

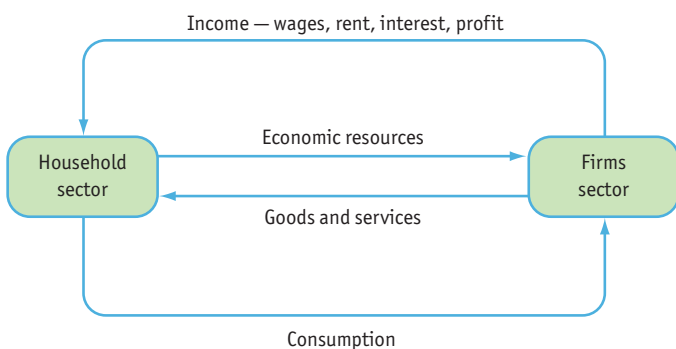
13.1

Economic links

Vanessa had a sudden flash of inspiration about how to best present her Commerce assessable task. 'I have always enjoyed model making so this could be a good place to start,' she thought. Vanessa's Commerce task was to explain the links within the economy. Her central theme was to be *income*.

The simple economic model

Vanessa had learned from her design teacher that when building a model it is easiest to start simply and build up to a more complex model. She started with just two groups of people. She called them 'households' and 'firms'. The household sector was made up of consumers. They were people who owned the economic resources (land, labour, capital and enterprise). Vanessa knew that they 'sold' their resources to firms that then used them to produce goods and services. This was called *production*. The firms paid an income for these resources. Households then used these incomes to purchase the goods and services produced by the firms. She knew this was called *consumption*. She called this version of the economy a two-sector model.

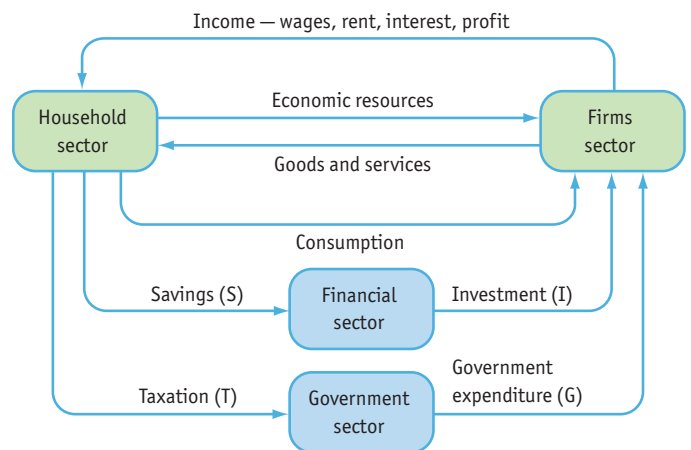


Vanessa's simple two-sector circular flow of income model

More complex models

Vanessa realised that this simple model did not adequately represent the economy. For a start, she knew that people do not spend all their income on consumption, but instead save part of it. Also, having a part-time job, she couldn't forget the money taken out as tax by the government. This meant two other sectors had to be added.

She labelled these sectors the financial sector and the government sector. Vanessa knew that firms paid taxes to the government and also saved with the financial sector but, to keep her model uncluttered, she drew money flowing from the household sector to these two new sectors and returning to the system through the firms sector. Vanessa recalled that money which is saved with the financial sector often returns to firms in the form of **investment**, while the money from taxation is used for government spending. She called this new version of the economy a four-sector model.



Vanessa's four-sector model of the economy

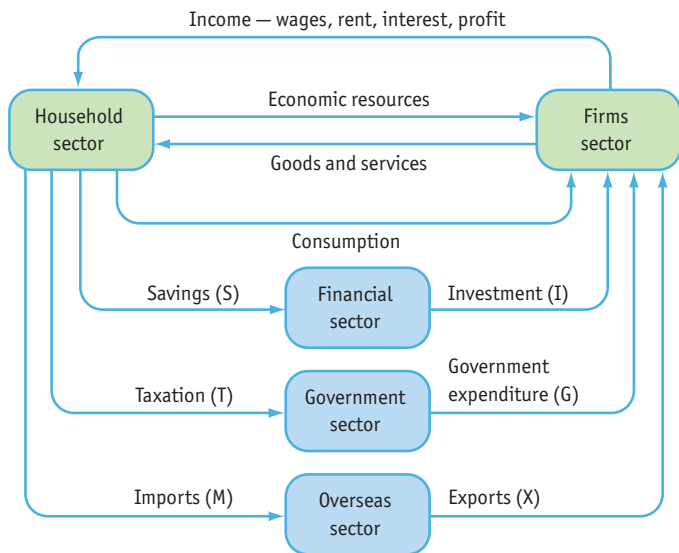
To complete her model, Vanessa had to add one more sector. Politicians are always talking about Australia's international trade, mentioning exports and imports and their effect on the economy. She called this the overseas sector and her final model was then ready to show the class.

Vanessa named her model 'The circular flow of income: a **macroeconomic** model'. When explaining it to the class, she said this:

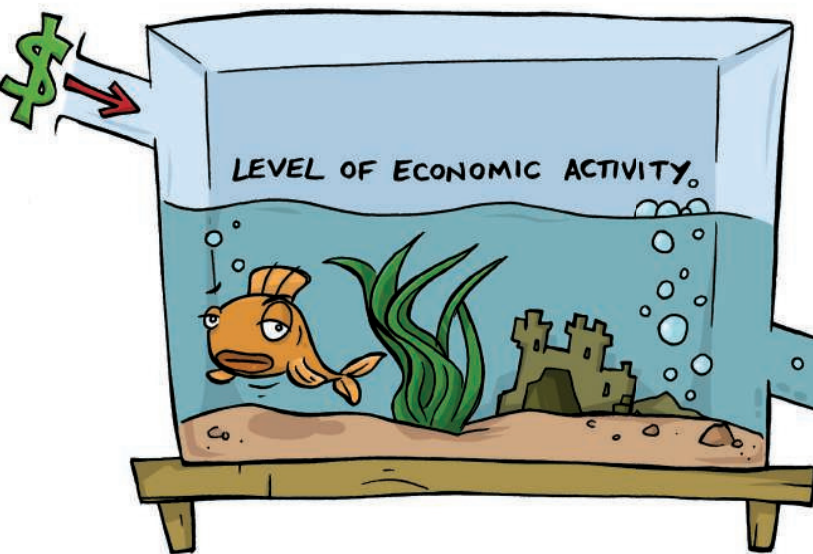
The diagram shows how each sector is dependent on others through money flows. Savings, taxation and imports are referred to as leakages (money leaving) from the model. Investment, government expenditure and exports are the injections (money entering) into the model.

Because leakages seldom equal injections, the level of economic activity fluctuates. Picture the economy as a fish tank. When more money enters the economy than leaves (injections are greater

than leakages) the economy will expand and experience economic growth. When more money leaves the economy than enters (leakages are greater than injections) the economy will contract and experience economic decline. To avoid the problems associated with growth or decline, the government tries to influence the decisions made by sectors to alter the flows of money, in order to achieve the correct balance in the economy.



Vanessa's completed model of the economy



The effect of injections and leakages is to raise or lower the level of economic activity.

The flow of money

Money is the medium used to exchange goods and services. It therefore links the main sectors within our economy: consumers, employers, businesses and governments.

Money is constantly flowing throughout the whole economy. It is what makes our economy function.

Oil is the lubricant that keeps your car engine running smoothly; in the same way, money is the oil that keeps our economic system working. Without money we would have to go back to bartering. This would result in fewer and weaker links between the sectors and a lower standard of living.

Activities

Understand

- What five sectors comprise the Australian economy?
- What is meant by the terms 'leakage' and 'injection'?
- If leakages are greater than injections, as described by Vanessa's model, suggest the effect that this will have on the economy.
- Complete the following table using appropriate symbols. The first one has been filled in for you.

Model (Sectors)	Leakages	Injections
(a) Three	S	—
(b) Four	— + —	— + —
(c) Five	— + — + —	— + — + —

- Explain the importance of money in our economy.

Think

- Copy the following table into your notebook. Next to each statement indicate whether each event will expand or contract the level of economic activity.

Statement	Expand or contract
(a) Increased investment	
(b) Higher taxes	
(c) Rising export sales	
(d) Reduced government spending	

- Using the completed five-sector model, identify the money flows which best describe each of the following transactions.

- An employee collects his wages.
- A car manufacturer installs a new welder.
- A teenager opens a bank account.
- A school student buys a mobile phone.
- An Australian miner sells iron ore to China.
- An employee pays income tax.

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Worksheet 13.1 Explore the circular flow of income model.

Glossary

investment the purchase of new plant and equipment

macroeconomics the study of the economy as a whole