

WJEC (Wales) Economics
AS-level
Macroeconomics

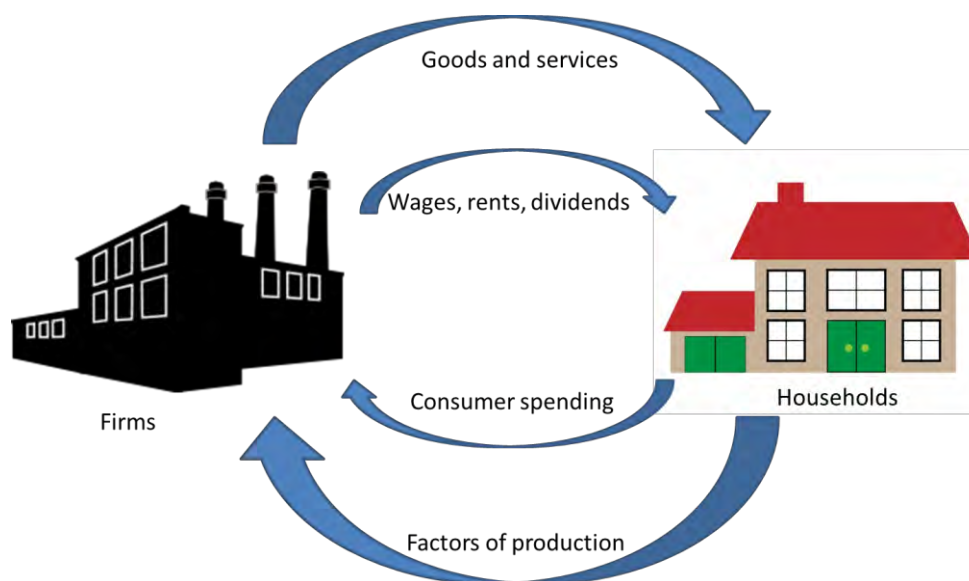
Topic 1: Macroeconomic Theory





1.1 The circular flow of income model



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.

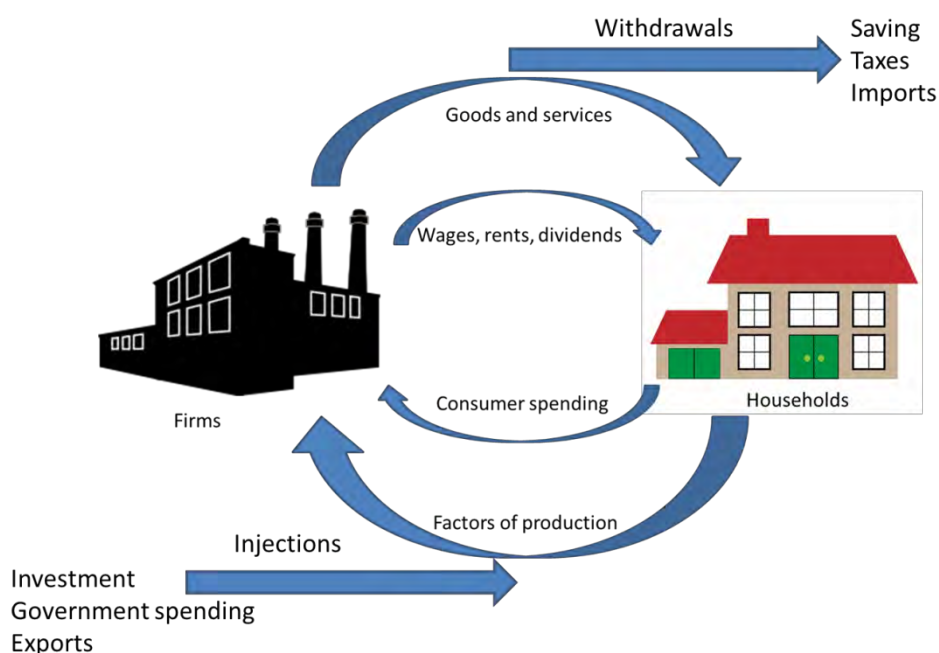
-  Saving income removes it from the circular flow. This is a **withdrawal** of income.
-  Taxes are also a withdrawal of income, whilst government spending on public and merit goods, and welfare payments, are **injections** into the economy.


-  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.

-  The economy reaches a state of equilibrium when the rate of withdrawals = the rate of injections.





 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.



The multiplier process

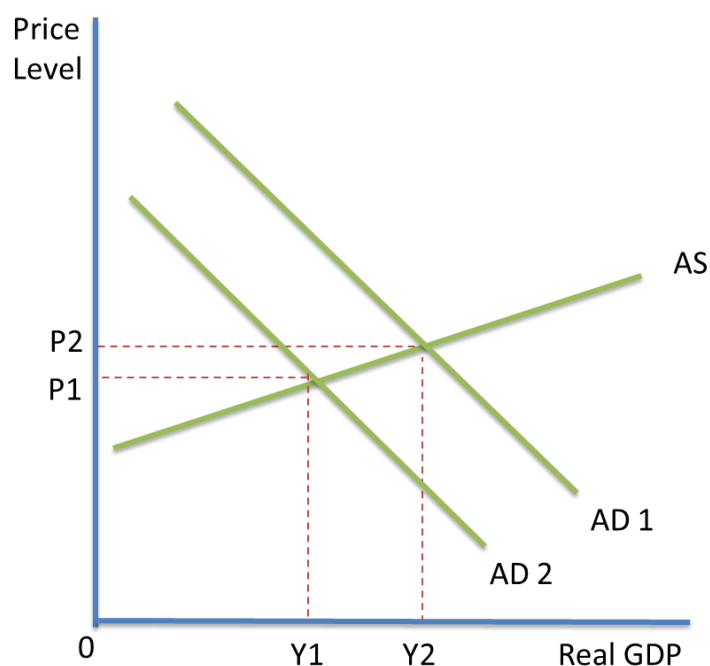
The multiplier effect occurs when there is new demand in an economy. This leads to an injection of more income into the circular flow of income, which leads to economic growth. This leads to more jobs being created, higher average incomes, more spending, and eventually, more income is created.

The multiplier effect refers to how an initial increase in AD leads to an even bigger increase in national income.

It occurs since 'one person's spending is another person's income'.

The significance of the multiplier to shifts in AD

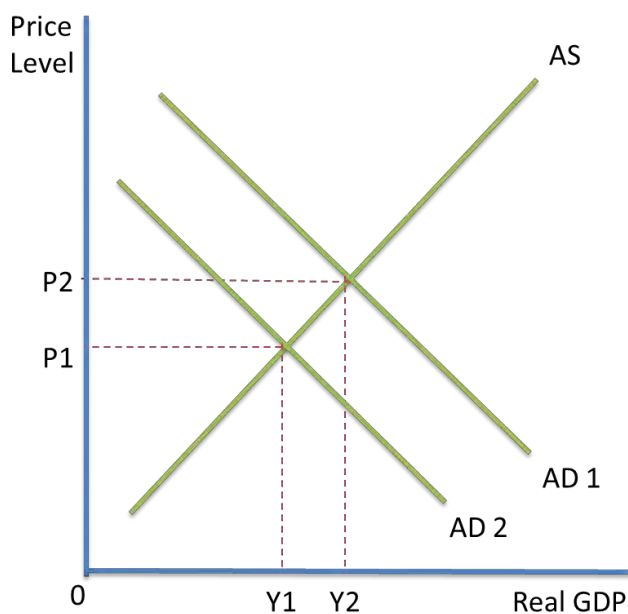
If an economy has a lot of spare capacity, extra output can be produced quickly and at little extra cost. This makes SRAS elastic and it means the size of the multiplier will be larger. A small increase in AD will lead to a large increase in national income.



If SRAS is inelastic, the multiplier effect is likely to be smaller than its potential. This is because if AD increases, prices will increase rather than a full increase in national income. This higher rate of inflation will lead to higher interest rates. This will



discourage spending and borrowing, and it will encourage saving, since the reward for saving is higher.



- It is also possible to have a 'reverse' multiplier. This means that a withdrawal of income from the circular flow of income could lead to an even larger decrease in income for the economy. This could decrease economic growth and potentially lead to a decline in the economy.

