The Components of Aggregate Demand

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Introduction

- Recall the Equation
 Y=C+I+G
- Thus the factors that affect the components of aggregate demand are:
- Consumption,
- Investment,
- Government spending.
- Saving and taxes also enter into our discussion

COMPONENT 1- CONSUMPTION

- Keynes believed that the level of consumer expenditure was a stable function of disposable income, where disposable income (*YD*) in our simple model is national income minus net tax payment (YD = Y - T).
- The specific form of the consumption-income relationship, termed the consumption function, proposed by Keynes was as follows:
- $C = a + bY_D, a > 0, 0 < b < 1$

• $b = AC/AYD \longrightarrow Marginal Propensity to Consume$ The intercept term a, which is assumed to be positive, is the value of consumption when disposable income equals zero



Continued

- The Keynesian assumption is that consumption will increase with an increase in disposable income (b > 0) but that the increase in consumption will be less than the increase in disposable income (b < 1).
- From the definition of national income, Y = C + S + T
- We can write $Y_D = Y T = C + S$ which shows that disposable income is, by definition, consumption plus saving
- In the case of the Keynesian theory, we have $S = -a + (1-b)Y_D$
- If consumption is *a* units with *YD* equal to 0, then *at* that point S = YD C = 0 a = -a

- Yd = C + S
- Yd= a + bYd +S
- S= Yd- a bYd
- S= -a + Yd- bYd
- S= -a + (1-b)Yd

- If a 1-unit increase in disposable income leads to an increase of *b* units in consumption, the remainder (1 *b*) is the increase in saving
- $1 b = \triangle S / \triangle Y_D \longrightarrow Marginal Propensity to Save$
- This increment to saving per unit increase in disposable income (1 b) is called the marginal propensity to save (MPS)

Marginal Propensity to Consume



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- What determines investment?
- Keynes suggested two variables as primary determinants of investment expenditures in the short run:
- \succ the interest rate
- \succ the state of business expectations
- The level of investment is assumed to be inversely related to the level of the interest rate.

COMPONENT 3- GOVERNMENT SPENDING

- Government spending is assumed to be controlled by the policy maker and therefore does not depend directly on the level of income.
- We assume that the level of tax receipts (*T*) is also controlled by the policy make and is a policy variable.
- A more realistic assumption is that the policy maker sets the tax rate, and tax receipts vary with income



"Successful investing is anticipating the anticipations of others."

- John Maynard Keynes