

Edexcel (B) Economics A-level  
**Theme 2: The Wider Economic  
Environment**

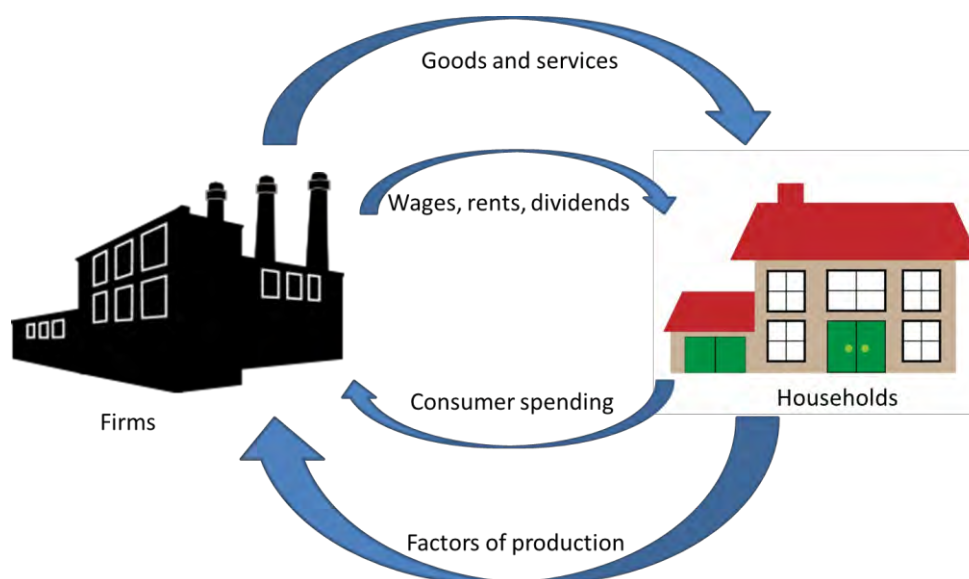
**2.5 The Economic Cycle**










**2.5.2 Circular flow of income, expenditure and output**

Notes

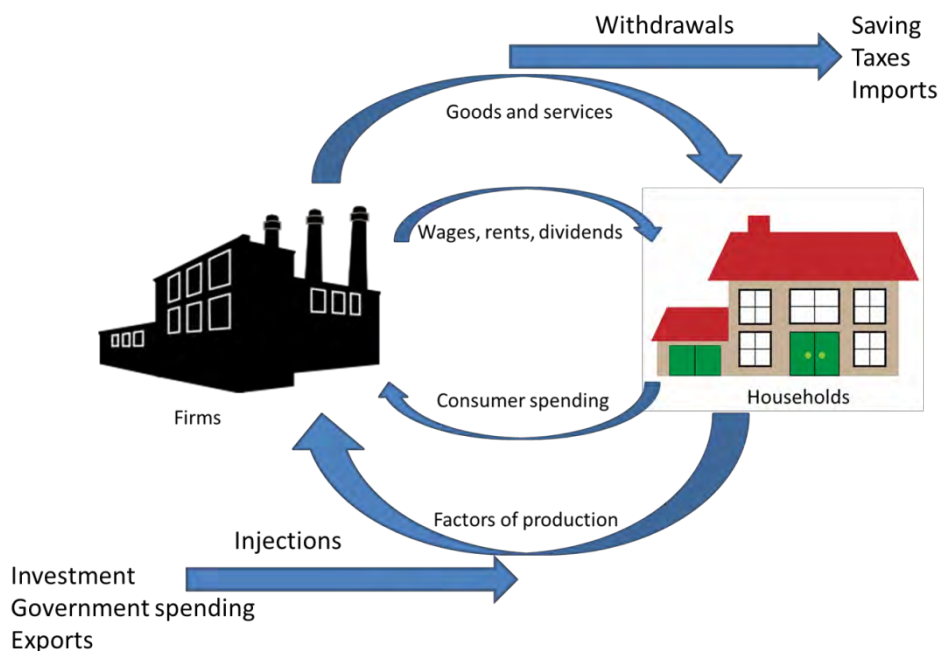


## The circular flow of income



-  Firms and households interact and exchange resources in an economy.
  -  Households supply firms with the factors of production, such as labour and capital, and in return, they receive wages and dividends.
  -  Firms supply goods and services to households. Consumers pay firms for these.
  -  This spending and income circulates around the economy in the circular flow of income, which is represented in the diagram above.
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-  Saving income removes it from the circular flow. This is a **withdrawal** of income.
  -  Taxes are also a withdrawal of income, whilst government spending on public and merit goods, and welfare payments, are **injections** into the economy.
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-  International trade is also included in the circular flow of income. **Exports** are an injection into the economy, since goods and services are sold to foreign countries and revenue is earned from the sale. **Imports** are a withdrawal from the economy, since money leaves the country when goods and services are bought from abroad.
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-  The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections.
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-  The full circular flow of income can be derived from this:





It is important to remember that **income = output = expenditure** in the circular flow.

### The effect of changes in injections and withdrawals on national income

An **injection** into the circular flow of income is money which enters the economy. This is in the form of government spending, investment and exports.

A **withdrawal** from the circular flow of income is money which leaves the economy. This can be from taxes, saving and imports.

The amount of savings in an economy is equal to the amount of investment. In the UK, there is a traditionally low savings rate, especially during periods of high economic growth, and this means that the rate of investment is also low. In Japan there is a high savings rate and with this comes a high level of investment.

If there are **net injections** into the economy, there will be an expansion of national output.

If there are **net withdrawals** from the economy, there will be a contraction of production, so output decreases.



## Factors influencing AD: components $C + I + G + (X-M)$

Aggregate demand is the total demand in the economy. It measures spending on goods and services by consumers, firms, the government and overseas consumers and firms.

It is made up of the following components, which make up the equation:  $C + I + G + (X-M)$

### Consumer spending:

This is how much consumers spend on goods and services. This is the largest component of AD and is therefore most significant to economic growth. It makes up just over 60% of GDP.

**Disposable income** is the amount of income consumers have left over after taxes and social security charges have been removed. It is what consumers can choose to spend.

Consumer income might come from wages, savings, pensions, benefits and investments, such as dividend payments.

### Influences on consumer spending:

#### Interest rates

- If the Monetary Policy Committee lowers interest rates, it is cheaper to borrow and reduces the incentive to save, so spending and investment increase. However, there are time lags between the change in interest rates and the rise in AD, so this is not suitable if a rise in AD is needed immediately. Lower interest rates also lower the cost of debt, such as mortgages. This increases the effective disposable income of households.

#### Consumer confidence

- Consumers and firms have higher confidence levels, so they invest and spend more, because they feel as though they will get a higher return on them. This is affected by anticipated income and inflation.
- If consumers fear unemployment or higher taxes, consumers may feel less confident about the economy, so they are likely to spend less and save more. This delays large purchases, such as houses or cars.



## **Capital investment:**

This accounts for around 15-20% of GDP in the UK per annum, and about  $\frac{3}{4}$  of this comes from private sector firms. The other  $\frac{1}{4}$  is spent by the government on, for example, new schools. This is the smallest component of AD.

## **Influences on investment:**

### **The rate of economic growth**

- If growth is high, firms will be making more revenue due to higher rates of consumer spending. This means they have more profits available to invest.

### **Business expectations and confidence**

- If firms expect a high rate of return, they will invest more. Firms need to be certain about the future, otherwise they will postpone their investments.
- Also, expectations about society and politics could affect investment. For example, if a change in government might happen, or if commodity prices are due to rise, businesses may postpone their investment decisions.
- Keynes coined the term **animal spirits** when describing instincts and emotions of human behaviour, which drives the level of confidence in an economy.

### **Demand for exports**

- This is related to the rate of market demand. The higher demand is, the more likely it is that firms will invest. This is because they expect higher sales, so they might direct capital goods into the markets where consumer demand is increasing.

### **Interest rates**

- Investment increases as interest rates falls. This means that the cost of borrowing is less and the return to lending is higher.
- The higher interest rates are, the greater the opportunity cost of not saving the money.
- Moreover, high interest rates might make firms expect a fall in consumer spending, which is likely to discourage investment.

### **Access to credit**

- If banks and lenders are unwilling to lend, such as shortly after the financial crisis when banks became more risk averse, firms will find it harder to gain



access to credit, so it is either more expensive or not possible to gain the funds for investment.

- Firms could use retained profits, however.
- The availability of funds is dependent on the level of saving in the economy. The more consumers are saving, the more available funds are for lending, and therefore for investing.

### The influence of government and regulations

- The rate of corporation tax could affect investment. Lower taxes means firms keep more profits, which could encourage investment.

### Government spending:

This is how much the government spends on state goods and services, such as schools and the NHS. It accounts for 18-20% of GDP. Transfer payments are not included in this figure, because no output is derived from them, and it is simply a transfer of money from one group of people to another. Government spending is the third largest component of AD.

### Influences on government expenditure:

#### Economic growth

- During recessions, governments might increase spending to try and stimulate the economy. This could involve spending on welfare payments to help people who have lost their jobs, or cutting taxes.
- This will increase the government deficit, and they may have to finance this.
- During periods of economic growth, governments may receive more tax revenue since consumers will be spending more and earning more. They may decide to spend less, since the economy does not need stimulating, and fewer people will be claiming benefits.

#### Fiscal policy

- Governments use fiscal policy to influence the economy. It involves changing government spending and taxation.
- Governments might spend on public goods and merit goods, as well as welfare payments.
- Fiscal policy is a **demand-side policy**, so it works by influencing the level or composition of AD.
- **Discretionary** fiscal policy is a policy which is implemented through one-off policy changes.



- The government might use **expansionary fiscal policy** during periods of economic decline. This involves increasing spending on transfer payments or on boosting AD, or by reducing taxes.
- During periods of economic growth, governments might use **contractionary fiscal policy** by decreasing expenditure on purchases and transfer payments. Additionally, tax rates might increase. This reduces the size of the government budget deficit.

### **Exports minus imports:**

This is the value of the current account on the balance of payments. A positive value indicates a surplus, whilst a negative value indicates a deficit. The UK has a relatively large trade deficit, which reduces the value of AD. This is the second largest component of AD.

### **The main influences on the (net) trade balances:**

#### **Real income**

- During periods of economic growth, when consumers have higher incomes and they can afford to consume more, there is a larger deficit on the current account.
- When consumers increase their spending, they consume more domestic products as well as more imports.
- During periods of economic decline, real incomes fall and historically, this has led to improvements in the UK's current account.

#### **Exchange rates**

- A depreciation of the pound means imports are more expensive, and exports are cheaper, so the current account trade deficit narrows.
- Depreciations make the currency relatively more competitive against other currencies.
- However, it depends on which currency the pound depreciates against. If it is the dollar or euro, it is likely to have a more significant effect, than a currency which is not from one of the UK's major trading partners.
- Moreover, the demand for UK exports has to be price elastic to lead to an increase in exports. If demand is price inelastic, exports will not increase significantly, and the value of exports will decrease.

### **State of the world economy**



- A decline in economic growth in one of the UK's export markets means there will be a fall in exports. This is because consumer spending in those economies will fall, due to falling real incomes.
- For example, the UK's largest export market is the EU. If they face an economic downturn then demand for UK goods and services will fall, since consumers in the EU are less able to afford imports.

### Degree of protectionism

- Protectionism is the act of guarding a country's industries from foreign competition. It can take the form of tariffs, quotas, regulation or embargoes.
- If the UK employed several protectionist measures, then the trade deficit will reduce. This is because the UK will be importing less due to tariffs and quotas on imports to the UK.
- However, since protectionism leads to retaliation, exports might decrease too, which undoes the effect of reduced imports.

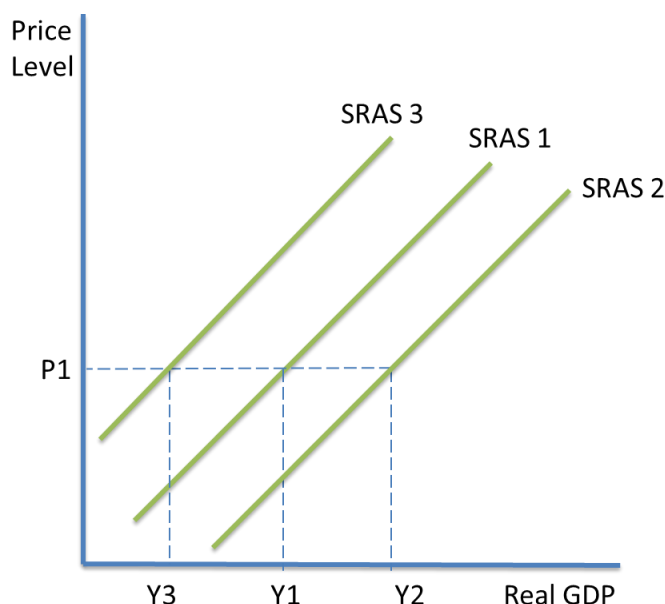
### Non-price factors

- The **competitiveness** of a country's goods and services, which is influenced by supply-side policies, impacts how many exports the country has.
- A country can become more competitive by being innovative, having higher quality goods and services, operating in a niche market, having lower labour costs, being more productive or by having better infrastructure. These increase exports.
- Moreover, trade deals and being part of trading blocs can influence how much a country exports. This either opens up a country to, or closes a country from, significant export opportunities.





## Factors influencing AS:



The AS curve shifts when there are changes in the conditions of supply. The price level and production costs are the main determinants of SRAS.

- The cost of employment might change, e.g. wages, taxes, and labour productivity. If costs increase, supply will shift inwards from SRAS1 to SRAS3.
- The cost of other inputs e.g. raw materials, commodity prices, and the exchange rate if products are imported. A stronger currency reduces the price of imports, so imported products will be cheaper. This would shift the AS curve outwards, from SRAS1 to SRAS2.
- Government regulation or intervention, such as environmental laws or green taxes and business regulation. Business regulation is sometimes called 'red tape'.
- There could be a net outward migration of workers, which causes a 'brain drain' on the domestic economy, as skilled workers move elsewhere.
- If there is a fall in business capital spending, supply will fall.

