

Microeconomics

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The Circular Flow Diagram Circular flow model attempts to explain the circulation of income between households (consumers) and firms (producers) as well as the link between money and resources. Basically, firms employ households (workers), who are compensated for their labour contribution in the production process. The households in turn spend the money paid to them by firms in the form of wages and salaries to purchase finished products from firms. The firm also uses the proceeds from sales of products to buy raw material for further production of goods, which will require human effort (labour). This relationship is repetitive making the circular flow continuous. The product market refers to where all the goods produced by the firm are sold to households while factor market is where all factors of production like labour, capital and land among others are traded (McEachern 5).

Households sell resources or factors of production in the factor market and use the money obtained to purchase products sold by the firm in the product market. My family as a household provides labour to the firm. The family is then rewarded for the labour it sells to the firm through wages and salaries. After payment, the family uses the payment from the firm to purchase goods manufactured by the firm, hence the firm gets proceeds from sales of products. This money obtained from the family through product purchase is again used to purchase raw materials for producing goods and also used to pay workers (my family). This relationship is continuous resulting into an endless circular flow pattern of income.

Source: Macroeconomics: A Contemporary Introduction.

Work Cited

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McEachern, William A. *Macroeconomics: A Contemporary Introduction*. ,
2014. Print.