OCR Economics A-level

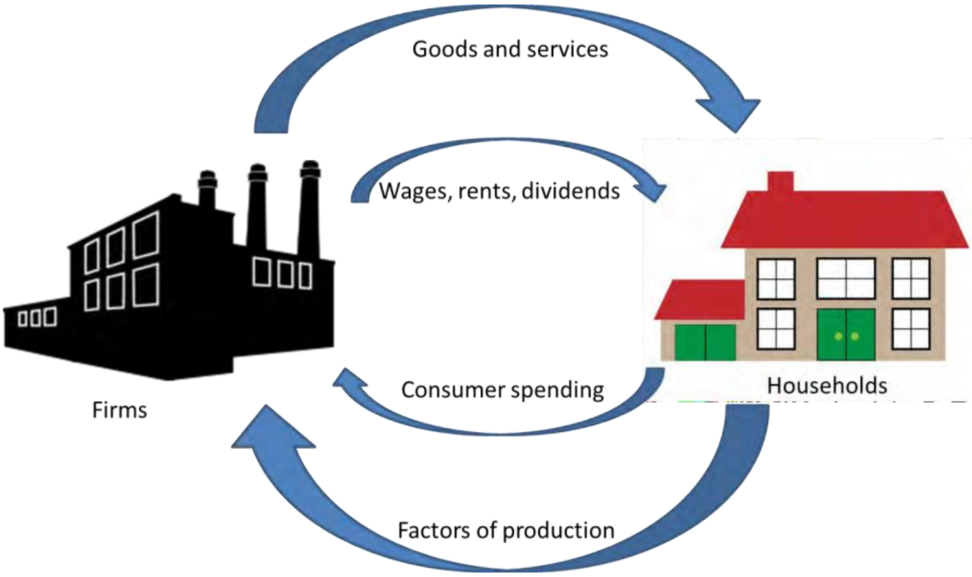
Macroeconomics

Topic 1: Aggregate Demand and Aggregate Supply

1.1 Circular Flow of Income

Notes

The circular flow of income



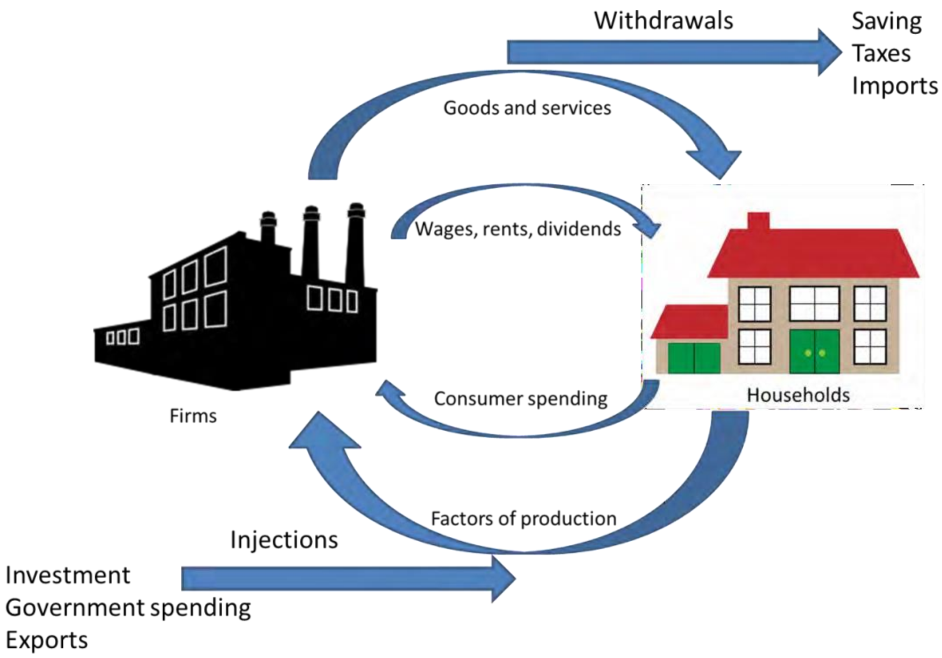
- Firms and households interact and exchange resources in an economy.
- Households supply firms with the factors of production, such as labour and capital, and in return, they receive wages and dividends.
- Firms supply goods and services to households. Consumers pay firms for these.
- This spending 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 **leakage** 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.

- 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. These measure the level of national income.

Injections and leakages within the circular flow of 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 **leakage** 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 leakages = 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 leakages** from the economy, there will be a contraction of production, so output decreases.

Methods of measuring national income, output and expenditure:

National income = National Output = National expenditure

These can be calculated through;

- Value added (the value gained through production i.e final goods value less intermediate goods value)
- Sum of incomes (sum of the incomes earnt through through production of goods and services). Incomes included are labour incomes, mixed incomes and capital incomes.
- Expenditure (total value of consumption of final goods and services)

Physical and monetary flows

- A **physical flow** is the flow of a good or service such as electricity.

- A **monetary flow** is the flow of money, which could be in the form of taxes or from consumption, for example.