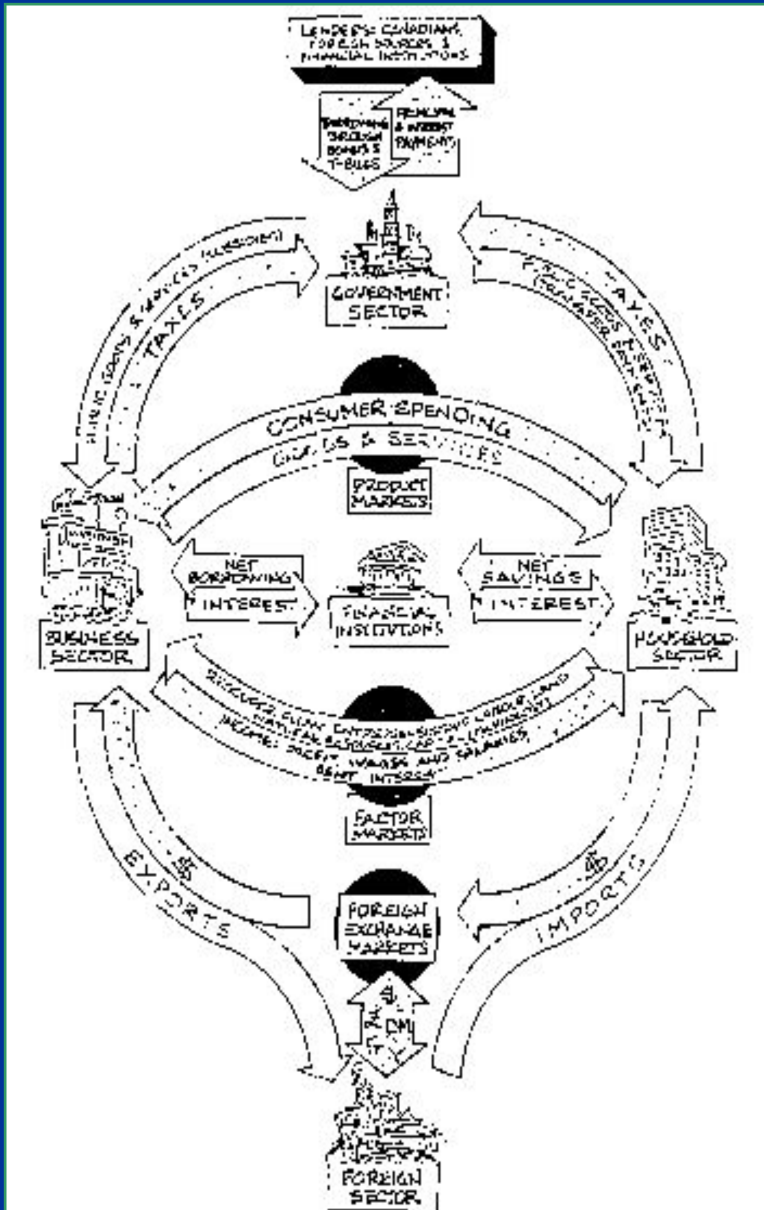


Macroeconomics: The Circular Flow

Macroeconomics vs. Microeconomics

Macroeconomics

- Studies the behaviour of aggregate (total) economic variables such as income, employment, price level etc…

Microeconomics

- Studies the behaviour of individuals and groups of individuals , such as consumers, households and businesses.

The Circular Flow Model

- traces the exchange of goods and services in the economy

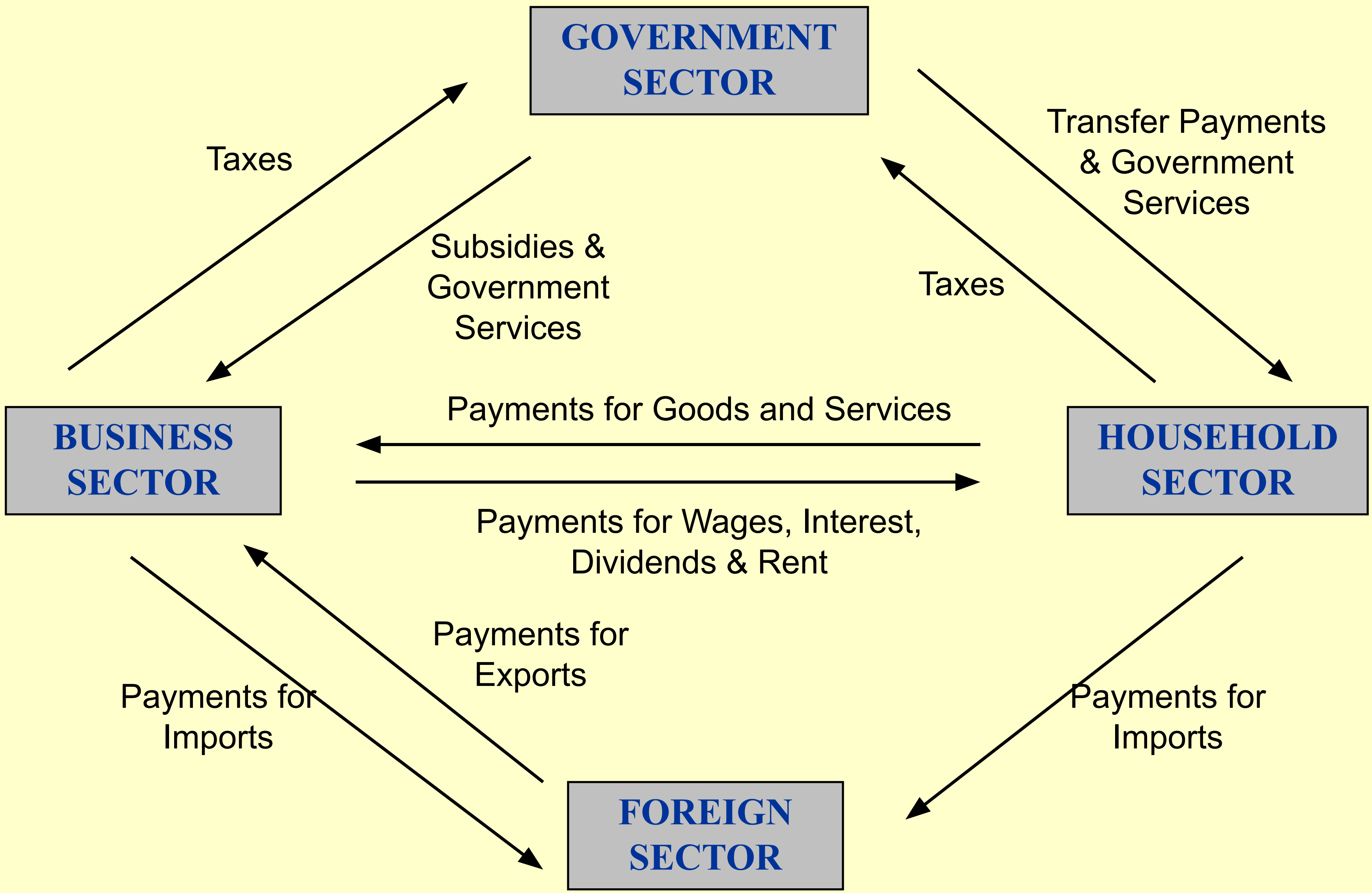
- use of money in the economy results in a two-way circular flow - of goods and services in one direction and money in the other direction - between:

> *Consumers (Households)*

> *Businesses (Firms)*

> *Government*

> *Other Countries*


GOVERNMENT SECTOR
BUSINESS SECTOR
HOUSEHOLD SECTOR
FOREIGN SECTOR
Taxes
Subsidies & Government Services
Transfer Payments & Government Services
Taxes
Payments for Goods and Services
Payments for Wages, Interest, Dividends & Rent
Payments for Exports
Payments for Imports
Payments for Imports

Mixed Market Economy Sectors

Consumption (C)

- spending by households on consumer goods and services
- primarily affected by consumer's *disposable income* (income remaining after taxes)

What percentage of total spending within the economy is generated by households?

Approximately 60%, meaning 60 cents out of every dollar spent comes from consumers

Gross Investment (I)

- creation of a new business or expansion of an existing one or the improvement in the production capability of a business through:
  - *a new factory, new equipment, better technology, worker retraining, new management techniques etc…*
- gross investment also includes:
  - changes in inventories (*stocks of unsold goods and materials*)
  - construction of all buildings, such as houses and apartments
  - expenditures by government agencies on equipment and machines
- decision to invest affected by *expectations of profit* and *interest rates (borrowing costs)*

Government (G)

- government purchases include current spending by all levels of government on goods and services
  - *federal government purchase of battleship for armed forces*
  - *municipality contracts a company to repave a stretch of road*
- government spending affected by tax revenues and spending priorities

Foreign Sector (X - M)

- **exports include purchases of Canadian goods and services by foreigners**
  - *British flour mill buys Canadian wheat*
  - *Foreign tourist spends a week in a Canadian hotel*
- payments for exports remain in Canadian circular flow of money and thus add to GDP
- **imports include Canadian purchases of foreign goods and services**
  - *Canadian imports of Italian wine*
  - *Canadian tourists spending abroad*
- payments for imports leave the Canadian circular flow of money and are subtracted from GDP
- **Statistics Canada uses Net Exports (X-M) to reconcile spending inside and outside Canada**

Gross Domestic Product (Total Spending)

- adding together (aggregating) the four categories of spending gives us the GDP expenditure equation:

$$\boxed{\mathbf{GDP = C + I + G + (X - M)}}$$

Excluded Items from GDP

- Financial exchanges

  > *gifts of money between friends & family; bank deposits or stocks purchases*

- Second Hand Purchases

  > *purchases of second-hand or used goods*

Questions To Consider

1. Which sector of the economy is the *most* stable during a typical business cycle? The *least*?

2. Why is savings spending?

3. If the federal government built new Canada Post offices, under what expenditure component would this be classified? (C, I, G, X-M)

4. What part of the GDP expenditure equation would we need to examine to determine if a country had a trade deficit?

5. If the Government states they are going to invest $50million into the LCBO (a Crown Corporation) what sector (G,I,C,X-M) would this fall under and why?

6. Why does consumption make up more than half of our country's GDP expenditures.