

Circular Flow of Income



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The **circular flow of income** describes the movement of goods or services and income among the different sectors of the economy. It illustrates the interdependence of the sectors and the markets to facilitate both **real and monetary flow**.

□ The **real flow refers** to the flow of factor services and flow of goods and services.

The movement to the money/cash payment from one sector to the other sector corresponding to the real flow is referred to as the **monetary flow**.

□



There are **four sectors** and **three markets** in the circular flow of income model.

The four sectors are

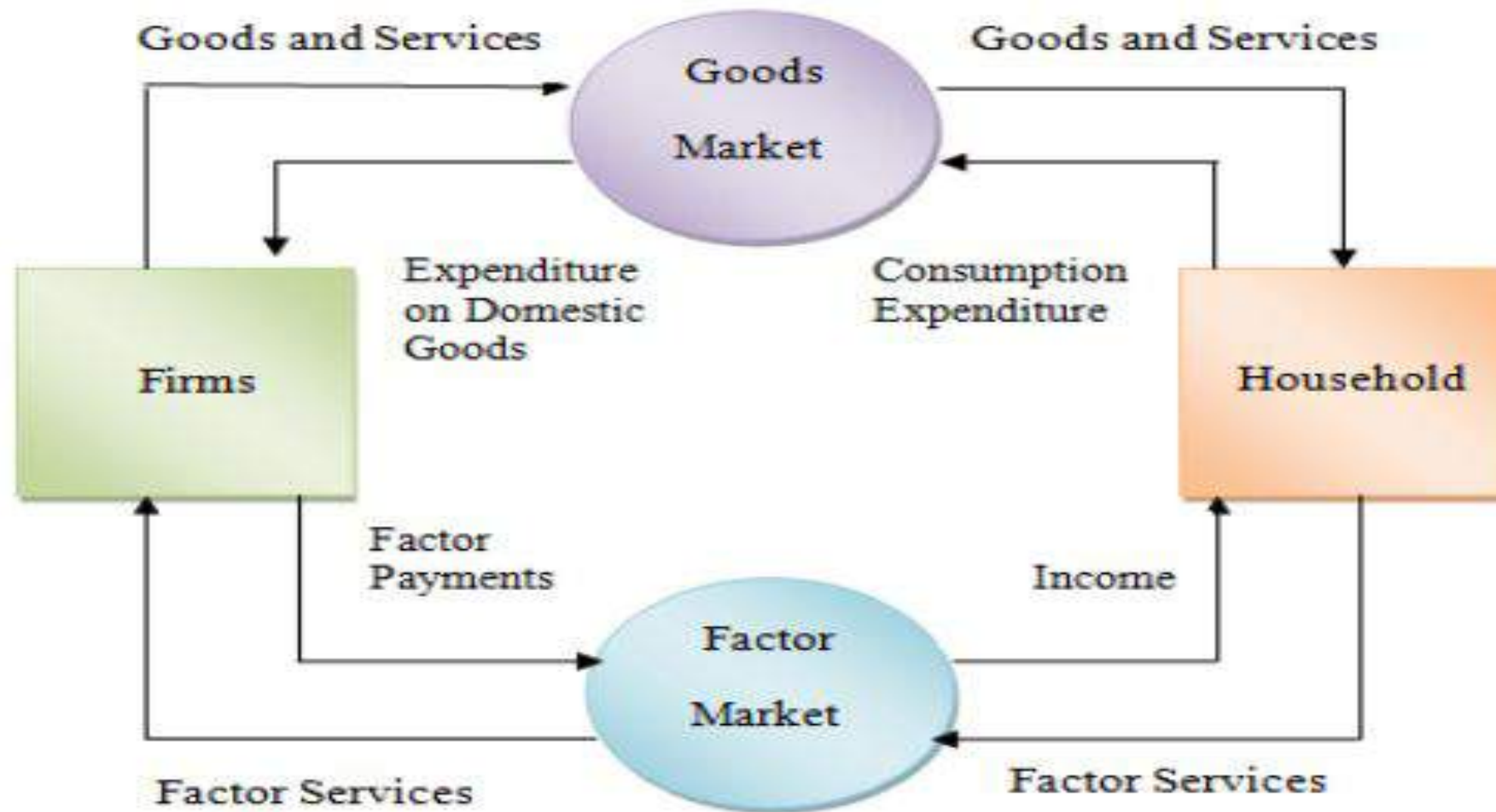
- i) household sector,
- ii) the firm sector,
- iii) the government sector
- iv) the foreign sector.

The three markets are

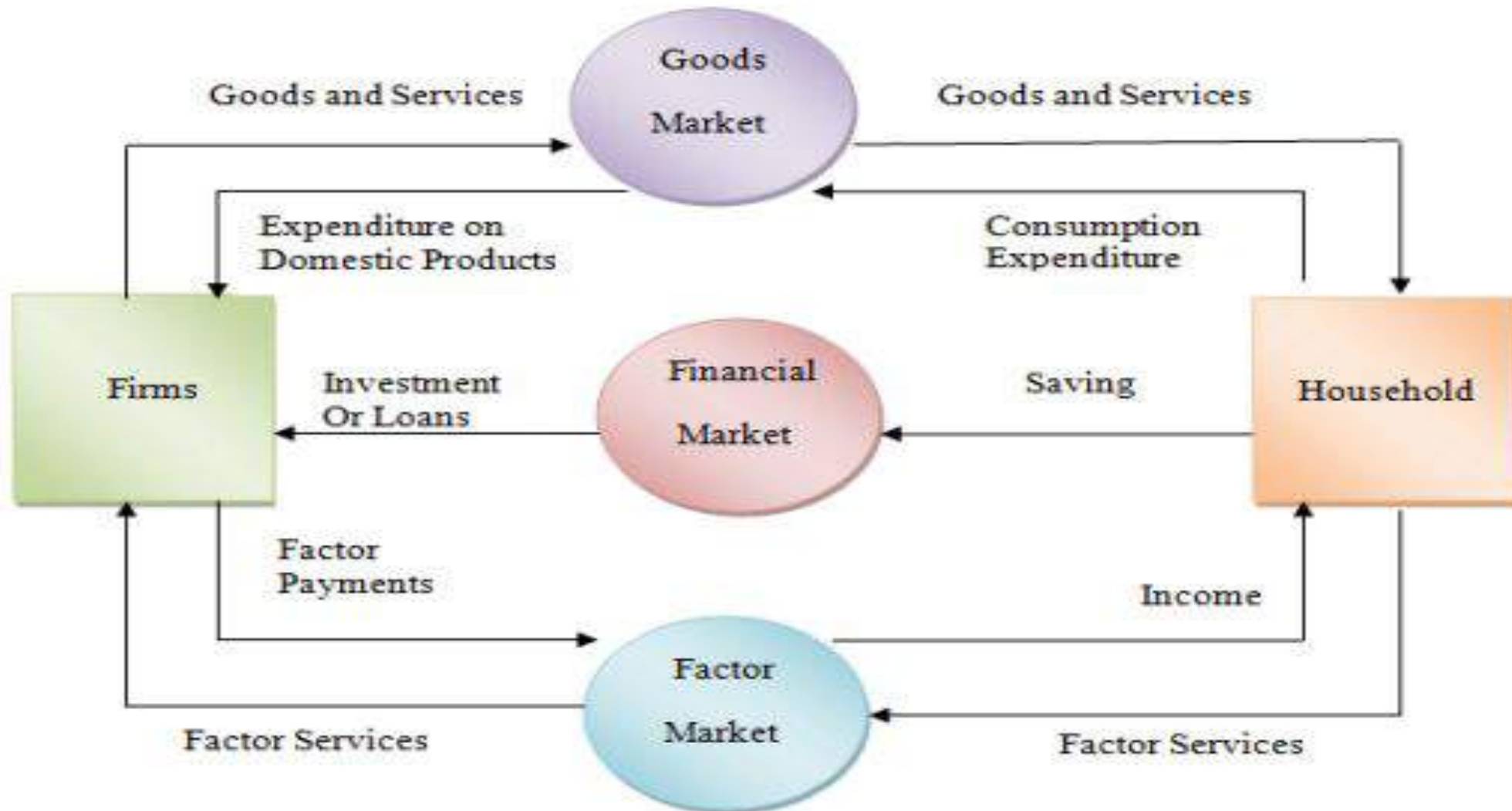
- i) the goods market,
- ii) the factor market
- iii) the financial market



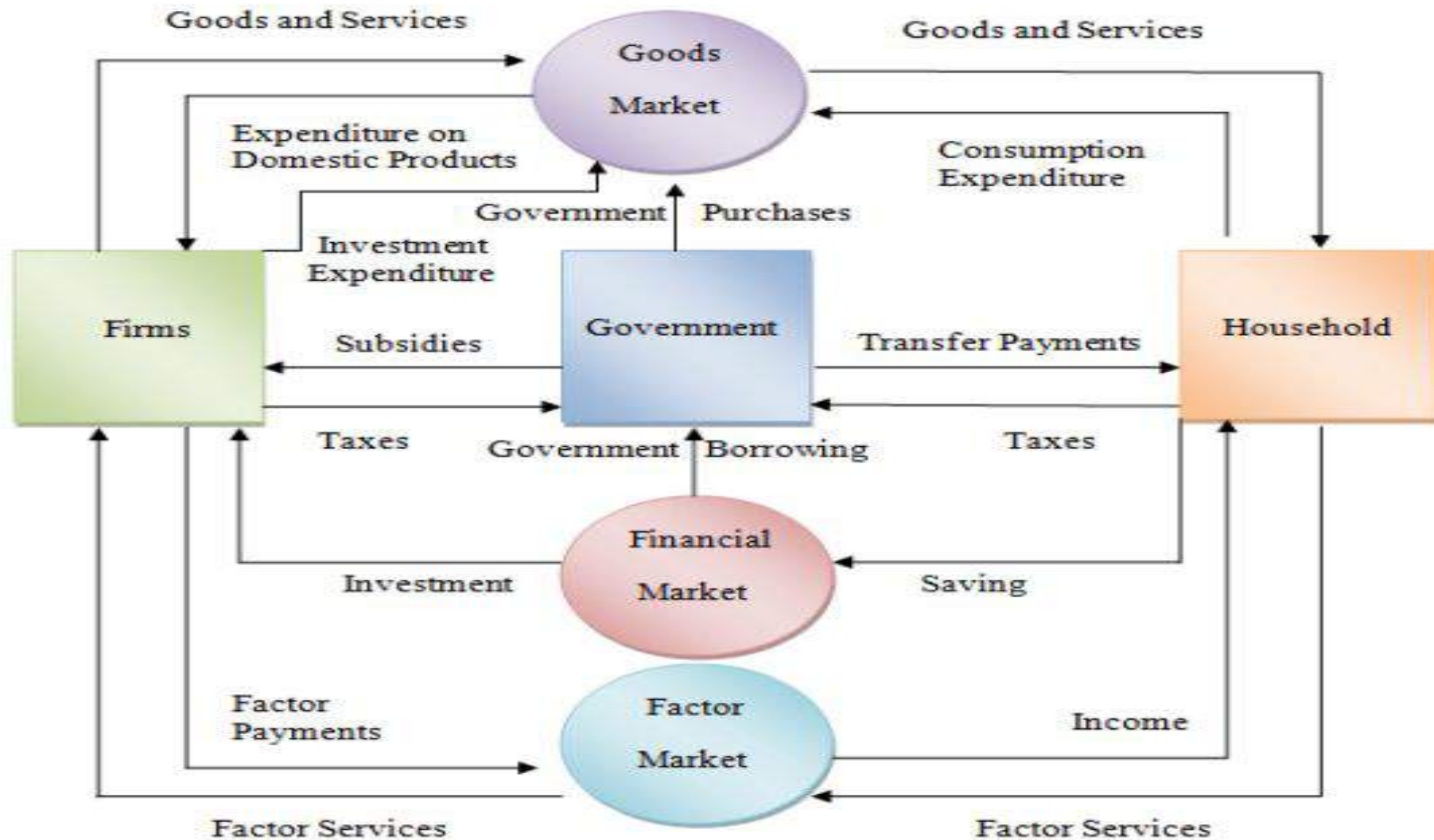
Circular Flow of Income in Two Sector Model



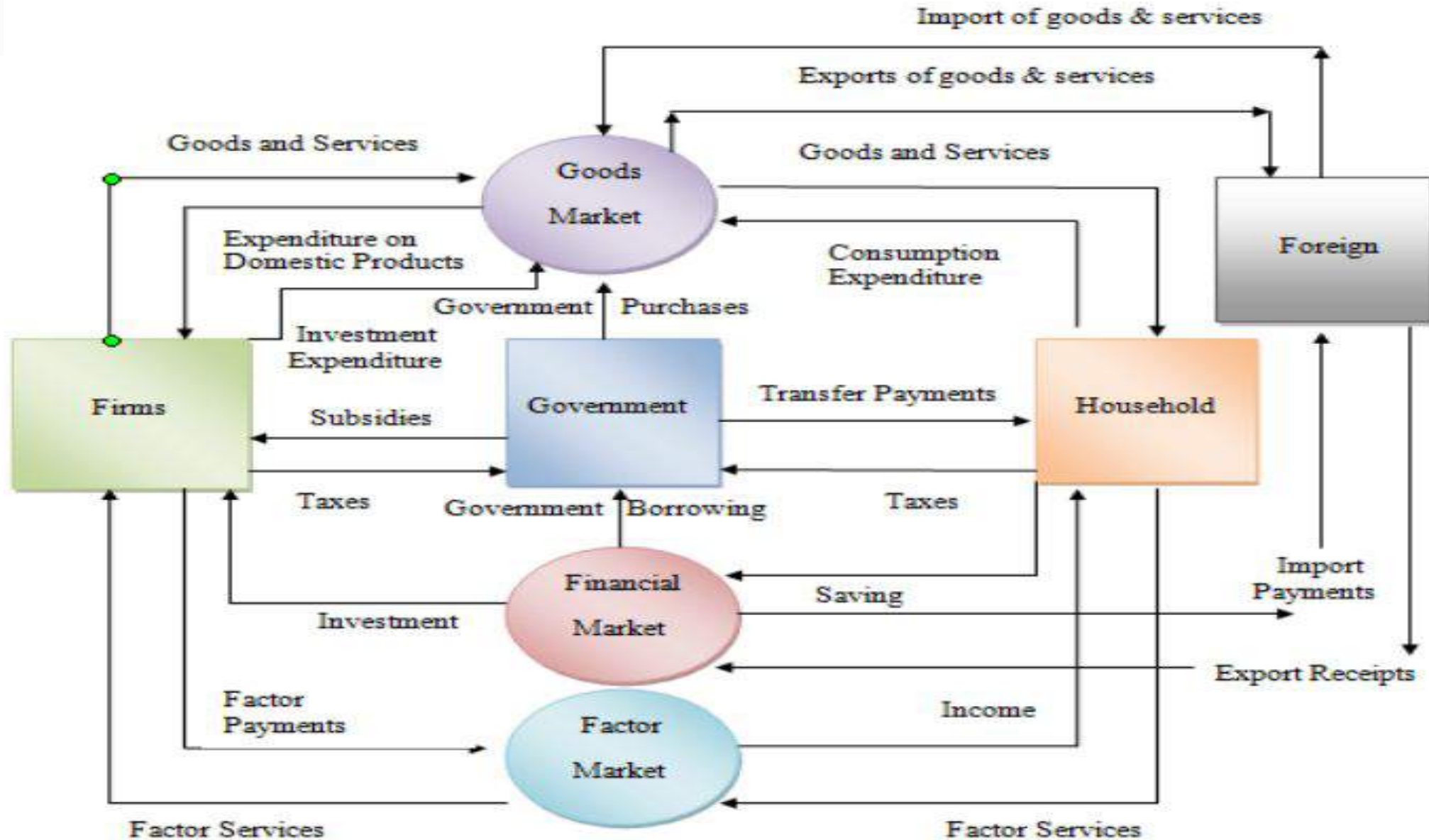
Two sector model with three markets



Circular Flow of Income in a Three Sector Model



Circular Flow of Income in a Four Sector Model



Leakages and Injections in the Circular Flow of Income

- **Leakages:** A leakage is referred to as an outflow of income from the circular flow model. Leakages are that part of the income which the household withdraw from the circular flow and is not used to purchase goods and services. This part of the income does not go to the goods market. There are three main leakages and these are:

Savings (S), Taxes (T) and Imports(M)

- **Injections:** An injection is an inflow of income to the circular flow. The volume of income increases due to an injection of income in the circular flow. There are three main injections and these are:

Investment(I) ,Govt expenditure(G) and Export(X)

Balance of leakages and Injections in an open economy is;

$$S + T + M = I + G + X$$

$$\text{Or, } (S - I) = (G - T) + (X - M)$$



- The equilibrium condition for a two-sector model with saving and investment is as follows:

$$Y = C + S \quad \text{or} \quad Y = C + I; \quad \text{or} \quad C + S = C + I$$

or, **S = I**

- In three sector Model

$$Y = C + I + G \quad \text{or} \quad Y = C + S + T$$

or, $C + I + G = C + S + T$

or, $I + G = S + T$

or, **G - T = S - I**

- In a four sector model

$$Y = C + I + G + (X - M) = C + S + T$$

or, $I + G + (X - M) = S + T$

Where, Y = Income, C = Consumption, S = Saving and I = Investment, G = Govt purchases of goods and services, X = export, M = imports



Thank you

