

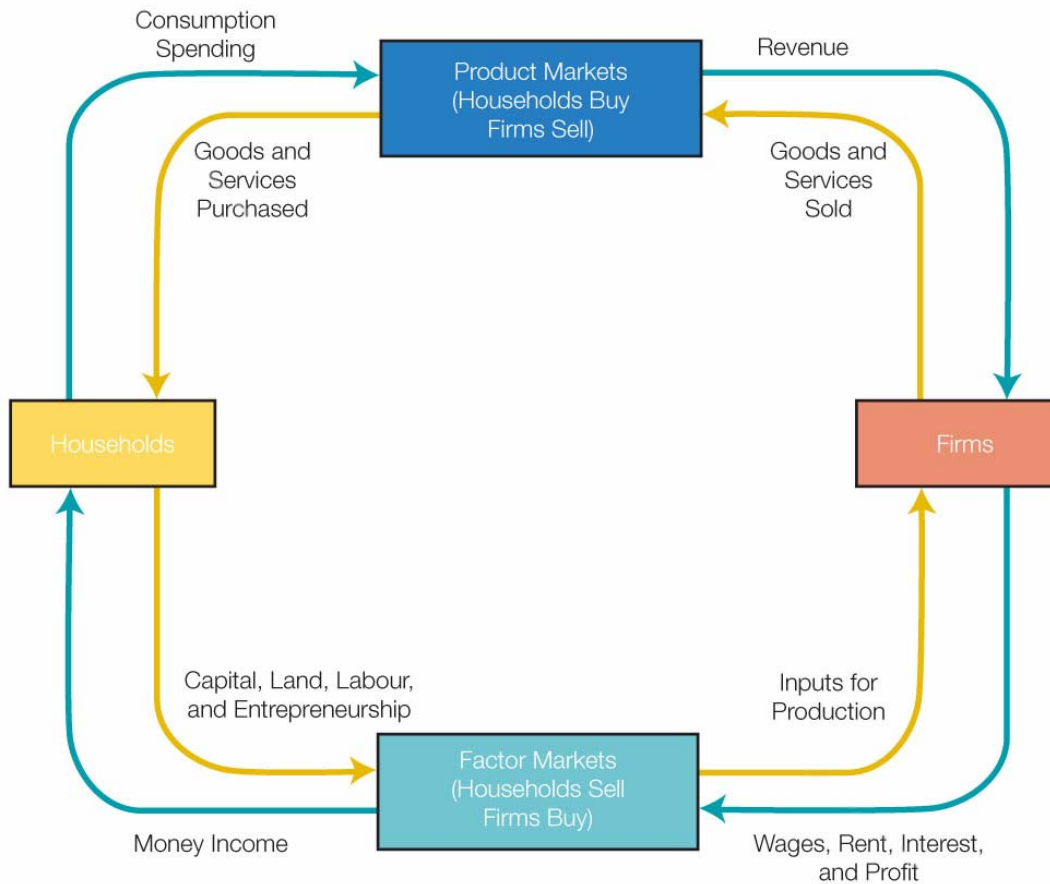
SECTION 2.2 THE CIRCULAR FLOW MODEL

- In a simple economy, there are two decision makers, firms and households. Exchanges between these two decision makers take place in product and factor markets and involve flows of goods, services, and money.
- **Product markets** are the markets for consumer goods and services. Households buy the goods and services that firms produce and sell.
- **Factor or input markets** are the markets where households sell their factors of production—capital, land, labor and entrepreneurship—to firms. In factor markets, households are the sellers and firms are the buyers.
- **The goods and services flow** represents the continuous flow of inputs and output in the economy. Households make inputs available to producers through the factor markets. These inputs are then turned into outputs which are then bought by households.
- **The income flow** represents the continuous flow of income and expenditure in the economy. Households receive money payments from firms for their inputs in the form of wages, interest payments and profits. The payments from households to firms are for the purchase of goods and services.
- **The circular flow model on income and output** is an illustration of the continuous flow of goods, services, inputs, and payments between firms and households.

section 2.2

Exhibit 1

The Circular Flow Model



Households and firms continuously trade goods and services and payments between themselves. For example, households receive income from firms in exchange for working and providing other inputs. Households then recycle that income to the firms in exchange for goods and services. Dollars flow clockwise and goods and services flow counterclockwise.

Exhibit 1: *The Circular Flow Model*

- The circular flow model can be extended to show the role of government, financial and foreign markets, as well as of taxes and saving.