

Unit 3: Understanding the National Economy

People experience the national economy through prices, wages, employment, taxes, interest rates, public services, and the cost of borrowing. A family may notice that food has become more expensive, a worker may struggle to find enough hours of work, or a business may postpone expansion because loans are costly. These experiences are connected to broader economic activities involving households, firms, government, banks, and the rest of the world.

Chapters 9 to 13 explain how these parts of the economy are linked. The unit begins with the circular flow of income, which shows how production, spending, income, savings, taxes, investment, and trade move across different sectors. It then examines how economic activity is measured through GDP and GNI, and why these indicators are useful but incomplete measures of well-being.

The unit also discusses inflation, unemployment, underemployment, informality, and job mismatch. Economic growth does not automatically mean that all people have stable jobs, adequate income, or access to essential services. A country may report rising national income while many families continue to face high prices, insecure work, weak public services, and unequal opportunities.

The final chapters introduce fiscal and monetary policy. Fiscal policy concerns government revenue, spending, transfers, deficits, and borrowing. Monetary policy concerns interest rates, credit, liquidity, exchange rates, and inflation expectations. These policies influence the economy through different channels and are most effective when they respond to the actual source of a problem.

The central lesson of this unit is that the economy is a system of relationships. Household spending becomes business income. Business production creates wages and profits. Taxes finance public services. Savings help support investment. Imports and exports connect the country to global markets. Government and central-bank decisions affect these flows, but their results depend on timing, implementation, productive capacity, and the behavior of households and firms.

After completing this unit, learners should be able to explain the circular flow of economic activity; distinguish GDP from GNI; interpret economic growth, inflation, and employment indicators; identify the limits of national-income measures; explain the causes and effects of unemployment and job mismatch; describe fiscal and monetary policy tools; and evaluate whether a policy is appropriate, timely, fairly designed, and sustainable.

Chapters in This Unit

Chapter 9: The Circular Flow of Economic Activity. Explains how production, income, spending, savings, investment, taxes, government expenditure, exports, and imports connect the major sectors of the economy.

Chapter 10: Measuring National Income and Economic Growth. Introduces GDP, GNI, nominal and real values, per-capita measures, growth rates, remittances, and the limitations of national-income statistics.

Chapter 11: Inflation and Employment. Discusses inflation, purchasing power, unemployment, underemployment, informality, contractual work, and job mismatch.

Chapter 12: Economic Instability and the Business Cycle. Examines expansions, slowdowns, recessions, recoveries, economic shocks, and their effects on households and sectors.

Chapter 13: Fiscal and Monetary Policies. Explains taxation, spending, social protection, deficits, debt, interest rates, liquidity, monetary-policy transmission, and the coordination and limits of fiscal and monetary policy.

Unit Key Idea: The national economy is more than a set of statistics. It is a system through which production, income, work, prices, public decisions, and financial conditions shape people's opportunities and vulnerabilities.

Chapter 9 | How Money, Goods, and Income Move Through the Economy

Comic strip idea: the spending of one sector becomes the income of another, linking households, firms, banks, government, and the wider economy.

A household receives wages, buys groceries, pays taxes, saves in a bank, and sends money to a relative. A business pays workers, imports equipment, borrows for expansion, and sells products at home and abroad. Government collects revenue and purchases medicines, roads, and other services. These transactions may look separate, but they form an interconnected system.

The circular flow model is a simplified way of seeing those connections. It shows how the spending of one sector becomes the income of another and how changes in one part of the economy can spread to households, firms, government, finance, and the rest of the world.

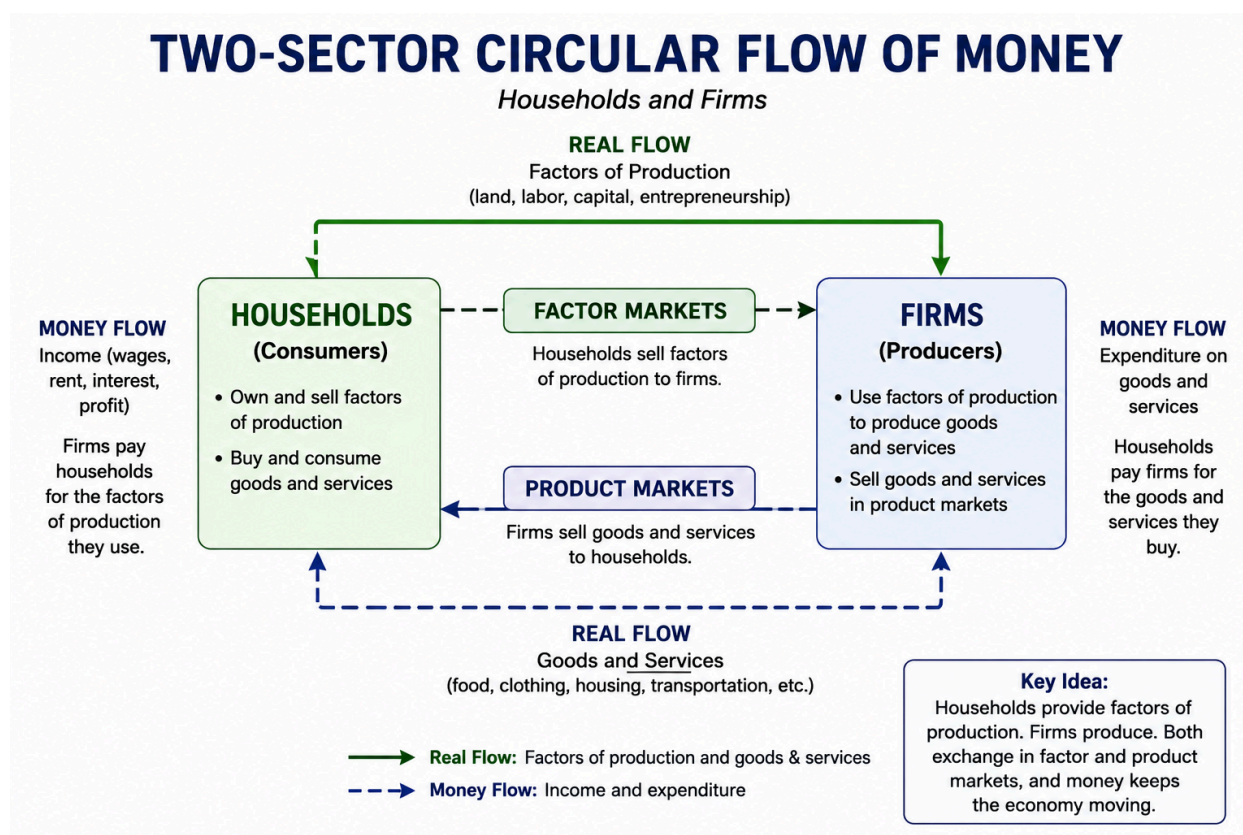
Like all models, it leaves out many details. Its value is that it makes interdependence visible. It helps explain why a fall in household spending can affect employment, why saving matters for investment, how taxes return to the economy through public spending, and why exports, imports, and remittances connect domestic activity to events abroad.

A. Start with Two Sectors: Households and Firms

The simplest circular flow has only two sectors: households and firms.

Households supply labor, land, capital, and entrepreneurial effort. In return, they receive income in the form of wages, rent, interest, and profits. Firms use these productive resources to make goods and services. Households then use part of their income to purchase what firms produce.

This creates two flows moving in opposite directions.



Key Idea: When a household buys a meal, the payment becomes revenue for the business. The business uses its revenue to pay workers, suppliers, rent, taxes, and other costs. The income received by those workers and suppliers can then be spent again.

B. Following One Household Through the Economy

Consider the Santos household. One parent works for a food-processing company. Another operates a small online business. The family receives a monthly remittance from a relative working overseas.

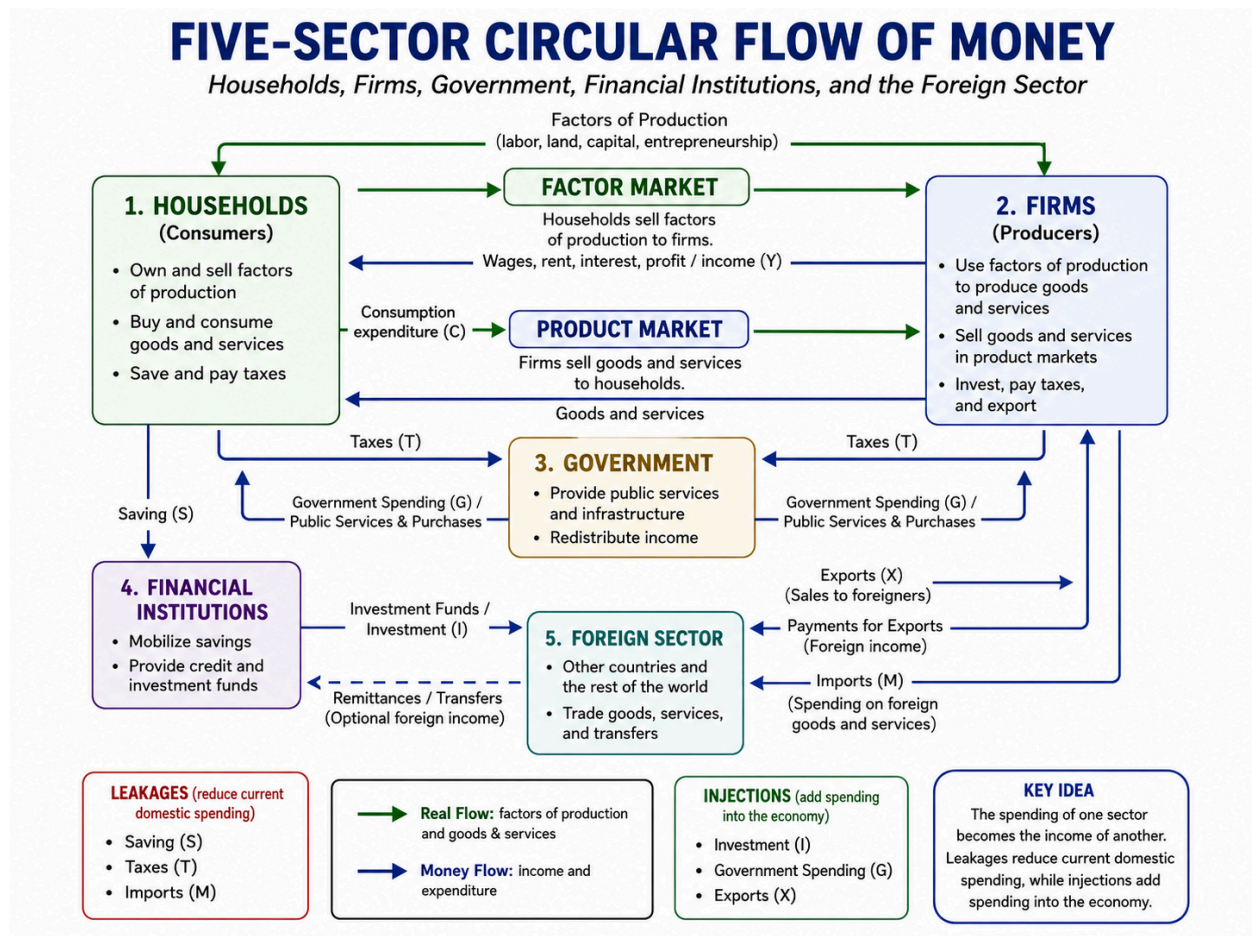
During the month, the household buys food and transport services, pays electricity and internet bills, saves part of its income in a cooperative, pays taxes, and purchases an imported mobile phone. The cooperative lends part of its funds to a local bakery. Government uses tax revenue to purchase supplies for a public health center.

This single household is connected to all five sectors of the circular flow:

- Households receive income, consume, save, pay taxes, and buy imported goods.
- Firms employ workers, purchase inputs, produce goods and services, borrow, invest, and trade.
- Financial institutions receive savings and channel funds toward loans and investments.
- Government collects taxes and purchases goods and services or provides transfers.

- The foreign sector buys exports, supplies imports, and sends or receives income and transfers.

C. The Five Sectors



1. Households

The household sector includes individuals and families. Households provide productive resources and receive income. They use that income for consumption, taxes, saving, debt repayment, and transactions with the rest of the world.

Household consumption is especially important in the Philippines. World Bank analysis has described household spending as a major driver of Philippine growth, accounting for more than two-thirds of gross domestic product before the pandemic (World Bank, 2020).

Households are not identical. Income, household size, location, employment security, and access to services affect how much they can spend or save. A circular-flow diagram treats households as one sector, but the effects of economic changes are distributed unequally.

2. Firms

Firms produce goods and services. They pay households for labor and other productive resources, purchase inputs from other firms, pay taxes, borrow, invest, and sell to domestic and foreign buyers.

Firms range from large corporations to family stores and informal enterprises. An unregistered food stall or home-based producer is still part of economic production even when the transaction is difficult to capture in official records. The Philippine Statistics Authority defines the informal sector as household unincorporated enterprises operated by own-account workers or informal employers (PSA, 2020).

3. Government

Government collects taxes and other revenues and uses them to purchase goods and services, pay public employees, build infrastructure, and support social programs.

Not every item in the government budget enters the circular flow in the same way. Government purchases of medicines, school supplies, and construction services directly create demand for current production. Cash assistance and pensions are transfers: they raise household income, but they enter gross domestic product only when recipients spend them on final goods and services.

The next chapter will examine how taxation, spending, borrowing, and central-bank decisions are used as fiscal and monetary policy. In this chapter, government is introduced mainly as one sector receiving and making payments.

4. Financial Institutions

Banks, cooperatives, insurance companies, pension funds, and other financial institutions connect savers with borrowers. Households and firms place funds in deposits and other financial assets. Financial institutions use part of these funds to finance home purchases, business equipment, inventories, and government borrowing.

Saving does not automatically become productive investment. Funds may be held in liquid assets, lent for consumption, invested in property, or used to finance government. The quality of financial intermediation matters: the sector contributes more to development when it channels funds toward productive and broadly accessible uses.

The BSP reported that total deposits in the Philippine banking system reached a record ₱20.4 trillion at the end of 2024, illustrating the scale of funds passing through financial institutions (BSP, 2025a).

5. The Foreign Sector

The foreign sector represents transactions between residents of the Philippines and the rest of the world. Exports are domestically produced goods and services purchased by foreign buyers. Imports are goods and services produced abroad and purchased by residents. Remittances are different from exports: they are income or transfers sent by overseas Filipinos to households in the Philippines rather than payment for current domestic production.

Personal remittances reached a record US\$38.3 billion in 2024, according to the Bangko Sentral ng Pilipinas (BSP, 2025b). Remittances can support consumption, education, housing, saving, and small enterprises, linking household decisions to labor markets abroad.

Imports should not be viewed only as money leaving the country. Imported fuel, medicine, machinery, and intermediate inputs can support domestic production. The economic effect depends on what is imported, how it is financed, and whether it strengthens future productive capacity.

D. Leakages and Injections

The five-sector model identifies three leakages and three injections.

Leakages reduce current spending on domestically produced goods at a particular point in the flow. Injections add spending into domestic production.

Leakages and Related Injections			
Leakage	Meaning	Related injection	Meaning
Saving (S)	Income not used for current consumption	Investment (I)	Spending on capital goods or additions to productive capacity
Taxes (T)	Income transferred to government	Government spending (G)	Government purchases of goods and services
Imports (M)	Spending on goods and services produced abroad	Exports (X)	Spending by foreigners on domestically produced goods and services

Leakages reduce current domestic spending, while injections add spending into the economy.

Leakage does not mean that money disappears or that the activity is harmful. Saving can finance investment. Taxes can finance public services. Imports can provide essential goods and productive inputs.

Similarly, an injection is not automatically beneficial. Investment can be poorly chosen, public spending can be wasteful, and export production can create weak local linkages or environmental damage. The model identifies flows; further analysis is needed to judge their quality and distribution.

In the simplified five-sector model, equilibrium is commonly written as $S + T + M = I + G + X$. This means total leakages equal total injections at the current level of activity. It does not mean the economy has full employment, low poverty, or an ideal distribution of income.

E. From the Circular Flow to GDP

The same categories used in the circular flow appear in the expenditure approach to measuring gross domestic product.

The expenditure identity is:

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

Here, C refers to household consumption, I to investment or gross capital formation, G to government final consumption and investment, X to exports, and M to imports. Imports are subtracted because C, I, and G can include spending on goods produced abroad. The Philippine Statistics Authority uses final consumption, capital formation, and exports less imports in the expenditure approach to GDP (PSA, 2026).

The equation should be understood as an accounting relationship, not a complete theory of growth. A rise in any component can increase measured demand, but the long-term effect depends on productivity, capacity, financing, environmental costs, and who benefits.

Case Study: How the Pandemic Disrupted the Circular Flow

Context

The COVID-19 pandemic provides a clear example of how a shock can spread across all five sectors.

Movement restrictions and health risks reduced travel, restaurant activity, retail trade, construction, and many personal services. Firms lost customers and some reduced hours, wages, or employment. Lower household income then reduced spending further.

The Philippine economy contracted by 9.5 percent in 2020. Household final consumption fell by 7.9 percent, gross capital formation by 35.8 percent, exports by 16.7 percent, and imports by 21.9 percent. Government final consumption was the only major expenditure component to grow, increasing by 10.4 percent (Philippine Statistics Authority, 2021).

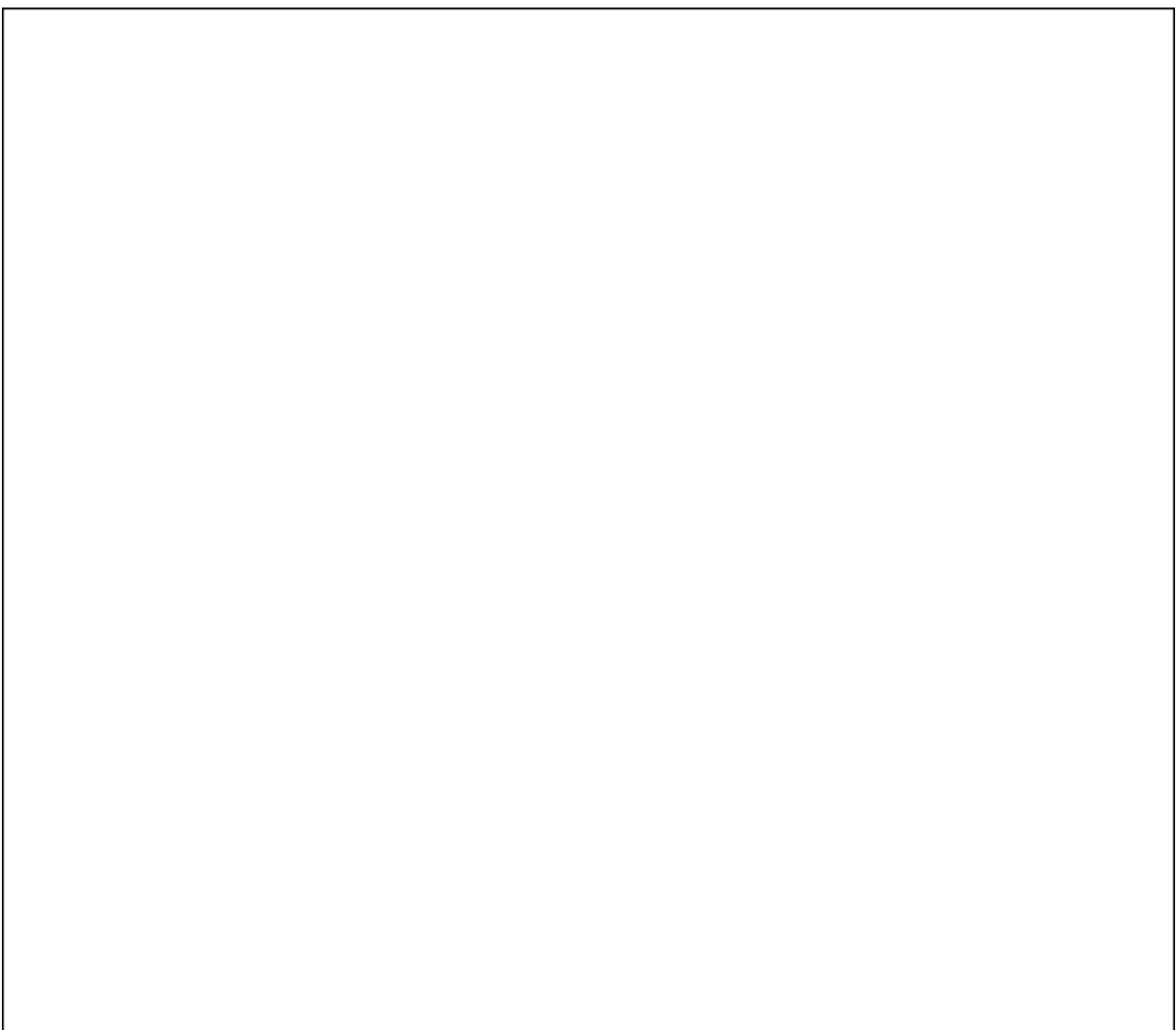
How the Shock Moved Through the Five Sectors

Households lost wages and business income, postponed non-essential purchases, and faced additional health expenses. The effects were especially severe for workers without savings, stable contracts, or social protection.

Firms experienced lower sales and disruptions in supply. Some businesses closed, while others shifted toward delivery, online sales, and remote services.

Government collected weaker revenues in some areas while spending more on health services and assistance. Financial institutions faced repayment risks and requests for loan restructuring. The foreign sector transmitted weaker tourism, trade, and global demand, while remittances remained an important source of household income.

The case demonstrates the core lesson of the model: a loss of income in one sector becomes a loss of spending and revenue elsewhere.



G. Remittances and a Philippine Household

Context

An overseas Filipino sends money to relatives in the Philippines. The household uses part of the remittance for food, tuition, rent, and medical expenses. It saves another part in a bank and uses some funds to improve a small store.

The remittance first enters the household sector as income from abroad. Household spending becomes revenue for domestic firms. Saving enters the financial sector, while business improvements can become investment.

BSP research finds that remittances provide macroeconomic benefits and can support household consumption, although the effects vary according to household conditions and the use of the funds (Bayangos & Lubangco, 2024).

Why Remittances Are Not Exports

An export is payment for a good or service produced in the Philippines. A remittance is generally a transfer of income between an overseas worker and a household. Both bring foreign exchange into the country, but they enter the accounts differently.

This distinction matters because the circular-flow model should not place every inflow from abroad under exports.

H. Imports

Context

A Philippine food manufacturer imports a machine that can package products faster and with less waste. The purchase is recorded as an import, which is a leakage in the simplified circular flow.

However, the machine is also a capital good. It may raise domestic productivity, allow the firm to expand, improve product quality, and support future exports. The immediate payment goes abroad, but the productive effects can remain in the domestic economy for many years.

This example shows why imports should not automatically be treated as harmful. Consumer luxuries, fuel, medicines, raw materials, and productive equipment have different effects. Analysis should ask what is imported, whether domestic substitutes exist, and whether the import supports future production.

It also explains why gross domestic product subtracts imports in the expenditure identity: the value of the machine may already appear under investment, but it was not produced domestically.

I. Stocks and Flows

The circular-flow model is mainly about flows measured over a period, such as income per month, consumption per year, or investment during a quarter.

A stock is measured at a point in time. Wealth, debt, bank deposits, inventories, and the existing stock of machines are examples.

Saving is a flow: it is the portion of current income not consumed. Savings often refers to the accumulated stock of deposits or other assets. Investment is a flow that adds to the capital stock.

Concept	Flow or stock?	Example
Income	Flow	Wages received during a month
Saving	Flow	Income set aside during a year
Bank deposits	Stock	Balance on a specific date

Investment	Flow	New equipment purchased during a year
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J. What the Model Leaves Out

Unequal Households and Firms

The model groups all households together and all firms together. It does not show that one household may own several businesses while another depends on irregular daily income. It also does not show differences between large corporations, cooperatives, microenterprises, and informal firms.

Unpaid Work

Household care, cooking, cleaning, and community work support the economy but are often unpaid and therefore absent from market transactions. Their exclusion can make the contribution of households, especially women, less visible.

The Environment

The monetary flow appears circular, but the physical economy is not a closed loop. Production takes materials and energy from the environment and returns waste and emissions. The System of Environmental-Economic Accounting records flows of natural inputs, products, and residuals between the environment and the economy (United Nations, 2014).

A complete economic analysis therefore asks not only how money circulates, but also what resources are depleted and what environmental costs are created.

Quality and Distribution

The model counts spending without showing whether it improves well-being. Two projects with the same monetary value can differ greatly in usefulness, environmental effect, corruption risk, and distribution.

The circular flow is best used as a map of transactions. It must be combined with analysis of productivity, equity, institutions, and sustainability.

Let's Review

- Households provide productive resources and receive income, while firms provide goods and services and receive spending.
- The real flow consists of resources, goods, and services. The money flow moves in the opposite direction.
- The five sectors are households, firms, government, financial institutions, and the foreign sector.
- Saving, taxes, and imports are leakages from current domestic spending. Investment, government spending, and exports are injections.

- Leakages are not automatically bad, and injections are not automatically good. Their effects depend on how funds and resources are used.
- The expenditure identity is $GDP = C + I + G + (X - M)$.
- Remittances are transfers from abroad and should not be confused with exports.
- Equilibrium between injections and leakages does not guarantee full employment, equality, or sustainability.
- The circular-flow model is useful for showing interdependence, but it leaves out unpaid work, inequality, environmental flows, and the quality of spending.

Key Takeaway

The circular-flow model shows that the spending of one sector becomes the income of another. A change in household consumption, business investment, government activity, finance, trade, or remittances can spread throughout the economy. The model helps us follow those connections, but it does not by itself tell us whether the resulting activity is productive, inclusive, or sustainable.

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