Notes on Chapter 6

Consumption and Investment:
We discussed different theories of consumption, one of the most important component of aggregate demand. We discussed Keynes's Absolute Income Hypothesis and what it says. We discussed the underlying Fundamental Psychological Law, Marginal Propensity to Consume (MPC) and the shape of the consumption function under this hypothesis. We also talked about Simon Kuznet's finding and how it leads to Duesenberry's Relative Income Hypothesis, Friedman's Permanent Income Hypothesis and Modigliani's Life Cycle Hypothesis. Each of these hypotheses tried to provide a reconciliation between Keynes's theory and Kuznet's findings (In class we only discussed the Duesenberry’s Relative Income Hypothesis and that is what you should study. I shall not cover Modigliani’s Life Cycle Hypothesis or Friedman’s Permanent Income Hypothesis in the exams or quizzes).

We discussed Autonomous Consumption and Induced Consumption and the distinction between the two. We wrote down the consumption equation, \( C = a + bY \) and showed how for a given income and for known values of \( a \) and \( b \) we can find out what the level of consumption would be. We also discussed the factors that cause the Consumption curve to shift.

Saving:
We talked about saving as a component of income. We made the assumption that there is no government sector and whatever is not consumed is saved. Under this situation we have, \( Y = C + S \).
As a result we also have, \( MPC + MPS = 1 \). We also used numerical examples to find out MPC, MPS and S for given values of Y and C.

Investment:
We talked about investment and discussed why it is considered to be autonomous to income. We discussed different factors which has significant effects on Investment and emphasized the role of interest rate as a major determinant of Investment. We also noted that because the factors that determines Investment can change in unison the changes in investment can sometimes be dramatic. That is why investment is considered to be a very volatile component of Aggregate Expenditure.