The Circular Flow Model

**Key Concepts:**

- The **circular flow model** illustrates the economic relationships among all players in the economy: households, firms, the factors market, the goods-and-services market, government, and foreign trade.
- In the macroeconomy, spending must always equal income.

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**Components of the circular flow model**

The **circular flow model** is a diagram illustrating the flow of spending and income in an economy.

The counterclockwise arrows represent the flow of money. The clockwise arrows represent the flow of goods and services.

In a **closed economy**, such as the example to the left, all the spending of households and firms must equal the income received by the factors and goods-and-services markets.

As households and firms pay the government net taxes, money and resources flow outside the model.

Government spending on goods and services must equal the income received from taxes that households and firms pay to the government.

Foreign trade in an **open economy** also allows money and resources to leak out of the circular flow model.

For macroeconomic equilibrium to occur, total spending must equal total income received from all players in the economy.