NOTES

ECC 103 M. No. 06

Module Name: Consumption function, Investment function,

Equilibrium GDP

- **Consumption Function:**
- ✓ Concept of Consumption Function: J. M. Keynes first introduced the term 'consumption function' to describe the relationship between household's planned consumption expenditure and the forces that determine it.
- ✓ The consumption function relates the amount of consumption to the level of income.
- ✓ Generally when income rises, consumption expenditure also rises.
- ✓ Amount of consumption is different at different levels of income.
- ✓ Consumption increases less than income- part of increment is saved.
- ✓ Difference between consumption and income is called savings.
- ✓ The consumption function is represented as:
- ✓ C = A + MYd
- ✓ (Where: C = Consumer spending; A = Autonomous consumption; M = Marginal propensity to consume; Yd = Real disposable income)
- ✓ The Keynesian consumption function expresses the level of consumer spending depending on three factors:

1. Yd = Disposable income

Income after government intervention – e.g. Taxes

2. A = Autonomous consumption

Consumption when income is zero. (e.g. even with no income, you may borrow to be able to buy food).

3. M = Marginal propensity to consume

The % of extra income that is spent, also known as induced consumption.

- ✓ **Factors influencing consumption function:**

1. **The general price level:** When general price level increases or, in other words, when inflation occurs, savings generally decline. Hence people generally spend more on consumption (presently) than before.

2. **Fiscal policy:** By levying excise duties, sales tax etc. the governemnt can cut down the consumption and thereby increase savings of the community. When governement redues tax rates, consumption of people likely to increase thus raising propensity to consume.

3. **Windfall gains and losses:** When the prices of the share goes up, the shareholders begin to think themselves better off and this increases their consumption. Conversely when the prices of shares go down (declines), the shareholders are likely to suffer sudden losses and they begin to think themselves relatively poorer than before, thus reducing consumption.

4. **Changes in Expectations:** When the people expect uncertainty like war or pandemic will break out in the near future and they expect prices to go up, then they will try to spend more on goods so as to meet the needs of immediate future. When people expect the prices to fall in future they reduce their current cconsumption so that they should spend more when the prices actually fall.

➢ **<u>Investment Function:</u>**

✓ **Meaning of Investment:** Investment refers to real investment which implies the creation of new factory buildings, roads, bridges and other forms. It is the new addition to the stock of physical capital. It is the Productive capital which directly generates new jobs and increases production.

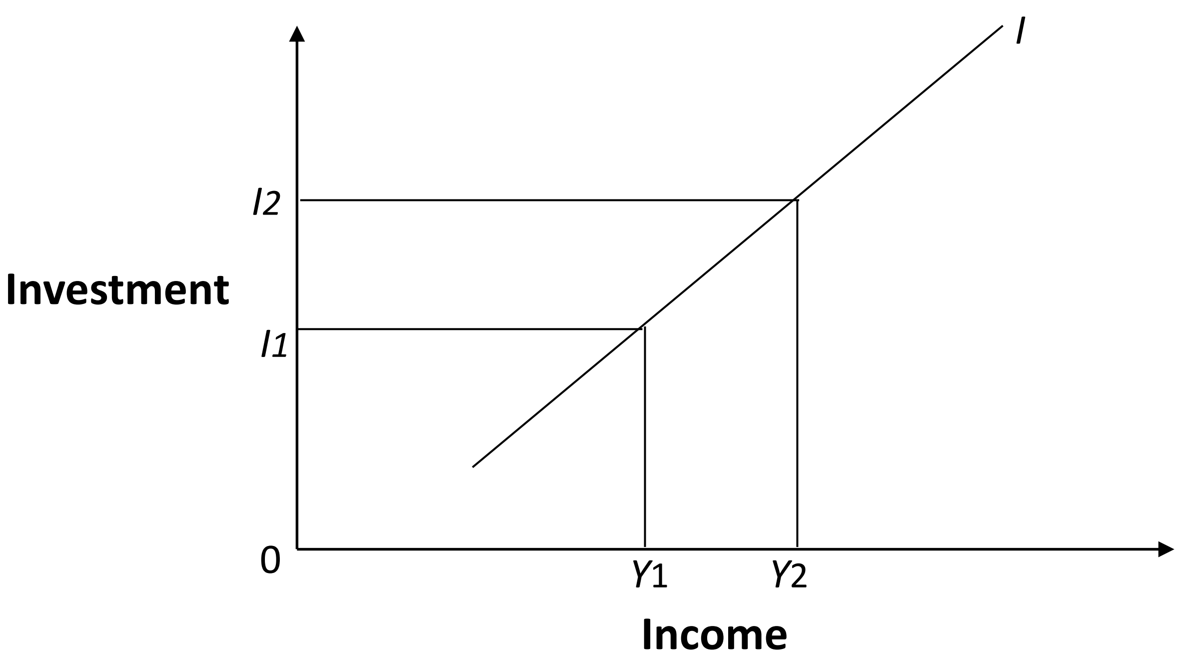
✓ At the macro level, investment comprises of three major factors:

i. Investment decisions made by business firms and organizations.
ii. Saving decisions made by the consumers.
iii. Decision on supply of investment goods by the producers of capital goods.

- ✓ According to Keynes, investment demand depends upon two factors, expected rate of profits and the rate of interest.
- ✓ Investment can be classified into induced investment and autonomous investment.

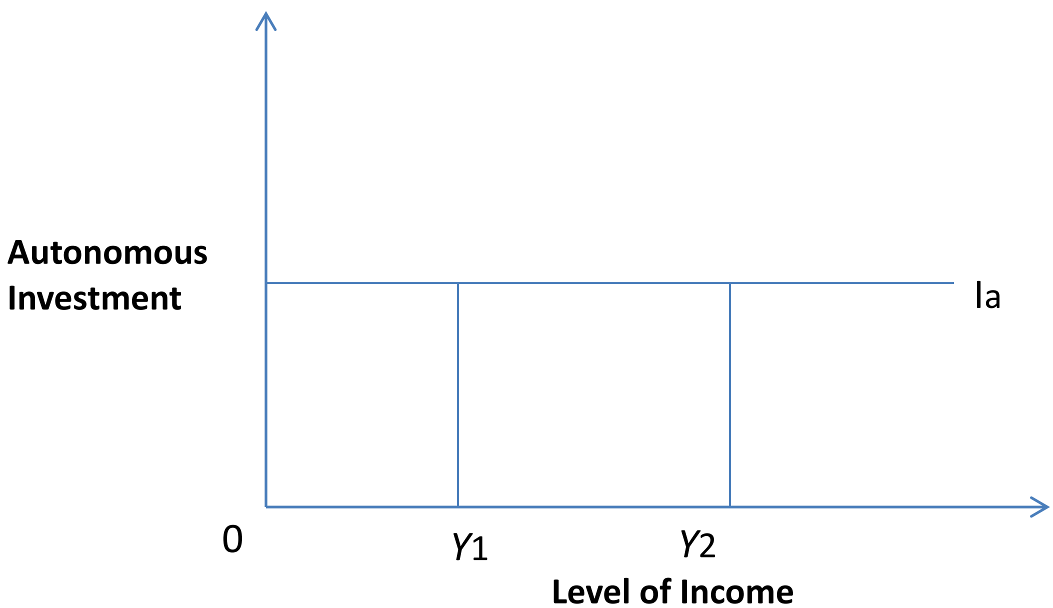
a) Induced investment

An investment influenced by expected profit or rising levels of income in the economy is termed as induced investment. The factors that affect profits such as prices, wages and interest influence induced investment. Investment expenditures are also induced by the increase in production. The shape of the induced investment curve, therefore, is upward sloping, indicating a rise in investment as a result of rise in income. Direct relationship between the amount of investment and the income and profit earned by the firm. (Shown in graph)



b) Autonomous Investment:

It is an investment expenditure made by the government with a view of promoting the level of aggregate demand in the economy. Such investment includes expenditure on building, dams, roads, canals, schools, hospitals, defense, equipments etc. Governments do this for public utility services- economic infrastructure such as power, transport and communication. There is consideration of the social welfare and economic revival. Irrespective of change (increases or decrease) in income, investment is done through government policy. Autonomous investment is shown as a curve parallel to the horizontal axis.



- ➢ **Equilibrium GDP:**
- ✓ It is the level of GDP where aggregate supply and aggregate demand are equal.
- ✓ Aggregate demand represents the total amount of goods and services that people are willing and able to buy.
- ✓ Aggregate supply is the total value of goods and services produced in a country within a single year.

- ✓ Equilibrium GDP implies that there is no surplus or shortage of goods. Changes in aggregate demand and aggregate supply can impact equilibrium GDP.