Chapter 6
Consumption & Investment

GDP = C + I + G + (X – M)
GDP = C + I + G
GDP = C + I

What determines Consumption Spending?
Consumption is a function of income
C = f(Y)

John Maynard Keynes:
Author of “The General Theory of Employment, Interest and Money”

What was Keynes central idea?
An economy can be in equilibrium at less than full employment.

How did this idea differ from the Classical School view?
The Classical Economists believed that the economy is always tending toward a full employment equilibrium
Keynes’s View on Consumption:

Consumers are guided by the “Fundamental Psychological Law”

In terms of consumption, we all strive to achieve a “comfort zone”. Once we achieve that or are closer to it, we do not need to increase our consumption as much with our income as we had done at lower levels of income.

What is Keynes’ Absolute Income Hypothesis?

As national income increases, consumption spending increases, but by diminishing amounts.

What is MPC?

The ratio of the change in consumption spending to a given change in income, that induces it.

\[ MPC = \frac{\Delta C}{\Delta Y} \]

If household's income rises from $12,000 to $12,700 and consumption rises from $13,000 to $13,500, then

\[ MPC = \frac{500}{700} = .71 \]

According to the “Absolute Income Hypothesis”, what happens to the Marginal Propensity to Consume as income increases?

MPC decreases as income increases and increases as income decreases.

The Consumption Function

\[ MPC = \frac{\Delta C}{\Delta Y} \]

\[ 800 \]

\[ 1000 \quad 4000 \quad \text{Real Disposable Income} \]

\[ 3200 \]

\[ \Delta C \]

\[ \Delta Y \]

\[ C \]
An Individual’s Marginal Propensity to Consume

<table>
<thead>
<tr>
<th>Total Income (Y)</th>
<th>Change in Income</th>
<th>Consumption (C)</th>
<th>Change in Consumption</th>
</tr>
</thead>
<tbody>
<tr>
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<td>1000</td>
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<tr>
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The Individual’s Marginal Propensity to Consume

The Nation’s Marginal Propensity to Consume

Who was Simon Kuznets?

He is the author of “National Income and Its Composition”, ..... won Nobel Prize in Economics in 1971 for his pioneering analysis of national income data.

What did Kuznets conclude about MPC?

His empirical research led to the conclusion that MPC tends to remain fairly constant regardless of the absolute level of national income.
The Marginal Propensity to Consume Remains Constant

Duesenberry’s Relative Income Hypothesis:
Because social status influences consumption spending, MPC remains constant as long as relative income remains unchanged.

Autonomous Consumption:
Consumption spending that is independent of the level of income

The Consumption Function

The Consumption Equation?

<table>
<thead>
<tr>
<th>Y</th>
<th>C_a</th>
<th>MPC</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>100</td>
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<td>0.50</td>
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</tr>
<tr>
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<td>0.80</td>
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<td>500</td>
<td>90</td>
<td>0.90</td>
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\[ C = a + bY \]

\[ C = a + bY = 90 + .90 \times 500 = 540 \]
Will a change in Income cause a shift in C?

No!

When income changes there is a movement along a stationary Consumption Curve.

What can cause a shift in the Consumption Function?

A change in...

- Real assets & money holdings
- Expectations of price changes
- Interest rates
- Taxation

What is Saving?

That part of national income not spent on consumption

If, \( Y = C + S \)

then, \( S = Y - C \)

What is the Marginal Propensity to Save (MPS)?

The Ratio of the change in saving to the change in income, which induced it.

\[
MPS = \frac{\Delta S}{\Delta Y}
\]
Let's assume that your income increases by $100. We observe that you increase your consumption by $80. What is your MPC?

\[ \text{MPC} = \frac{\Delta C}{\Delta Y} = \frac{80}{100} = .80 \]

\[ \text{MPS} = \frac{\Delta S}{\Delta Y} = \frac{20}{100} = .20 \]

\[ \text{MPC} + \text{MPS} = 1 \]

\[ \text{MPC} = 1 - \text{MPS} \]

\[ \text{MPS} = 1 - \text{MPC} \]

At each Y level, calculate the MPC, MPS and the S

<table>
<thead>
<tr>
<th>Y</th>
<th>C</th>
<th>MPC</th>
<th>MPS</th>
<th>S</th>
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</table>

\[ \text{MPC} = \frac{\Delta C}{\Delta Y} = \frac{80}{100} = .80 \]

\[ \text{MPC} + \text{MPS} = 1 \]

\[ Y = C + S \]