Economic Flows

The five-sector circular flow of income, aggregate demand, the economic cycle and the forces that move them

How to use this guide

Information in this guide is colour-coded and labelled. Each coloured box carries a word label as well as a colour, so you can use it whether or not you distinguish the colours easily.

KEY DEFINITION	The precise meaning of a syllabus term. Learn the wording.
AUSTRALIAN CONTEXT	Real Australian evidence or data you can quote as examples.
WORKED EXAMPLE	A model, diagram or calculation worked through step by step.
COMMON MISTAKE	An error that commonly costs marks — check yourself against it.
EXAM TIP	How to turn the knowledge into marks in an exam response.
BRETTONOMICS INTERACTIVE	A matching interactive tool on brettonomics.com.

SECTION 1 Key concepts and terminology

1.1 The core terms

Term	What it means
Circular flow of income model	A model showing the flows of resources, goods, services and money between the five sectors of the economy. It shows how spending by one party becomes income for another.
Aggregate demand	Total planned spending on an economy's goods and services over a period: C + I + G + (X − M).
Aggregate supply	The total quantity of goods and services producers are willing and able to supply over a period, determined by the economy's productive capacity.
Consumption (C)	Household spending on goods and services. The largest component of aggregate demand in Australia.
Investment (I)	Business spending on capital goods — plant, equipment, buildings and inventories. Not the purchase of shares.

Term	What it means
Government expenditure (G)	Government spending on goods and services, including public sector wages and infrastructure. Excludes transfer payments such as pensions.
Exports (X)	Goods and services produced domestically and sold overseas, bringing foreign income into the flow.
Imports (M)	Goods and services produced overseas and bought domestically, taking income out of the flow.
Gross domestic product (GDP)	The total market value of all final goods and services produced within an economy over a period.
Taxes (T)	Compulsory payments to government by households and businesses. A withdrawal from the circular flow.
Subsidy	A government payment to producers that lowers their costs, encouraging greater output of a particular good or service.

COMMON MISTAKE

Investment does not mean buying shares. In economics, investment means spending on new capital goods that add to productive capacity. Buying existing shares transfers ownership of an asset; it is saving, not investment.

Government expenditure excludes transfers. Pensions and unemployment benefits are transfer payments — they move purchasing power to households, which then shows up in consumption. Counting them in G would double-count the spending.

IN ONE SENTENCE One party's spending is another party's income — that identity is what makes the flow circular.

SECTION 2 Building the five-sector model

2.1 The five sectors

Sector	What it does in the model
Households	Own the factors of production, supply them to businesses, receive factor incomes, and spend on goods and services
Businesses (firms)	Hire factors of production, pay factor incomes, and produce goods and services for sale
Financial sector	Receives savings from households and lends to businesses for investment

Sector	What it does in the model
Government	Collects taxation from households and businesses and spends on goods, services and infrastructure
Overseas (international)	Buys exports from domestic businesses and sells imports to domestic households and businesses

2.2 The assumptions the model makes

- Households own all factors of production and supply them to businesses.
- Businesses produce all goods and services and own no factors themselves.
- All income received is either spent, saved or taxed — there is no other use for it.
- Flows are continuous and measured over a period of time, not at a point in time.
- The model shows the direction and size of flows, not the prices at which transactions occur.

2.3 How to draw it

WORKED EXAMPLE

Constructing the five-sector diagram

1. Place the two core sectors. Draw households on one side and businesses on the other.

2. Draw the two inner flows. Factors of production flow from households to businesses; factor incomes (rent, wages, interest, profit) flow back from businesses to households.

3. Draw the goods market. Goods and services flow from businesses to households; consumption expenditure flows back from households to businesses.

4. Add the three outer sectors. Place the financial sector, government and overseas sector between the two core sectors.

5. Put withdrawals on one side. Savings, taxation and imports all leave the flow — draw them together on one side.

6. Put injections on the opposite side. Investment, government expenditure and exports all enter the flow — draw them on the opposite side, as the syllabus requires.

7. Label everything. Mark each flow with its symbol: S, T, M on the withdrawals side and I, G, X on the injections side.

EXAM TIP

Diagram marks are earned on labels. A diagram with arrows but no labels earns almost nothing. Label every sector, every flow and the direction of each arrow, and separate withdrawals from injections as the syllabus specifies.

BRETTONOMICS INTERACTIVE

Circular Flow of Income — move a slider for any one flow and watch the diagram, aggregate demand, total injections and total leakages respond

brettonomics.com/circular-flow-of-income

IN ONE SENTENCE Five sectors, two inner flows between households and businesses, three withdrawals and three injections.

SECTION 3 Injections, withdrawals and equilibrium

3.1 The three withdrawals and three injections

Flow	Type	Where it goes or comes from
Savings (S)	Withdrawal	Household income placed with the financial sector rather than spent
Taxation (T)	Withdrawal	Income paid to government rather than spent on domestic output
Imports (M)	Withdrawal	Spending that flows to overseas producers rather than domestic ones
Investment (I)	Injection	Business spending on capital, funded through the financial sector
Government expenditure (G)	Injection	Government spending on domestic goods and services
Exports (X)	Injection	Overseas spending on domestically produced goods and services

3.2 The equilibrium condition

KEY DEFINITION

Equality of the totals, not of the pairs

The condition. The circular flow is in equilibrium when total injections equal total withdrawals: I + G + X = S + T + M.

When injections exceed withdrawals. More money enters the flow than leaves it. The flow expands, output and income rise, and the economy grows.

When withdrawals exceed injections. More money leaves the flow than enters it. The flow contracts, output and income fall, and unemployment tends to rise.

3.3 Why equilibrium does not require S = I, T = G and M = X

- Equilibrium requires only that the three withdrawals together equal the three injections together. The individual pairs need not match.
- The sectors are connected through the financial system, so a withdrawal through one channel can be returned to the flow through another.
- For example, household savings may be lent to government to fund a budget deficit rather than to businesses for investment. Saving still exceeds investment, yet the flow is in balance because G exceeds T by the same amount.

WORKED EXAMPLE

An economy in equilibrium with no matching pairs

The figures. Savings $100bn, taxation $150bn, imports $120bn. Investment $90bn, government expenditure $180bn, exports $100bn.

Check each pair. S $100bn is greater than I $90bn. T $150bn is less than G $180bn. M $120bn is greater than X $100bn. No pair matches.

Total the withdrawals. $100bn + $150bn + $120bn = $370bn.

Total the injections. $90bn + $180bn + $100bn = $370bn.

Conclude. Total injections equal total withdrawals, so the circular flow is in equilibrium despite every individual pair being unequal.

COMMON MISTAKE

Do not require the pairs to match. A very common error is to claim an economy is out of equilibrium because savings exceed investment. Always total the three withdrawals and compare them with the three injections.

IN ONE SENTENCE Equilibrium is S + T + M = I + G + X. Individual pairs can differ and frequently do.

SECTION 4 Aggregate demand and GDP

4.1 The components of aggregate demand

KEY DEFINITION

The aggregate demand equation

The equation. AD = C + I + G + (X − M).

Net exports. The bracketed term is net exports. Imports are subtracted because they represent spending on foreign output, which does not generate domestic income.

Relative size in Australia. Consumption is much the largest component, typically over half of aggregate demand. Investment is the most volatile. Net exports can be positive or negative.

4.2 The link between aggregate demand and GDP

- Aggregate demand measures total planned spending on domestic output over a period.
- Because every dollar spent on domestic output becomes income for someone producing it, the level of aggregate demand determines the level of output and income — that is, GDP.
- If aggregate demand rises, firms produce more, employ more and pay more income. GDP rises. If it falls, the reverse occurs.
- This is why the circular flow and aggregate demand are two descriptions of the same thing: the flow is the mechanism, aggregate demand is its size.

4.3 Finding GDP in the national accounts

AUSTRALIAN CONTEXT

Where the data lives. The Australian Bureau of Statistics publishes GDP quarterly in Australian National Accounts: National Income, Expenditure and Product, available free at abs.gov.au under the National Accounts topic.

Which figure to use. Quote real GDP growth, not nominal, when discussing whether the economy is genuinely expanding. Real GDP removes the effect of price changes; nominal GDP does not.

What to look for. The expenditure breakdown reports household consumption, private investment, government spending and net exports separately — the components of aggregate demand set out in the national accounts.

BRETTONOMICS INTERACTIVE

Gross Domestic Product — trace Australian GDP in levels and in annual growth, and read the analysis of each major episode
brettonomics.com/gross-domestic-product

IN ONE SENTENCE AD = C + I + G + (X − M), and the level of aggregate demand determines the level of GDP.

SECTION 5 The resources and goods markets

5.1 Two markets, two directions

Market	What is traded	Who supplies	Who buys	The money flow
Resources market	Land, labour, capital, enterprise	Households	Businesses	Factor incomes to households
Goods market	Finished goods and services	Businesses	Households	Consumption expenditure to businesses

5.2 Why both are needed

- Households and businesses meet in both markets, but in opposite roles. Households sell in the resources market and buy in the goods market; businesses do the reverse.
- The two markets are what make the flow circular. Income earned by selling factors funds the purchase of goods, and spending on goods funds the payment of factor incomes.
- A real flow and a money flow run in opposite directions in each market. Resources and goods move one way; payments move the other.

> EXAM TIP
>
> **Name the market when you explain a change.** If unemployment rises, say that it originates in the resources market and reduces factor income, which then reduces spending in the goods market. Tracing the effect through both markets demonstrates the model rather than merely describing an outcome.

> IN ONE SENTENCE The resources market pays income to households; the goods market returns that income to businesses.

SECTION 6 Forces that change the size of the flow

6.1 What to watch, and where to find it

Force	Which flow it affects	ABS or RBA series to consult
Retail sales growth	Consumption (C)	ABS Retail Trade, Australia — monthly
Business investment	Investment (I)	ABS Private New Capital Expenditure and Expected Expenditure — quarterly
Exports and imports	Net exports (X − M)	ABS International Trade in Goods and Services — monthly
Consumer confidence	Consumption (C)	Westpac–Melbourne Institute Consumer Sentiment Index — monthly
Business confidence	Investment (I)	NAB Monthly Business Survey
Household saving ratio	Savings (S)	ABS National Accounts — quarterly

6.2 How confidence moves the flow

- When households expect secure employment and rising incomes, they spend a larger share of income. Consumption rises, the flow expands, and businesses respond by producing more.
- When confidence falls, households save a larger share as a precaution. Savings rise, consumption falls, and the flow contracts.
- Business confidence works the same way on investment. Firms commit to new capital only when they expect demand to justify it, which makes investment the most volatile component of aggregate demand.

6.3 Other events that move the flow

- **A minimum wage rise:** raises household incomes, lifting consumption — though firms may offset part of this by reducing hours.
- **A subsidy to an industry:** lowers production costs, encouraging output and investment in the subsidised industry.
- **Currency movements:** a falling Australian dollar makes exports cheaper for foreign buyers and imports dearer, raising X and reducing M.
- **Conditions in a major trading partner:** a slowdown in a major trading partner reduces demand for Australian exports, contracting the flow.

> IN ONE SENTENCE Anything that changes C, I, G, X or M changes the size of the flow and therefore the level of income.

SECTION 7 Government spending and taxation in the flow

7.1 The two government flows

- Taxation is a withdrawal. It removes income from households and businesses before it can be spent on domestic output.
- Government expenditure is an injection. It adds spending on domestic goods and services directly to the flow.
- The net effect depends on which is larger, not on the size of either alone.

7.2 Budget outcomes and the flow

Budget position	Relationship	Effect on the circular flow
Deficit	G exceeds T	Net injection — the flow expands, raising aggregate demand and GDP
Surplus	T exceeds G	Net withdrawal — the flow contracts, reducing aggregate demand and GDP
Balanced	G equals T	No net effect on the size of the flow from the government sector

COMMON MISTAKE

A surplus is not automatically good for the economy. A surplus withdraws more from the flow than it injects, which slows aggregate demand. Whether that is desirable depends on the stage of the economic cycle. In a boom it helps restrain inflation; in a downturn it deepens the contraction.

EXAM TIP

At this level, keep the analysis directional. Unit 1 asks for the direction of the effect on the flow, not a full fiscal stance analysis with cyclical and structural components. That complexity belongs to Units 3 and 4. State the direction clearly and link it to aggregate demand.

IN ONE SENTENCE A deficit injects more than it withdraws and expands the flow; a surplus does the opposite.

SECTION 8 The cash rate, basis points and percentage points

8.1 What the cash rate is

- The cash rate is the Reserve Bank of Australia's policy interest rate — the rate on unsecured overnight loans between banks.
- It anchors the interest rates banks charge on loans and pay on deposits, so a change in the cash rate transmits through the whole economy.

8.2 How a cash rate change moves the flow

If the RBA...	Borrowing costs	Consumption (C)	Investment (I)	The flow
Raises the cash rate	Rise	Falls — higher mortgage repayments leave less to spend	Falls — fewer projects are profitable	Contracts
Lowers the cash rate	Fall	Rises — lower repayments free up income	Rises — more projects become profitable	Expands

8.3 Basis points and percentage points

KEY DEFINITION

Three ways to describe the same move

Percentage point. The arithmetic difference between two percentages. A move from 4.10% to 4.35% is a rise of 0.25 percentage points.

Basis point. One hundredth of a percentage point. 1 basis point = 0.01 percentage points, so 100 basis points = 1 percentage point. The 0.25 percentage point move above is 25 basis points.

Per cent change. A proportional change. From 4.10% to 4.35% is a rise of 0.25 ÷ 4.10 = 6.1 per cent. This is a different number from the 0.25 percentage point change, and the two must not be confused.

AUSTRALIAN CONTEXT

The Australian cash rate cycle. The cash rate sat at a record low of 0.10 per cent from November 2020. From May 2022 the RBA raised it at thirteen meetings to 4.35 per cent by November 2023 — a rise of 4.25 percentage points, or 425 basis points — and held it there throughout 2024.

The easing and the turn. Three cuts of 25 basis points each during 2025 took the rate to 3.60 per cent by August 2025. The RBA then tightened again through 2026, reaching 4.85 per cent in November 2026.

Why it matters for this topic. Each move changes the cost of borrowing, which changes consumption and investment, which changes the size of the circular flow. Always check the current rate before using it in assessment, because it changes several times a year.

COMMON MISTAKE

Never write "the RBA raised rates by 0.25 per cent". A rise from 4.10 to 4.35 is 0.25 percentage points, not 0.25 per cent. Written as a per cent change it is about 6 per cent. Examiners mark this distinction.

IN ONE SENTENCE 100 basis points = 1 percentage point. Rate rises contract the flow; rate cuts expand it.

SECTION 9 The economic cycle

9.1 The four phases

Phase	What happens to the flow	Typical conditions
Expansion (recovery)	Injections exceed withdrawals; the flow grows	Output and employment rising, confidence improving
Peak (boom)	The flow is at its largest	Low unemployment, capacity pressures, inflation rising

Phase	What happens to the flow	Typical conditions
Contraction (downturn)	Withdrawals exceed injections; the flow shrinks	Output falling, unemployment rising, confidence weak
Trough	The flow is at its smallest	High unemployment, low inflation, spare capacity

9.2 How government can smooth the cycle

- In a downturn, government can increase expenditure or reduce taxation, raising net injections and supporting the flow.
- In a boom, it can reduce expenditure or raise taxation, increasing net withdrawals and restraining inflationary pressure.
- The Reserve Bank can act alongside this by lowering the cash rate in a downturn and raising it in a boom.
- Some smoothing happens automatically: in a downturn, tax receipts fall and welfare payments rise without any new decision being taken.

BRETTONOMICS INTERACTIVE

The Business Cycle — drag along the cycle to move between phases and watch output, unemployment and inflation respond

brettonomics.com/business-cycle

IN ONE SENTENCE The cycle is the flow expanding and contracting; policy aims to reduce the size of the swings.

SECTION 10 The paradox of thrift

10.1 The paradox

KEY DEFINITION

What is sensible for one is damaging for all

For one household. Saving more is prudent. It builds a buffer against job loss and funds future spending, and it has no measurable effect on the economy.

For every household at once. If all households save more simultaneously, consumption falls sharply. Aggregate demand falls, businesses produce less, employment falls and incomes fall.

The paradox. Because income has fallen, total saving may end up no higher — and can end up lower — than before. The attempt to save more collectively defeats itself.

10.2 The fallacy of composition

- The paradox of thrift is one example of the fallacy of composition: assuming that what is true of one part must be true of the whole.
- The circular flow model exposes the fallacy by showing that one household's saving is a withdrawal from a flow that forms another household's income.
- The same reasoning applies elsewhere. One firm cutting wages may gain a cost advantage; every firm cutting wages reduces household income and therefore demand for everyone's output.

> EXAM TIP
>
> **Use the flow to prove the point.** A strong answer traces the mechanism: higher saving means a larger withdrawal, which reduces consumption, which reduces business revenue, which reduces factor incomes, which reduces the income out of which saving is done. Do not simply assert the paradox.

> IN ONE SENTENCE What is prudent for one household is contractionary for all — the flow turns individual saving into lost income.

SECTION 11 Aggregate supply, capacity and growth

11.1 Factors that raise aggregate supply

Factor	How it raises productive capacity
Technology	Raises output per unit of input across industries
Innovation	Creates new products and more efficient processes
Entrepreneurship	Combines resources in more productive ways and brings new ventures to market
Immigration	Adds to the size and skill level of the labour force
Investment in capital	Increases the stock of equipment and infrastructure each worker has to work with
Education and training	Raises human capital, lifting output per hour worked

11.2 The link back to the production possibility curve

- An increase in aggregate supply means the economy can produce more with its resources — exactly what an outward shift of the production possibility curve represents.
- Aggregate demand determines where in the economy production currently sits; aggregate supply determines the outer limit of what is possible.
- If aggregate demand rises while capacity is unchanged, the economy moves toward its frontier. Once there, further demand raises prices rather than output.
- Sustained economic growth therefore requires the frontier itself to move outward, which means raising aggregate supply.

WORKED EXAMPLE

Tracing a supply-side change through the model

The event. A skilled migration programme raises the size and skill level of the labour force.

Effect on capacity. Aggregate supply rises; the production possibility curve shifts outward.

Effect on the flow. More workers earn factor incomes, so consumption rises and the flow expands.

Effect on employment. Output can rise without the labour shortages that would otherwise force wages and prices up.

The judgement. Capacity and demand both rise, so growth can continue without adding to inflationary pressure — which is why supply-side measures are described as expanding the economy's potential.

IN ONE SENTENCE Aggregate demand sets the current size of the flow; aggregate supply sets the limit it can reach.

ASSESSMENT Multiple choice questions

20 questions covering the circular flow of income, aggregate demand, the economic cycle and the forces that move them. Answers and explanations follow the question set.

Question 1

The five sectors of the circular flow of income model are:

A. Households, businesses, banks, exporters and importers

B. Consumers, producers, retailers, wholesalers and government

C. Households, businesses, the financial sector, government and the overseas sector

D. Primary, secondary, tertiary, quaternary and quinary industries

Question 2

Which of the following is a withdrawal from the circular flow of income?

A. Taxation

B. Government expenditure

C. Exports

D. Investment

Question 3

In the circular flow model, the equilibrium condition is:

A. S = I, T = G and M = X simultaneously

B. C + I + G = S + T + M

C. Total income equals total consumption

D. S + T + M = I + G + X

Question 4

An economy records savings of $80bn, taxation of $140bn and imports of $110bn, with investment of $70bn, government expenditure of $170bn and exports of $90bn. This economy is:

A. Out of equilibrium, because savings exceed investment

B. In equilibrium, because total withdrawals of $330bn equal total injections of $330bn

C. Out of equilibrium, because imports exceed exports

D. Expanding, because government expenditure exceeds taxation

Question 5

Aggregate demand is correctly expressed as:

A. C + I + G + (M − X)

B. C + S + T + (X − M)

C. C + I + G + (X − M)

D. C + I + G + X + M

Question 6

In economics, "investment" as a component of aggregate demand means:

A. Household purchases of shares and bonds
B. Money deposited in savings accounts at a bank
C. Government spending on welfare payments
D. Business spending on new capital goods such as plant, equipment and buildings

Question 7

If total injections exceed total withdrawals, the most likely result is that:

A. The circular flow expands, raising output, income and employment
B. The circular flow contracts, reducing output and income
C. The flow remains unchanged because the sectors offset each other
D. Savings automatically rise to restore the original flow

Question 8

A government budget surplus affects the circular flow by:

A. Acting as a net injection, which expands the flow
B. Acting as a net withdrawal, which contracts the flow and reduces aggregate demand
C. Having no effect, because taxation and spending always offset
D. Raising investment automatically through the financial sector

Question 9

The Reserve Bank of Australia raises the cash rate. The most likely effect on the circular flow is that:

A. Consumption and investment rise, expanding the flow
B. Exports rise, expanding the flow
C. Government expenditure rises to offset the change
D. Consumption and investment fall, contracting the flow

Question 10

The cash rate moves from 3.60 per cent to 3.85 per cent. This is correctly described as a rise of:

A. 0.25 per cent
B. 2.5 basis points
C. 25 basis points, or 0.25 percentage points
D. 25 per cent

Question 11

The paradox of thrift states that:

A. If all households attempt to save more at once, falling consumption reduces income so that total saving may not rise
B. Households always save too little for their retirement needs
C. Saving is harmful to an individual household's financial position
D. Higher interest rates always reduce the level of household saving

Question 12

The paradox of thrift is an example of the fallacy of composition because it shows that:

A. Economic models are unable to make accurate predictions

B. What is true for one part of the economy is not necessarily true for the economy as a whole

C. Households behave irrationally when interest rates change

D. Saving and investment can never be equal in an open economy

Question 13

In the resources market of the circular flow model:

A. Businesses supply goods and services to households in return for consumption spending

B. The financial sector lends savings to businesses for investment

C. Households supply factors of production to businesses and receive factor incomes in return

D. The government collects taxation from households and businesses

Question 14

Which event would most directly increase the injection component of Australia's circular flow?

A. An increase in household saving as a precaution

B. A rise in Australian household spending on imported cars

C. An increase in the rate of income taxation

D. A rise in overseas demand for Australian iron ore

Question 15

A fall in the value of the Australian dollar would be expected to:

A. Reduce exports and raise imports, reducing net injections

B. Raise exports and reduce imports, increasing net injections into the flow

C. Leave the flow unchanged, because trade flows offset exactly

D. Reduce both exports and imports simultaneously

Question 16

The connection between aggregate demand and GDP is that:

A. The level of aggregate demand determines the level of output and income produced, which is measured as GDP

B. GDP measures productive capacity while aggregate demand measures prices

C. Aggregate demand and GDP are unrelated measures of different economies

D. GDP determines aggregate demand by setting the level of government spending

Question 17

Which of the following would shift Australia's production possibility curve outward and raise aggregate supply?

A. A rise in household consumption spending

B. An increase in the government budget deficit

C. A skilled migration programme that increases the size and skill level of the labour force

D. A fall in the exchange rate that raises export demand

Question 18

An economy is operating close to full capacity and aggregate demand rises further. The most likely result is:

A. A large rise in output with no effect on prices

B. An immediate outward shift of the production possibility curve

C. A fall in employment as firms reduce production

D. Rising prices rather than a substantial rise in output

Question 19

Government expenditure in the circular flow model excludes transfer payments such as pensions because:

A. Transfers move purchasing power to households, where the spending is already counted as consumption

B. Transfer payments are too small to affect the circular flow

C. Transfer payments are classified as a withdrawal rather than an injection

D. Pensions are paid by state governments rather than the Commonwealth

Question 20

Business investment is usually the most volatile component of aggregate demand because:

A. It is the largest component of aggregate demand in Australia

B. It depends heavily on expectations of future demand and on the cost of borrowing, both of which change quickly

C. Governments change investment levels directly each budget

D. It is unaffected by interest rates or business confidence

ASSESSMENT

Marking guide

Answer key

Q1	Q2	Q3	Q4	Q5	Q6	Q7	Q8	Q9	Q10
C	A	D	B	C	D	A	B	D	C
Q11	**Q12**	**Q13**	**Q14**	**Q15**	**Q16**	**Q17**	**Q18**	**Q19**	**Q20**
A	B	C	D	B	A	C	D	A	B

Explanations

Q1 **C** The five-sector model adds the financial, government and overseas sectors to the two core sectors of households and businesses.

Q2 **A** Savings, taxation and imports are withdrawals. Investment, government expenditure and exports are injections.

Q3 **D** Equilibrium requires total withdrawals to equal total injections. The individual pairs need not be equal.

Q4 **B** Withdrawals total $80 + $140 + $110 = $330bn and injections total $70 + $170 + $90 = $330bn, so the flow is in equilibrium despite no pair matching.

Q5 **C** Imports are subtracted because that spending flows to foreign producers and does not generate domestic income.

Q6 **D** Investment means spending that adds to the capital stock. Buying existing financial assets transfers ownership and is classified as saving.

Q7 **A** More money entering the flow than leaving it expands the flow, raising aggregate demand, output and income.

Q8 **B** In a surplus, taxation withdrawn exceeds government expenditure injected, so the government sector is a net withdrawal.

Q9 **D** A higher cash rate raises borrowing costs, which reduces both household consumption and business investment, contracting the flow.

Q10 **C** One basis point is 0.01 percentage points, so a 0.25 percentage point rise is 25 basis points. Expressed as a per cent change it would be about 6.9 per cent.

Q11 **A** The paradox arises because one household's saving is a withdrawal from a flow that forms another household's income.

Q12 **B** The fallacy of composition is the error of assuming the whole behaves like the part. The circular flow exposes it by tracing the effect of saving on income.

Q13 **C** The resources market is where households sell land, labour, capital and enterprise, earning rent, wages, interest and profit.

Q14 **D** Higher export demand raises X, an injection. The other three options all increase withdrawals.

Q15 **B** A lower dollar makes Australian goods cheaper for foreign buyers and imports dearer domestically, so X rises and M falls.

Q16 **A** Every dollar of spending on domestic output becomes income for those producing it, so aggregate demand determines the level of GDP.

Q17 **C** Aggregate supply depends on productive capacity. The other three options raise aggregate demand without changing what the economy is capable of producing.

Q18 **D** Once an economy is at its frontier, additional demand cannot be met with additional output, so it is absorbed by higher prices.

Q19 **A** Counting a transfer in G and again in C when the household spends it would double-count the same spending.

Q20 **B** Firms commit to capital spending only when they expect future demand to justify it, so investment swings sharply with confidence and interest rates. Consumption, not investment, is the largest component.