to firms as an investment through financial markets, then it leads to expansion in the productive activities of the firms. Hence, national income expands.

To the Government both Households as well as firms pay the taxes, which Government spends on them to improve their functioning further.

Source: Google Image

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Circular Flows of National Income in Open Economy (Four Sector Economy)



The inclusion of the foreign sector reveals to us the interaction of the domestic economy with foreign countries. Foreigners interact with the domestic firms and households through exports and imports of goods and services as well as through borrowing and lending operations through financial market. Goods and services produced within the domestic territory which are sold to the foreigners are called exports. On the other hand, purchases of foreign-made goods and services by domestic households are called imports. This figure indicates an additional money flows that occur in the open economy when exports and imports also exist in the economy. In our analysis, we assume it is only the business firms of the domestic economy that interact with foreign countries and therefore export and import goods and services.

If exports are equal to the imports, then there exists a balance of trade. Generally, exports and imports are not equal to each other. If value of exports exceeds the value of imports, trade surplus occurs. On the other hand if value of imports exceeds value of exports of a country, trade deficit occurs.

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Importance of the Circular Flows of National Income

Study of circular flow of national income help to analyse –

- Problems of Disequilibrium
- Effects of Leakages and Inflows
- Interdependence of consumers and producers
- Importance of Fiscal and Monetary policies to work together
- The effects of different trade policies

Long Question to be Studied

- Q. 1. Discuss two sector circular flow of national income.**
- Q. 2. Explain three sector circular flow of national income.**
- Q. 3. What is four sector open economy circular flow of national income?**
- Q. 4. Write a note on importance of studying circular flow of national income.**