- Saving is a direct function of the interest rate and investment is an inverse function of the interest rates.

- Interest rate is the measure of the reward for the saving. The higher interest rate the greater will be the volume of savings.

- With the interest rate as the price of capital goods, the lower the interest rate the greater will be the volume of investment.

- Interest rate is determined by the intersection of the savings and investment function.

KEYNESIAN ECONOMICS

- Keynesian Economics developed during and after the Great Depression from the ideas presented by J.M. Keynes in his 1936 book, The General Theory of Employment, Interest

- Great depression - It is a state of economic fluctuations which involves deep recession. There was large scale unemployment in the economy, the GDP was falling etc.

- The major reason of the crisis was the deficiency of demand given supply. i.e. there was general overproduction leading to unemployment. which lead to a vicious cycle.

- Keynesian Economics came up as a repudiation to the aggregate supply-focused Classical Economics that preceded his works.

- It applies to short run.

- He argues that output is strongly influenced by aggregate demand.

- In Keynesian view, aggregate demand does not necessarily equal the productive capacity of the economy; instead, it is influenced by a host of factors and sometimes behaves erratically, affecting production, employment, and inflation.

- The point where aggregate demand becomes equal to aggregate supply, it is the effective demand.

- Total employment will depend on total demand & decrease in demand will result in unemployment.

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- The effective demand can become equal to the aggregate supply but it cannot be full employment eq. i.e. if saving ≠ investment, then it will not be full employment eq.

- ∴ An economy can attain eq. income not necessarily at full employment level. The economy can attain eq. income at less than full employment level.

- Full employment eq. cannot be attained and maintained automatically.

- Market may not be perfectly competitive and there can be money wage rigidity.

- A/c to Keynes, there are problems cropping up in the economy in the short run & they have to be adressed in the short run only.

- Income should become equal to expenditure. Supply should become equal to demand.

- An economy can attain eq. income, when sum total of demand becomes equal to sum total of supply.

- If we consider consumption & investment demand, then $Y = C + I$

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* Psychological Law of Consumption: The consumption Function.

- Men are disposed, as a rule, and on the average, to increase their consumption as their income increases but not by as much as the increase in their income.

- In other words "as income increases consumption increases but not by as much as the increase in ~~consu~~ income".

- Keynes recognized the role of subjective and objective factors including interest rate and wealth influence the level of consumption expenditure.

- But he argued it is the current level of income on which the consumption spending of an indiviual and the society depends.

- Consumption is a function of the current income. Aggregate consumption is an increasing function of the income.

- With the rise in income, a part of income will always be saved ∴ the increase in ~~incom~~ consumption will not be the same as the increase in income.

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- People develop the tendency to save as the income rises.

- Here, the income referred is the absolute income. Absolute income of one indivival is independent of the absolute income of other.

- Here, personal disposable ~~personal~~ income is considered.

- Disposable personal income = Personal income - taxes.

- Two factors that affect consumption:
Subjective factors: Not measurable directly.
Objective factors: Interest rate, wealth.

- A/c to classical theory, consumption is the decreasing func^n of interest rate. i.e. saving, investment & consumption, all are func^n of interest rate.

- And as saving is increasing with rise in rate of interest then consumption must decrease with rise in rate of interest ~~as~~ because as saving increases, income left for spending on consumer goods will decrease. ∴ Consumption must be a decreasing func^n of interest rate a/c to classical economists.

- A/c to Keynes, current level of income is the major factor that determines the consumption. Higher is the income, higher is the consumption and vice-versa.

* Consumption Function

- The Keynesian consumption func^n is expressed as

$$Y = C + S. \text{ (Income)}$$

- Consumption is a stable func^n of current disposable income.

$$\boxed{C = a + bY} \qquad b > 0,\ 0 < b < 1$$

- where C = consumption
  Y = Disposable Income.
  a = Autonomous consumption
  b = MPC

- Consumption func^n is a linear func^n with positive intercept.

- a → Consumption at 0 level of income.

- b = MPC
- Marginal propensity to consume $\left(MPC = \frac{\Delta C}{\Delta Y}\right)$ varies between zero and one is constant.

$$0 < MPC < 1.$$

- MPC is the slope of consumption func^n i.e. change in consumption resulting from one unit change in income.

★ Three Conjectures

- Marginal propensity to consume ($MPC = \Delta C/\Delta Y$) varies between zero and one and is constant.

$$0 < MPC < 1.$$

i.e. slope is b/w 0 & 1.

- If MPC = 0, then the whole income is saved, nothing is spent to consume goods.
- If MPC = 1, it implies that entire income is consumed, nothing is saved.

∴ Neither of them true.
When income rises, a part of it is saved & the rest is consumed ∴
$0 < MPC < 1.$

- If b is constant, then the relation b/w consumption & income is linear but even if b is not constant the relation b/w C & Y is nearly linear especially in the short run.

- If MPC = 1/2, then with 2 rupees increase in income, 1 rupee will be consumed & 1 rupee will be saved.