Welcome students. I will be covering model number 6, "Consumption function, Investment function, Equilibrium GDP" from unit 2- Determination of National Income: Two sector model.

I will be covering the topics, Consumption function, Investment function and Equilibrium GDP. At the end of this module, you will be able to understand and inter-relate the concept of consumption function, investment function and equilibrium GDP. Also, you will be able to differentiate between consumption function and investment function.

First we will see the concept of Consumption Function. Economist J.M. Keynes first introduced the term consumption function to describe the relationship between households planned consumption expenditure and the forces that determine it. Consumption function is a functional relationship between consumption expenditure and its determinants. The consumption function relates the amount of consumption to the level of income. Generally, when income rises, consumption expenditure also increases. Amount of consumption is different at different levels of income.

According to the psychological law of consumption given by Keynes, when the income increases, the consumption also increases, but not at the same increase in income. Hence consumption increases slightly less than income and the part of that increment is saved, which we call it as savings.

Consumption function is represented as C is equal to A + MYD, where C is consumer spending, A stands for autonomous consumption, M for marginal propensity to consume and YD for real disposable income. We will break out these terms. The condition consumption function expresses the level of consumer spending depending on three factors. First is disposable income. That is, the income left after government intervention, means for instance the government charges you with tax. Whatever the income left with you or with the consumer after the tax deduction, that is called disposable income.

Autonomous consumption- when your income is zero, even with no income, you can still buy the food by having borrowings. M stands for a marginal propensity to consume, that is the percentage of extra income that is spent, also known as induced consumption.

Let us see some factors which influence consumption function. The first one is the general price level. When the price level or the inflation in the market or in the economy increases, people tend to spend more on consumption and vice versa.

Second factor is fiscal policy. Government can influence consumption through its taxation policy. When the government increases the tax, people will spend less similarly, when the government reduces tax, people will go for more or higher consumption.

Next factor is windfall gains and losses. When the share prices go up, shareholders think that they are in a better position and they will spend or consume more. Similarly, when the share prices go down, they think that they are not in a better position and they will spend less as compared to previously.

Next is changes in expectation. When situations such as war arises people think that prices will go up in future and they will buy today more to meet their today's consumption and very immediate near future consumption. Hence they will spend more on consumption keeping in view war or similar uncertainties. When people think that prices will decline in future they will spend less today and they will spend more in the future when the prices go down.

Next we will see the meaning of investment. Investment refers to the real investment, which implies the creation of new factory buildings, roads, bridges and other forms. It means a new addition to the stock of physical capital. Productive capital which directly generates new jobs and increases production is termed as investment at a macro level. Investment comprises three major factors. Investment decisions made by business firms and organization, saving decisions made by the consumers, and decisions on supply of investment goods by the producers of capital goods.

According to Keynes, investment demand depends upon two factors, expected rate of returns and the rate of interest. Investment can be classified into induced Investment and autonomous investment. First, we will see the induced investment. An investment which is 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 influences induced investment.

When the income level rises, the investment also rises. Induced investment is influenced by the rise in profits. When a firm wants to generate more profit, it will go for higher induced investment. So this is basically done for a large output to meet the rising demand.

When the income rises, the consumption in the economy also rises. Thereby the induced investment goes up. Here on X axis, we have income and on the Y axis, we have the investment. Here you can see that when the income rises from Y1 to Y2, the investment, the induced investment also rises, hence we have an upward rising induced investment curve.

Next is autonomous investment. It is investment expenditure made by the government with a view of promoting the level of aggregate demand in the economy. Such investment includes expenditure on buildings, dams, roads, canals, schools, hospitals, defence equipment and other projects. Such investment is not influenced by profit or any such kind of motive.

When the government anticipates that there is recession in the economy and the demand or consumption should go up, the government will spend on a number of such projects. Government will do public utility services like it will spend on economic infrastructure such as power, transport and communication. By doing autonomous investment, the government considers social welfare and economic revival. Hence irrespective of change in income, whether it increases or decreases, investment is done through government policies.

Here in this diagram, you can see that autonomous investment is shown on a horizontal line Ia. It is parallel to the X axis where we measure the level of income. So whatever the level of income, the government will have a specific autonomous investment level.

Next topic is equilibrium GDP. It is the level of GDP where aggregate supply and aggregate demand are equal. It is the level at which the total quantity of goods that are produced equates to the total quantity of goods purchased. 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 shortage or no surplus of goods. With the change in aggregate demand or change in aggregate supply, equilibrium GDP will change.

The equilibrium GDP is represented in this diagram. On the X axis you can see the quantity measured, on Y axis you can see the price level. The downward sloping curve shows the total demand and upward rising curve shows the total supply. At point 'e' there is an intersection of demand and supply curve which represent the equilibrium level of GDP, corresponding to the total quantity and the price level.

I hope with this discussion you are able to understand the consumption function, investment function and equilibrium GDP. For more reading you can refer to these books.