



STD :- 12th CBSE

Subject :- Macro Economics

Chapter :- 1. Circular flow of income

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1. Definition of Circular Flow of Income

It is referred to **cycle** of generation of income and passing the payment from household to firm and vice versa. It is Distributed as **Factor of Productions** It Circulated from Household to firms in the form of **Consumption Expenditure** of Goods and Services Produced by Them.

2. Factor of Production

- 1. Land
- 2. Labour
- 3. Capital(money)
- 4. Enterprises (Owner)

- Pay rent
- Pay wages
- Pay interest
- Pay profit

Called As Factor of Productions

3. Three phases of circular flow of income

i. Generation phase

- 1. first Phase(Production Phase), firm produces goods using factors of production(Land, Labor, capital and Enterprise)
- 2. This Phase Also Called As **Production Phase**

ii. Distribution phase

- 1. In second Phase (Income Phase), the firms make factor payments (Rent, wages, Interest & Profit) to household for providing factor services.
- 2. This Phase Also Called As **Payment Phase**

iii. Disposition phase

- 1. In third phase (Expenditure Phase), the households spend the amount received by firms in purchasing their products.
- 2. This Phase Also Called As **Disposition Phase**

Stock Variable

- 1. It refers to that Kind of variable, which is Measured at a Particular **Point of Time**.
- 2. It does not have a time dimension
- 3. It is a **Static Concept**

Example :

- Stock of goods in godown
- Population of country
- Growth rate
- Inflation rate

Flow Variable

- 1. It refers to that kind of variable, which is measured over a **Period of time**.
- 2. It has a time dimension as it is measured over a period of time.
- 3. It is a **dynamic Concept**

Example:

- Saving , Deprecation
- GDP Calculation
- National Income



Real Flow		Money Flow	
1	It is the flow of Non-Monetary Transaction	1	Monetary Nature Transaction
2	This flow is also called as Physical flow	2	This Flow is also called as Nominal Flow
3	It is the flow of goods and services between households and firms	3	It is the flow of money between firms and households
4	These may be difficulty of Barter system in exchange of goods & factor services	4	There is no such difficulty in case of money flow.

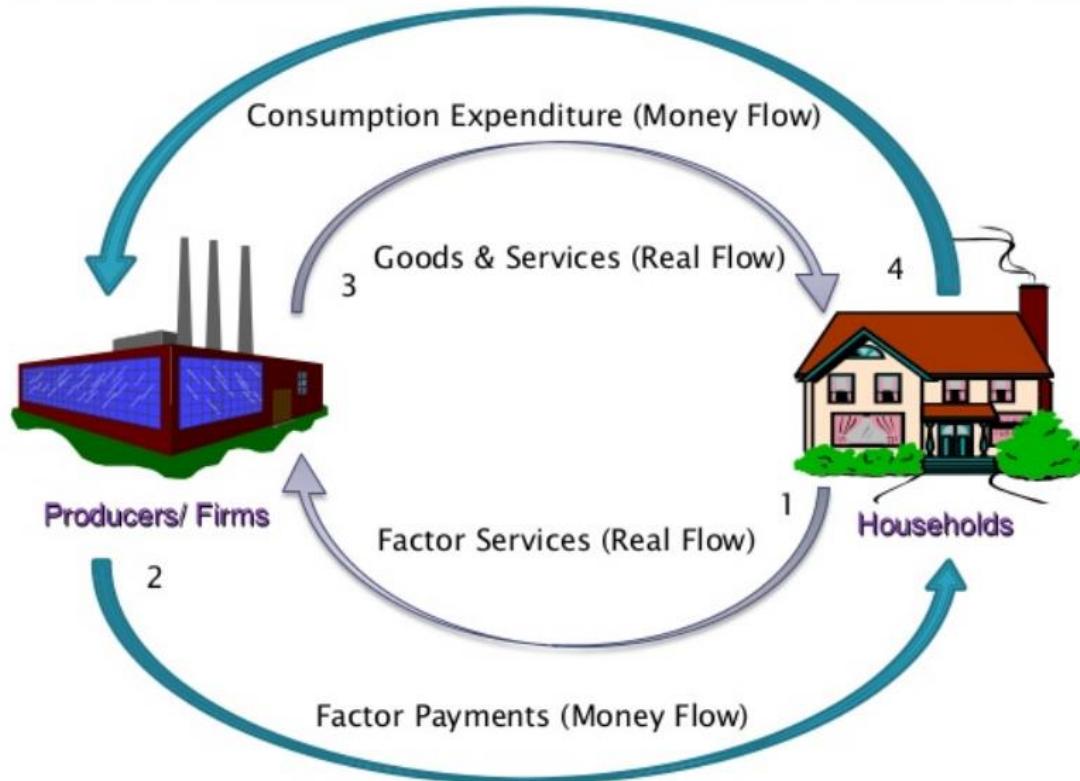
Circular Flow of Income in Two Sectors Economy

In a simple two sector economy, there exist only 2 sectors i.e. household and firms, where households provide factors of production (**Land, Labour, Capital and Enterprise**) and **consumes goods & services** made by firm and sell them to households.

In order to make our analysis simple, we can take some assumptions:-

- Only two sectors in an economy are there i.e. **Households and firms**.
- Households provide factor services to firms only and firms hire factor services from household only.
- The amount received by household from firm for providing factor services is used entirely on consumption.

Circular Flow Model in 2 Sector Economy (Closed Economy)



This brings us to the following conclusion.

There are no savings in economy, i.e. neither the household saves from their incomes nor the firm saves from their profits.

In the given diagram, It can be seen that households are providing factor services in exchange of factor payment and firms are providing goods & services to households in exchange of consumption expenditure.

- **Total Production = Total Consumption,**
- **Consumption Expenditure = Factor Income,**
- **Factor Payment = Factor Income**
- **Real Flow = Money Flow**