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- When the income of an individual keeps rising, the consumption of the individual also rises. Then the income reaches the peak value & then starts falling but the individual doesnt reduce its consumption a/c to fall in income as it has become a habit of the consumer to enjoy that standard of living.

- ∴ When income rises, we keep increasing the consumption but when it reaches the peak and falls, the consumer keeps maintaining that standard of living as he/she has got habituated.

- Relative income (income relative to others) is a factor ~~of~~ to determine consumption. ~~Of~~ The lifestyle or basic consumption pattern of a group having similar relative income is almost same. This is sometimes also called bandwagon effect or neighbourhood effect.

- ~~Co~~ Consumption determines the standard of living and by habit, people enjoy raising their standard but hate letting it slide downwards.

- When income rises, they raise their consumption but they refuse to reduce their consumption

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when income falls.

- Ratio of the household's current income to the past peak income acts as an additional determinant of its current consumption.

- If this ratio falls, ceteris paribus, the current consumption goes up and vice-versa. Or when this ratio falls, current savings fall and vice-versa.

- Algebraically, it can be expressed as

$$\boxed{C = a + bY - c\frac{Y}{Y_{mp}}}$$

- Y_{mp} represents the past peak income.

$$\boxed{APC = \frac{C}{Y} = \frac{a}{Y} + b - \frac{c}{Y_{mp}}}$$

- Here APC varies directly with the past peak income.
  Higher is the past peak income, higher is the consumption and vice-versa.

Hence, $$\boxed{APS = \frac{S}{Y} = (1-b) - a\left(\frac{1}{Y}\right) + c\left(\frac{1}{Y_{mp}}\right)}$$

- Saving ratio is a negative function of the past peak income.

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- If income continues to rise, the ratio $\frac{Y}{Y_{mp}}$ goes up and hence, consumption falls. Opposite holds good when income tends to ~~Opposite~~ fall.

★ Implications of RIH.

- An economy's saving ratio rises slower than otherwise during the time of prosperity and to fall slower than otherwise during recession.

- During prosperity, ~~A~~APS increases & ~~A~~APC falls ∵ $\frac{Y}{Y_{mp}}$ ~~increases~~.

- ∴ During prosperity, ~~APC~~ ~~to~~ APS will rise but at a slower rate in comparison to the general condition. ∴ Prosperity will not lead to recession.

- Due to relative income as a factor to determine to saving and consumption, APS will rise during prosperity but not as much as it would have done otherwise, ∴ ~~prosp~~ prosperity may not lead to recession.

- A/c to Keynes, a prosperous economy is bound to face recession more often then not.

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- Due to presence of relative income, APC will fall but at a slower rate or APS will rise at a lower rate.

- A/c to Keynes, when during prosperity APS rises i.e. savings increase, if all the savings are not directed to productive investment then the economy is bound to face stagnation or recession.

- However, a/c to other consumption models, APC & APS either remain constant with change in current income or APS will rise but not at the rate that it would have done otherwise.

* ~~Random - Walk Hypothesis~~

- There is no ideal model for consumption pattern, it depends on the context, time-period and the economy under study.

* Random - walk Hypothesis (Robert Hall, 1978)

- Based on Fisher's model & PIH, in which forward looking consumers base consumption on expected future income.

- Hall adds the assumption of rational expectations that people use all available information to forecast future variables like income.

- In PIH, permanent income is predicted using the

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past incomes. It is an adaptive expectation model. We adapt to the past behaviour.

- From the past behaviour of a variable or quantity, we can predict or expect its ~~val~~ future values.

- A/c to Hall, we should not only use past income and also other available factors in order to predict future income values.

- Future income may not depend on the past income only, it may depend on many other dynamic factors. It could depend upon age or education of the individual, govt policies, etc.

- Therefore, rational expectations is more realistic than adaptive expectation.

- If there is a monotonic increasing or decreasing behaviour of income in the past years, then taking average for predicting future income can give contradictory results as the future income may be expected to follow the monotonic trend.

- If PIH is correct and consumers have rational expectations, then changes in consumption over time is unpredictable.

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- A/c to adaptive expectations, consumption is predictable as it depends on income which is predictable from the past income.

- Consequently, consumption should follow a random walk.

- A change in income or wealth that was anticipated has already been factored into expected permanent income, so it will not change consumption.

- Only unanticipated changes in income or wealth that alter expected permanent income will change consumption.

- Implications

- If consumers obey the PIH and have rational expectations, then only unexpected policy changes will affect their consumption.

- If the govt. policy is conducive then consumption will increase & if it is not conducive then consumption will fall. ∴ It depends on the type of govt. policy put in place.

- Example: The dearness allowance has ~~was~~ not been revised by the govt. during the pandemic, this unexpected policy change may affect the

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consumption pattern of the people.

- All the models consider consumers to be rational, i.e. consumers act to maximize utility.

★ The Psychology of Instant Gratification
(David Laibson)

- Theories from ~~Fis~~ Fisher to Hall assumes that consumers are rational and act to maximize lifetime utility.

- Recent studies by David Laibson and others consider the psychology of consumers.

- Consumers utility maximization is based upon rational considerations. i.e. consumers consume more when price falls or income rises.

- Similarly, producer is considered a rational entity whose aim is to maximize profit.

- In the new branch of study: Behavioural economics, this rational behaviour of producers and consumers is argued. Psychology of the economic agents is taken into account.

- Many times, the decisions of consumers and

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producers is guided by irrational considerations i.e. they are guided by psychology.

- Consumers consider themselves to be imperfect decision-makers.
  E.g. in one survey, 76% said they were not saving enough for retirement.

- The "pull of instant gratification" explains why people dont save as much as a perfectly rational lifetime utility maximizer would save. The new generation of population is guided by the pull of instant gratification. There is a mentality of "have it" or "do without it", there is no expectation or planning of having the commodity in future.

This type of behaviour is not considered in any of the models. In all the models, the consumers are expected to plan to maximize utility for the entire lifetime which is not ~~not~~ realistic these days.

Two Questions and Time Inconsistency

1. Would you prefer
(A) a candy today, or
(B) two candies tomorrow?

2. Would you prefer
(A) a candy in 100 days, or

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(B) two candies in 101 days?

In studies, most people answered A to question 1, and B to question 2.

A person confronted with question 2 may choose B. When he is confronted with question 1, the pull of instant gratification may induce him to change his mind.

★ Summary

- Keynesian Consumption Function:

$$C = a + bY$$

where only current income (Y) mattered.

- Other models advocate that other things should be included:

- expected future income (permanent income model)
- wealth (life cycle model)
- interest rates (Fisher Model)
- but current income should still be present (due to borrowing constraints)

- Consumer expectations: Even if current income is less, people may consume more if they expect income to rise in future.

- Income/Wealth distribution: MPC is higher with the lower income group while MPS & APS is higher with the higher income group. ∴ For increasing the consumption, there should be a redistribution of income from rich to poor.

- Credit availability: If ~~I or~~ taking credit is feasible for the consumers, then consumption is high.

- Consumption doesnt depend on income only, it depends on wealth, interest rates, consumers expectations about the price change, distribution of income and wealth and also the availability of credit.

INFLATION

Inflation: Continuous rise in general price level.
Deflation: Continuous fall in general price level.

→ What is inflation?
→ Measurement of inflation?
→ Sources of inflation
→ Types of inflation
→ Causes of inflation.
→ Theories behind inflation to occur.
→ Consequences and effects of inflation

- Inflation refers to a continuous rise in the general price level.

It refers to the continuous rise in the