

Circular Flow of Income

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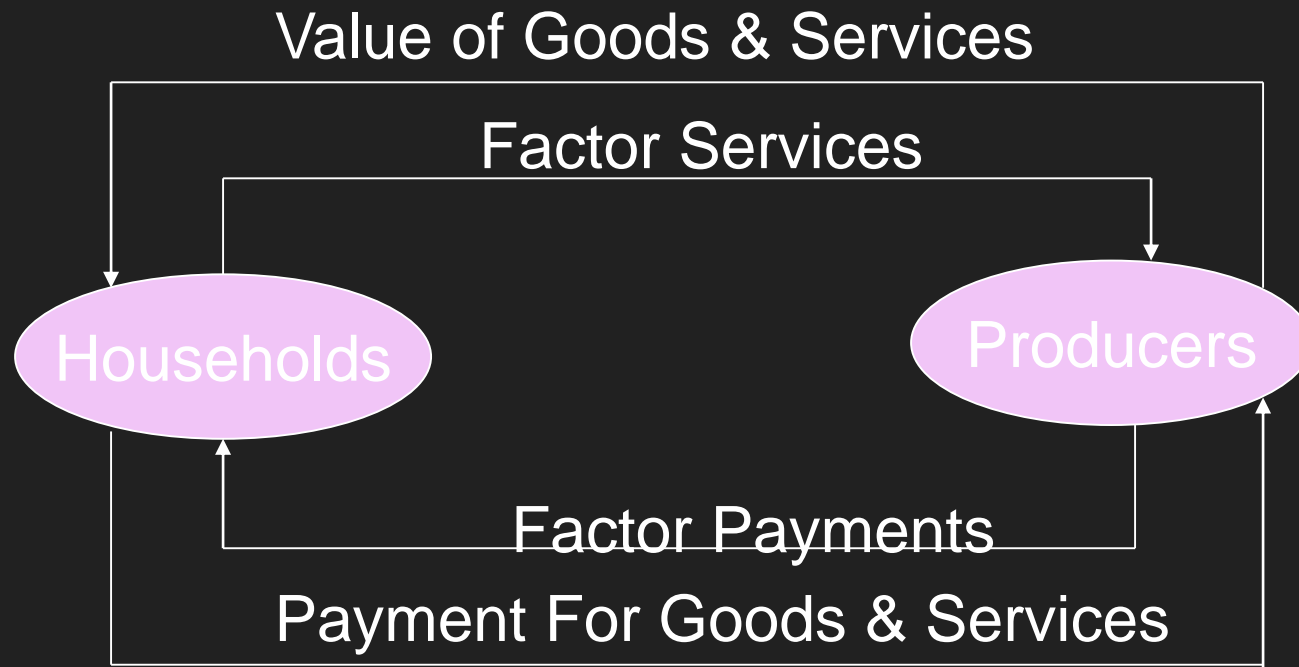
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Circular Flow of Income

- The process of production is a continuous process. In it, various Factors of Production such as Land, Labor, Capital & Entrepreneurship are combined together for the production of goods & services.
- The supply of these factors come from households. These factors offers their services to the producers like- firms, who in returns produce goods & services & make payments as reward in the form of rent, wages, interest & profits.
- The households spend this money on goods & services produced by the firms. Thus income first flows from the firms to the households in the form of factor payments & then from the households to the firms in the form of consumption expenditure.
- The income continue to flow in a circular way so it is called circular flow of income.

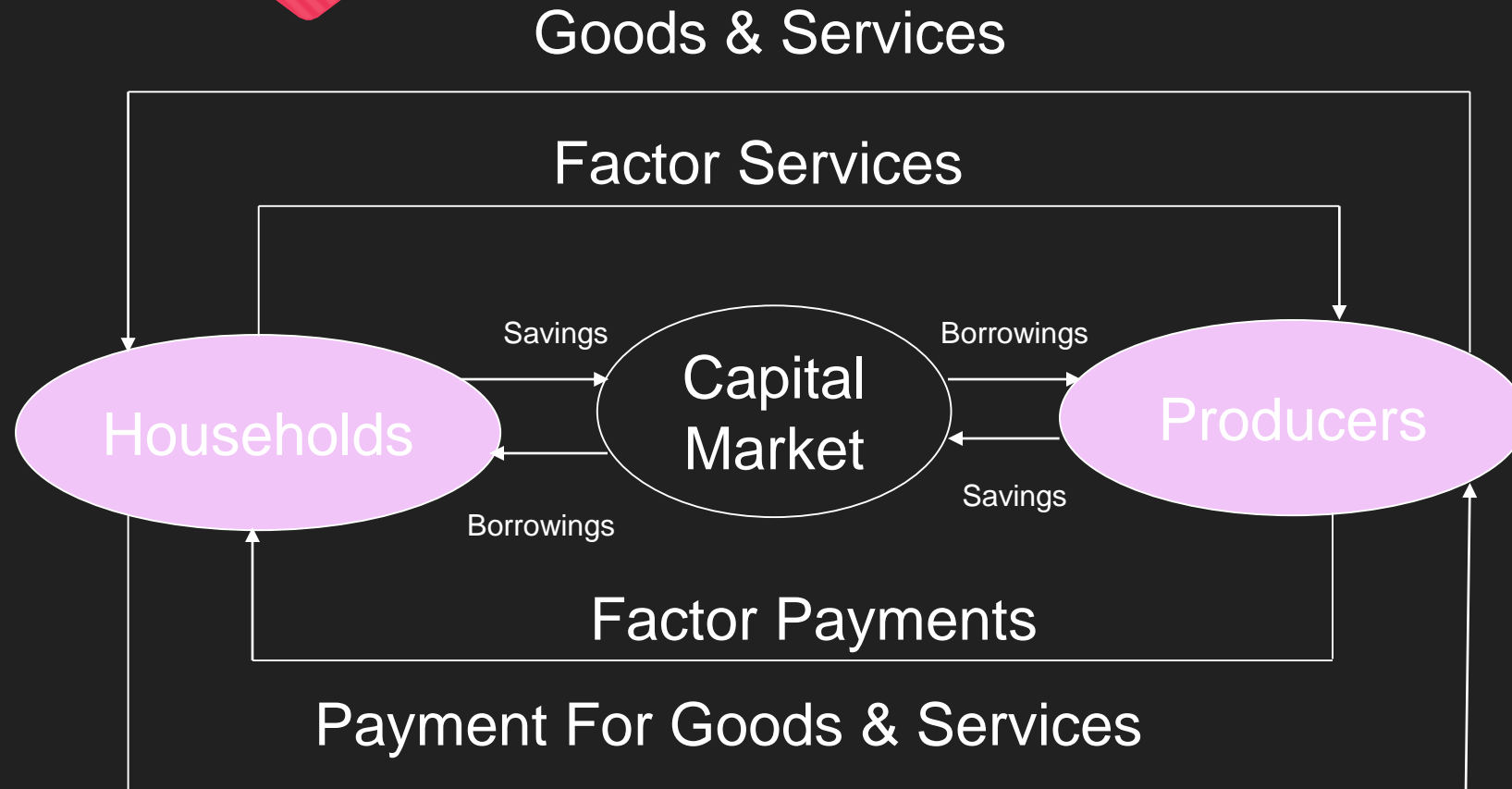
Two Sector Model



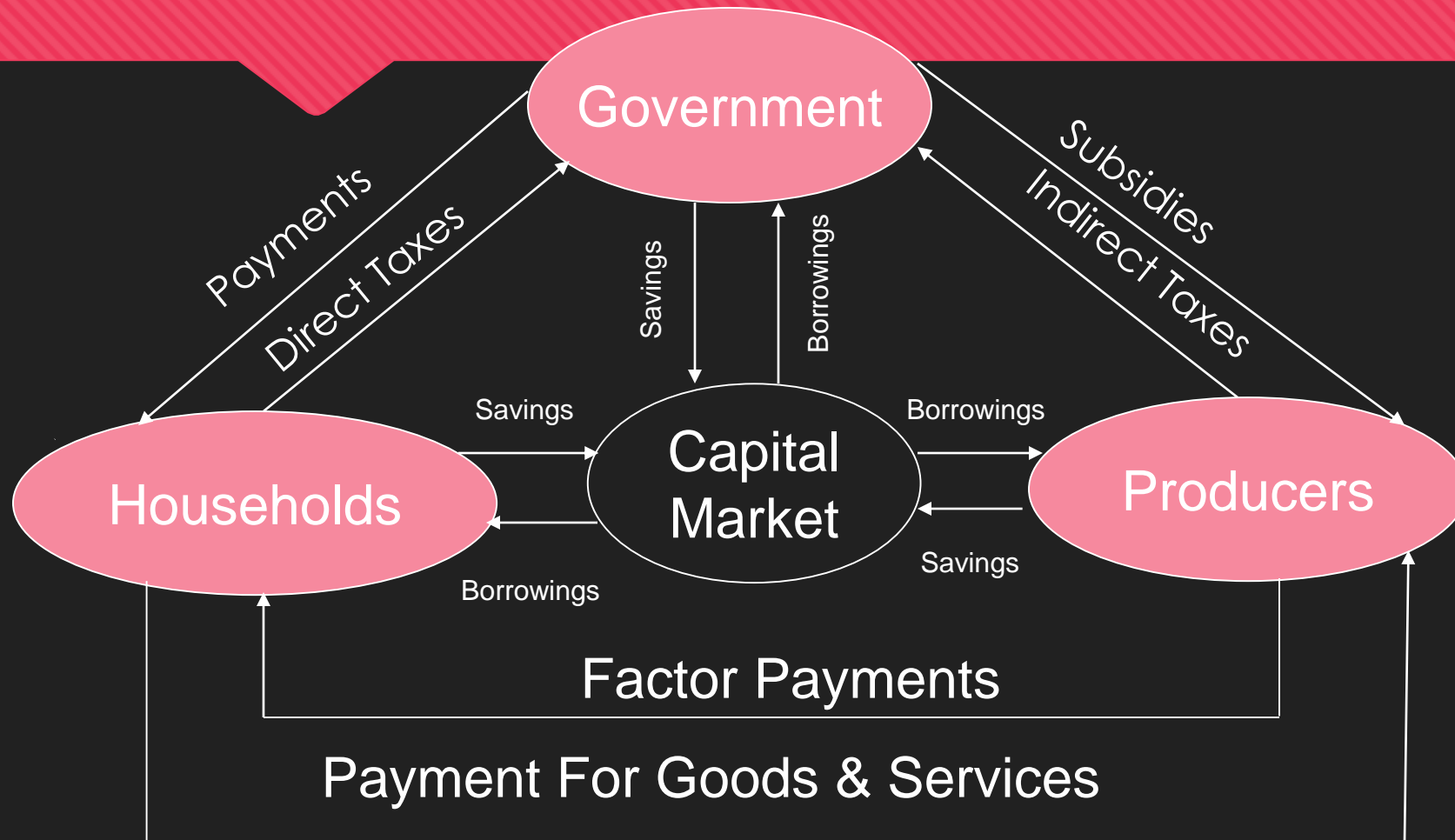
Role of Savings:

- We assumed that household sector and firms do not save.
- But the Households save (S) which is some part of their income for several reasons.
- Hence, Households are known as Deficit Spending Units (DSU).
- Firms, on the other hand, Invest (I) in capital goods.
- They, therefore, are known as Surplus Spending Units (SSU).
- All the banking institutions and Non-Bank Financial Corporations: (NBFC) like insurance companies & mutual funds taken together constitute capital market of the economy in which the savings are lodged.
- From capital market these savings flow to firms as loans for investment. Thus, $S=I$ through the capital market.

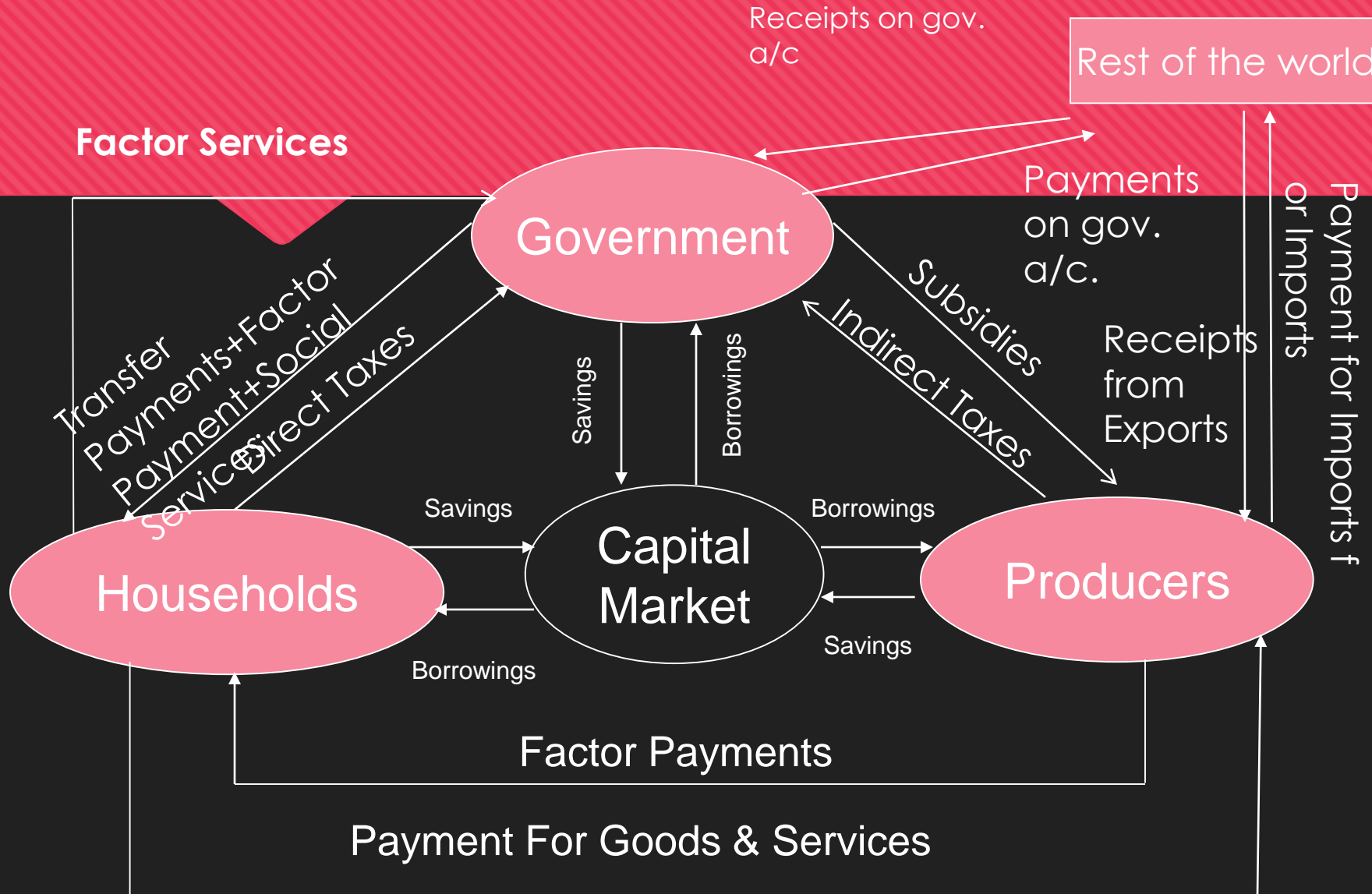
Two Sector Model with savings



Three-Sector Model With Savings



Four-Sector Model



Conclusion:

- Hence, the Circular flow of Income provides the relationship between different stakeholders of the economy.
- In four Sector model, Open economy, rest of world transactions plays an important role.
- Capital market mobilises the savings and borrowings from Households, Government Sector as well as firms.
- Government sector provides subsidies.



 Thank You

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