# AQA Economics AS-level

## Macroeconomics

## Topic 2: How the Macroeconomy Works

### 2.1 The circular flow of income

Notes

## What national income measures

National income is the total value of the goods and services a country produces. It is the output in one year.

It can be measured by GDP, GNP and GNI.

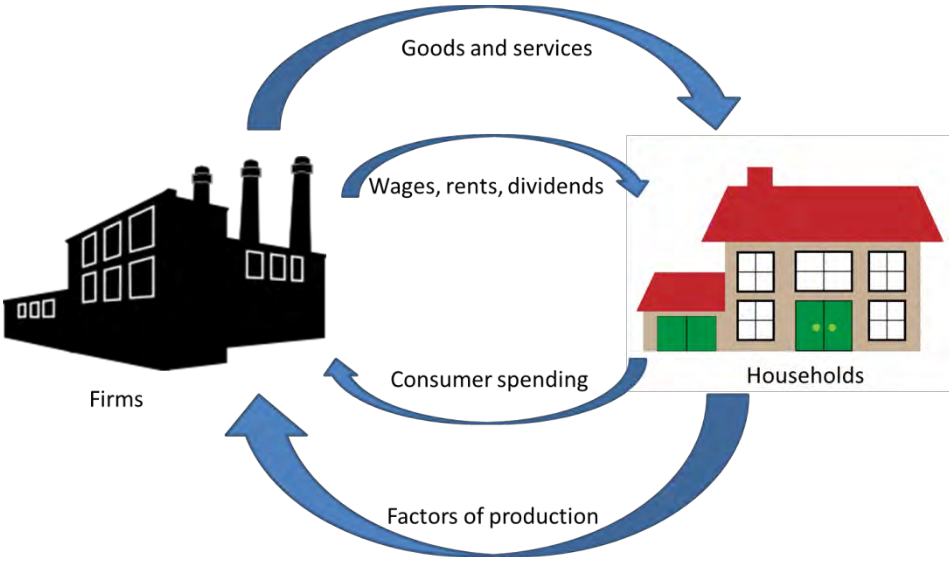
**Real GDP** is the value of GDP adjusted for inflation. For example, if the economy grew by 4% since last year, but inflation was 2%, real economic growth was 2%.

**Nominal GDP** is the value of GDP without being adjusted for inflation. In the above example, nominal economic growth is 4%. This is misleading, because it can make GDP appear higher than it really is.

**Gross National Product (GNP)** is the market value of all products produced in an annum by the labour and property supplied by the citizens of one country. It includes GDP plus income earned from overseas assets minus income earned by overseas residents. GDP is within a country's borders, whilst GNP includes products produced by citizens of a country, whether inside the border or not.

**Gross National Income (GNI)** is the sum of value added by all producers who reside in a nation, plus product taxes (subtract subsidies) not included in the value of output, plus receipts of primary income from abroad (this is the compensation of employees and property income).

## The circular flow of income



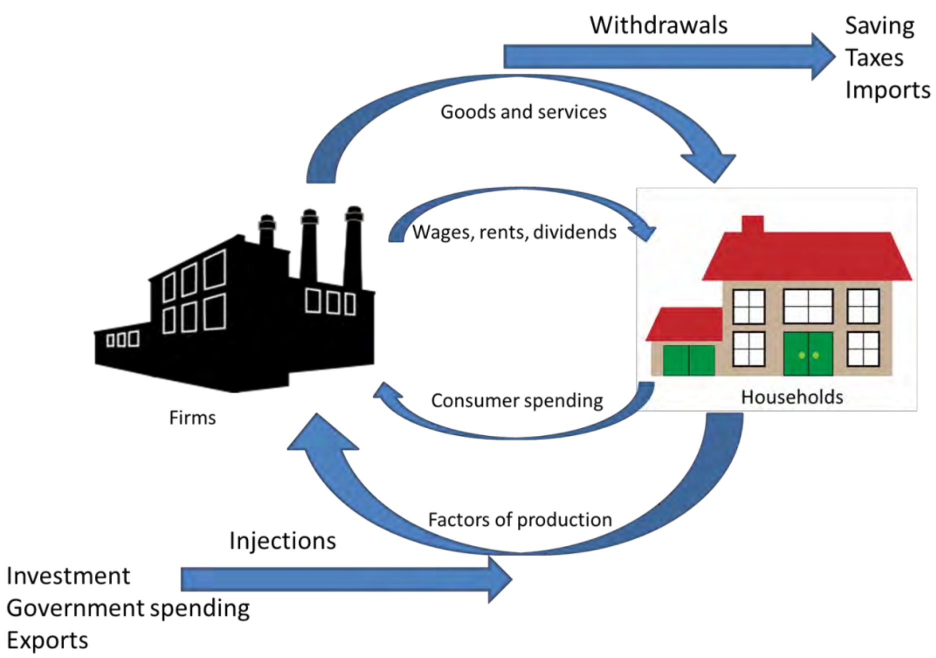
- Firms and households interact and exchange resources in an economy.
- Households supply firms with the factors of production, such as labour and capital, and in return, they receive wages and dividends.
- Firms supply goods and services to households. Consumers pay firms for these.
- This spending 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 in earned from the sale. **Imports** are a withdrawal from the economy, since money leaves the country when goods and services are bought from abroad.

- **Full employment income** is the total output of an economy when unemployment is minimised or is at the government target. This accounts for frictional unemployment.

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

- 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.