

Circular flow of income and expenditures

[Economics](#)



Introduction

In this assignment I will explain what the circular flow of income is. I will also give examples of what might cause changes in the business cycle. I will also explain what GDP is and give examples of what its limitations are and why it's a good form of measure. I will also explain what automatic fiscal stabilisers are. Finally I will discuss different types of inflation.

In economics the term “ circular flow of income” is just the flow of money within the economy. It shows us how the money is being circulated through the economy, for example it shows how the firms pay the households who then spend the money and it goes back to the firms, who then pay wages again to the households. This is just basically the way money goes around in the economy. Everything is somehow connected as all the money works its way around the economy and ends up where it started. Also it shows in the diagram how the government plays its part in the flow, for example the government receive tax from the households and firms. However they then spend the money again on benefits etc and from this the benefits will be spent on products for the home, therefore the households are spending the money from the government on the firms. Again this money ends up coming back to the households and the government in wages and taxes. If the households decide they may want to save some of their money and put it in the banks it would be known as a leakage. However this money then gets pumped back in to the economy as firms will want loans from banks. In general all the money in the economy just goes round in circles.

Here is the diagram which shows it more clearly.

This diagram looks at the households and business side of the cycle.

I have also got another diagram which allows us to see the full circular flow of income diagram which is just below. This diagram shows the business side as well as the government side to it.

GDP stands for gross domestic product. GDP measures the amount of output of goods or services a country has to offer. For example goods or services which are provided by the country itself and does not include imported products or services. Imported products and services are known as GNP. However to measure the overall macroeconomic activity you could use either GDP or GNP. This is usually calculated over a year.

This is not the only type of measure they can use however it is the most favourable form of measure and also it is the most comprehensive form of measure. What makes this a useful measure is that whatever it calculates works well however it should go in to more depth and include more individual based scenarios such as the less wealthy people.

There are some limitations to the uses of GDP for example they cannot calculate each individual's needs as well as what they already have.

Therefore this means that for every person they just calculate their income on an average which would make the overall result inaccurate as it will not allow the people who have a lower income to stand out from the rest in terms of living standards. The same would apply to the people who are richer as they do not stand out as having a better standard of living. This means

<https://assignbuster.com/circular-flow-of-income-and-expenditures/>

that the figures that are shown do not necessarily show the poverty in relation to the wealth as it's not calculated in such a way to be more accurate.

Economic growth and externalities can have a negative impact on the economy as there might be a raise in the national output which could include a raise in pollution; therefore it would affect the economic welfare. Another factor which affects it a lot is the balance between consumption and investment. For example if the economy uses too many resources in short term needs and wants of consumers then there might not be enough resources to use for future economic development. If the resources are used up too quickly then it may have a better standard of living now however in the long run it won't be as good due to the resources being used up too quickly therefore they need to balance it more so that the economy would benefit overall, it might be that the living standards go down a little bit however in the long run the economy would be better off as they will have a better standard of living on average.

Automatic fiscal stabilisers are instruments which influence the rate of growth and help counter swings in the economic cycle. An example of an automatic stabiliser could be high growth, if there was an economic growth then automatic stabilisers will help to reduce the amount of growth. However with higher growth the government will receive more taxes. As there will be more people working which means they will be more taxes to be paid to the government. Also with a higher growth there will be a fall in unemployment therefore the government would be spending less on unemployment benefits. When there's a recession the automatic stabilisers will help to limit the fall in growth. So if people have got lower incomes it means that they will

be paying less tax therefore the government will be spending more on unemployment benefits.

There are four main types of inflation. Demand-pull inflation, cost push inflation, pricing power inflation and sectoral inflation are the four types of inflation. The main type of inflation is demand-pull inflation also known as excess demand inflation, this is when the total amount of goods or services in the economy exceed the available supply therefore the prices rise in the market economy. This is without doubt the most common type of inflation for example war materials and man power grows quickly without shrinkage elsewhere. The second most popular type of inflation is the cost push inflation which is caused by costs of production raising for one reason or another therefore this makes the prices of goods and services increase as well. Usually what makes the prices raise is the cost of wages as there may be an increase in wages which means the overall unit cost would increase which leads to a higher resale price. This type of inflation is not as common as demand-push inflation however it can occur independently.

At the moment I think the UK is suffering from cost push inflation. The reason that the UK is suffering from this type of inflation is because the prices for pretty much everything has increased. The value of the currency has also dropped. Also as the prices are all increasing some businesses are able to cope with short term increases in price however in the long run they will be forced to close down as they are unable to meet the current pricing. This is why a lot of businesses are being forced to shut down and the number of unemployment has increased.

I think the Bank of England should not put the interest rates up at the moment as the economy is unstable. I think that the Bank of England should wait till the economy is coping better when unemployment levels drop then there should be a possible increase in interest rates, however this is only if the economy is doing well and people can afford to pay the higher interest rates. Also if the prices and taxes are decrease and product prices are lower then people will have more disposable income which means they wouldn't mind paying a slightly higher interest rate. Another reason for the interest rates not to be increased at the moment is that as there are becoming more and more job cuts across the UK less people are able to afford to purchase houses etc which means that if the base interest rates are increased then the banks will suffer again and therefore the recession will go worse. Overall I think that if anything the rates should go even lower possibly to 0% and then people will start to get credit and the economy should start to rise. This means that businesses will start to make more money which means they can expand and create more jobs. And with these jobs people can start to pay back any money they have received from the banks.

Bibliography

Internet

(2008). Circular Flow of Income. Available: <http://www.economicshelp.org/blog/economics/circular-flow-of-income-diagram/comment-page-1/>. Last accessed 4th April 2011.

Robert Schenk. Gross Domestic Product . Available: <http://ingrimayne.com/econ/Measuring/GNP1.html>. Last accessed 5th April 2011.

<https://assignbuster.com/circular-flow-of-income-and-expenditures/>

Olivier Vaury. (2003). Is GDP a good measure of economic progress?*

Available: <http://www.paecon.net/PAERReview/issue20/Vaury20.htm>. Last accessed 5th April 2011.

GDP. Available: http://www.cliffsnotes.com/study_guide/GDP.topicArticleId-9789,articleId-9733.html. Last accessed 5th April 2011.

Limitations of GDP when measuring living standards. Available:

http://tutor2u.net/economics/content/topics/livingstandards/limitations_of_gdp.htm. Last

accessed 5th April 2011.

(2010). Automatic Stabilisers . Available: <http://www.economicshelp.org/dictionary/a/automatic-stabilisers.html>. Last accessed 6th April 2011.

Types of Inflation . Available: <http://www.docstoc.com/docs/1043355/Different-Types-of-Inflation>. Last accessed 6th April 2011.

Book

David Campbell and Tom Graig (2005). Organisations and the businessenvironment. 2nd ed. 185.