

Understanding the Circular Flow of the Macroeconomy

Firms provide goods and services to households through the product market. Households pay firms for these goods and services.

Households supply firms with the factors of production (also called resources) through the factor market. Firms pay households for resources (land, labor, capital, and entrepreneurial skill).

The income firms pay to households includes rent, wages, interest, and profits. It equals the dollar value of the output sold as shown in the circular flow diagram in Figure 2-1.1. The flow on the diagram that includes expenditures for goods and services produced and sold in the product market represents gross domestic product (GDP). The approach to measuring GDP using this flow is called the *expenditures approach*.

 **Student Alert:** Using the expenditures approach,

$$\text{GDP} = C + I + G + X_n.$$

The details about this equation for GDP are developed in a later activity. For now, make sure you understand how the expenditures approach measures GDP, and that this equation forms the basis for models developed throughout the rest of the course.

The flow on the diagram that includes payments for the resources used to produce goods and services in the factor market is another way to represent GDP. The approach to measuring GDP using this flow is called the *income approach*.

In addition to the basic flow of economic activity illustrated by the flows between the product and factor markets shown on the outside of the diagram, there are leakages from the flow and injections into the flow that affect its size. The leakages and injections happen through the government, financial institutions (e.g., banks), and international trade. These are shown using the boxes in the center of the circular flow diagram.

Identify which of the following terms belongs in each of the numbered blanks in the circular flow diagram, and fill in the blanks.

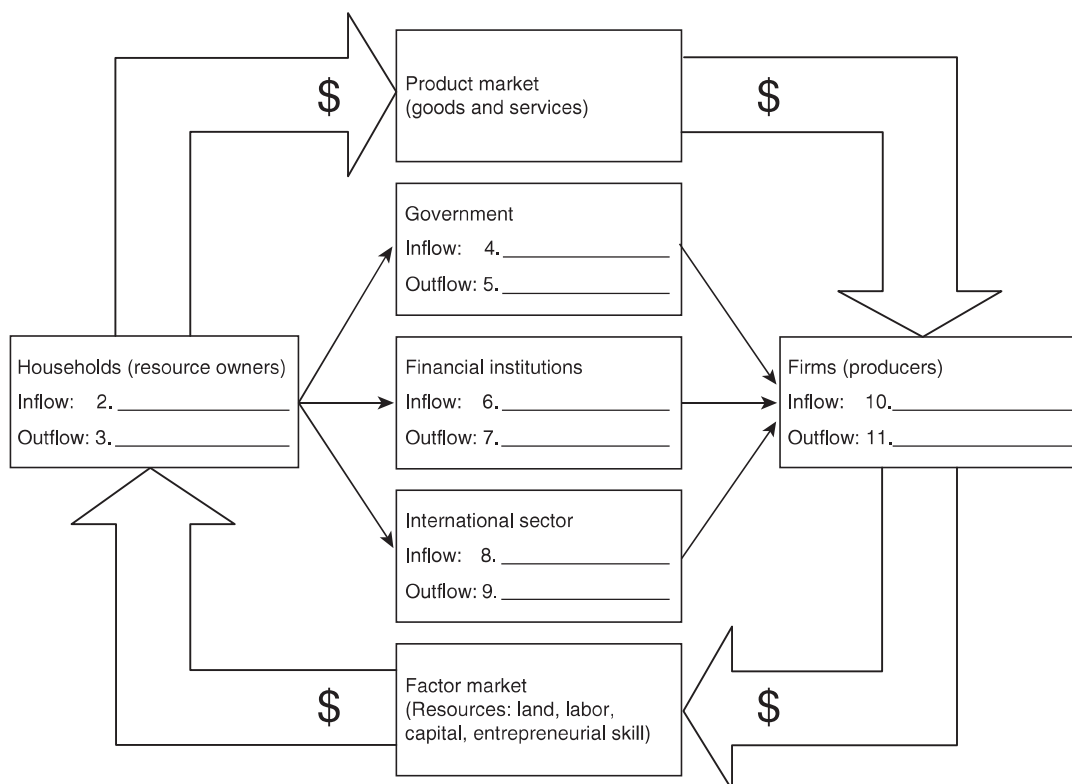
Expenditure approach	Exports	Payments for goods and services
Income approach	Government spending	Income (rent/wages/interest/profit)
Taxes	Imports	
Saving	Payments for resources (rent/wages/interest/profit)	Revenue from selling goods and services
Investment		



Figure 2-1.1

The Circular Flow of Resources, Goods, Services, and Money Payments

Measuring GDP using this flow is the 1. _____.



Measuring GDP using this flow is the 12. _____.