UNIT – II

Consumption, saving and investment

Keynesian C · Saving · MEC · I

Explanatory Lecture Slides

Macro Economics · Major-6 · Semester IV

MACRO ECONOMICS

LEARNING OBJECTIVES

Topics covered in this unit

01 **Write Keynes's consumption function**

02 **Derive the saving function**

03 **Define MEC and MEI**

04 **List determinants of investment**

05 **Place autonomous v induced I**

06 **Note interest, expectations and animal spirits**

How this unit is organised

01	02	03	04	05	06
Consumption function	Saving function	MEC	Determinants of I	Autonomous / induced	Expectations

Consumption function

$C = a + bYd$. Psychological law; $0 < b < 1$. Shifts: wealth, taxes, prices, expectations, distribution, credit.

- Absolute-income (Keynes) v relative-income (Duesenberry) v permanent-income (Friedman) v life-cycle (Modigliani) — a 16-mark of four names if asked ‘theories of consumption’.
- Otherwise Keynes is enough, plus one rival.

Consumption function

KEYNES

- C follows current Yd.

FRIEDMAN

- C follows permanent Y — a tax holiday may do little.

Saving function

$S = Yd - C = -a + (1-b)Yd$. $MPS = 1 - MPC$. Paradox of thrift: if all save more, Y falls and realised S may not rise.

- A 10-mark with the paradox. Thrift is a private virtue and a public vice in a slump.

Saving function

MPS

- Slope of S.

PARADOX

- More planned S → less Y → less realised S.

MEC (Keynes)

The rate of discount that equates the present value of expected yields of an asset to its supply price. I proceeds until MEC = r.

- MEC falls as more of a type of capital is installed (expected yield falls, supply price rises).
- Uncertain expectations make MEC jump — the source of instability.

MEC (Keynes)

I UNTIL

- MEC = r.

MEC FALLS WITH

- More capital already in place.
- Pessimism.

Determinants of investment

r, MEC/expectations, animal spirits, capacity, tax (accelerated depreciation), public capex (crowding in or out), finance (credit channel).

- A 10-mark list with an Indian hook each (repo, IBC, Budget capex, PLI).

Determinants of investment

CHEAP MONEY HELPS IF

- MEC is not collapsed.
- Banks will lend.

CHEAP MONEY FAILS IF

- Liquidity trap.
- Balance-sheet wreckage.

Autonomous and induced I

Autonomous: does not depend on current Y (a new port, an animal-spirit factory). Induced: the accelerator — I depends on the change in Y.

- Accelerator: $I = v \Delta Y$. Needs spare-less capacity and stable v. Super-multiplier combines k and v — Unit III.

Autonomous and induced I

AUTONOMOUS	INDUCED
• Public infra. • Innovation.	• More Y → more machines if firms are already at capacity.

Animal spirits and the lawyer

Contracts, insolvency, a stable tax code, an independent regulator — these are how a legal system holds expectations still enough for I to happen.

- Swiss Ribbons (IBC) is a macro case in a company-law costume.

Animal spirits and the lawyer

STABILISE MEC WITH

- IBC.
- Contract enforcement.
- Tax certainty.

FRIGHTEN MEC WITH

- Retrospective tax.
- Policy flip.

Determinants of investment

r, MEC/expectations, animal spirits, capacity, tax (accelerated depreciation), public capex (crowding in or out), finance (credit channel).

- A 10-mark list with an Indian hook each (repo, IBC, Budget capex, PLI).

LANDMARK AUTHORITIES

Cases a KSLU answer should name

CASE

Swiss Ribbons v Union of India

(2019) 4 SCC 17

Insolvency as an investment-climate institution.

CASE

Vodafone International Holdings v Union of India

(2012) 6 SCC 613

Retrospective tax frightens MEC — a macro event in a tax case.

CASE

BALCO Employees

(2002) 2 SCC 333

Policy stability as a signal to I.

STATUTE / SECTION MAP

Provisions & materials to quote

IBC 2016	Exit that makes entry rational.
Income-tax (depreciati	The tax shifter of MEC.
RBI repo / liquidity w	The r in MEC = r.
Art. 112 / Budget cape	Autonomous I by the State.
FRBM Act	A rule so G does not always eat I.

WRITE IT IN THE HALL

10 / 16-mark frames from this unit

Q1 Explain Keynes’s psychological law of consumption. What factors shift the consumption function?

Q2 What is the paradox of thrift?

Q3 Explain the concept of marginal efficiency of capital.

Q4 What are the determinants of investment in an economy?

BEFORE YOU CLOSE THE FILE

Unit recap

1. $C = a + bY_d$; name one rival theory.
2. Paradox of thrift in a slump.
3. I until MEC = r; MEC is mostly expectations.
4. Accelerator = induced I from ΔY.
5. Law's job: keep the rules still enough that MEC can be calculated.