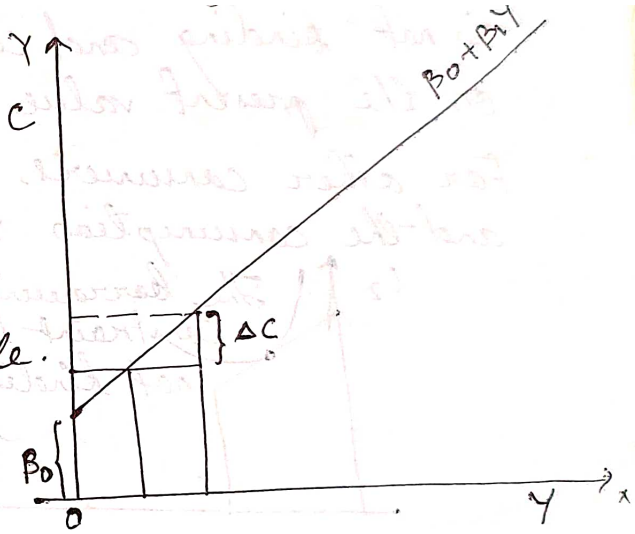
Keynes consumption function :-

1) MPC lies betn 0 to 1.

2) APC falls as income rises.
Saving was a luxury.

3) Interest rate doesn't play any role.

$C = \bar{C} + cY$, $\bar{C} > 0$, $0 < c < 1$, MPC + MPS = 1.



Kuznet's consumption puzzle:-

On the basis of keynesian consumption functions, the economy would experience secular stagnation (a long depression of indefinite duration, unless the govt. used fiscal policy to expand aggregate demand.) The end of world war II didn't throw the country into another depression. Although incomes were much higher after the war than before, these higher incomes didn't lead to large increases in the rate of saving.

Fisher's intertemporal choice model:-

$S = Y_1 - C_1$

$C_1 = Y_1 - S$

$C_2 = S + rS + Y_2$

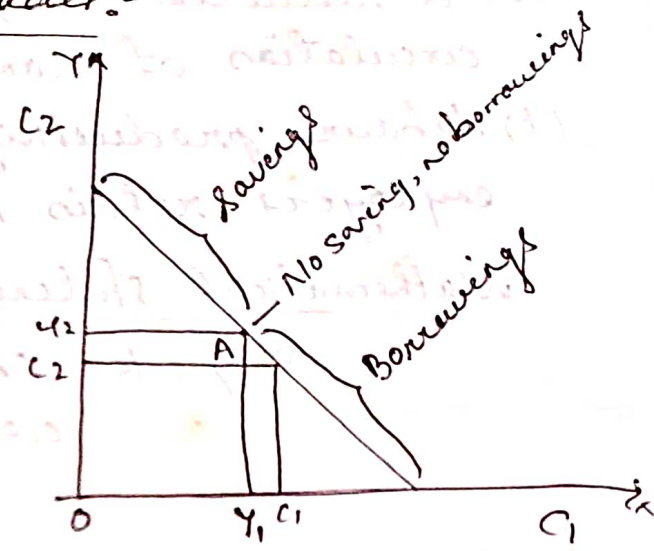
$= (1+r)S + Y_2$

$C_2 = (1+r)S + Y_2$

$C_2 = (1+r)(Y_1 - C_1) + Y_2$

$\Rightarrow (1+r)C_1 + C_2 = (1+r)Y_1 + Y_2$

$\Rightarrow C_1 + \frac{C_2}{(1+r)} = Y_1 + \frac{Y_2}{(1+r)}$



when, $C_2 = 0$

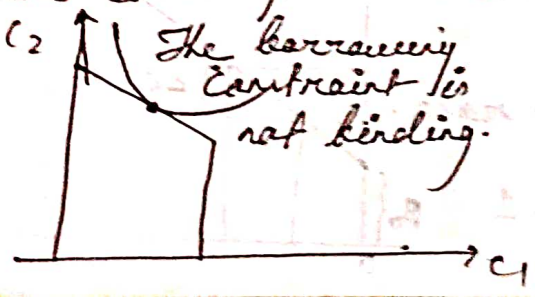
$C_1 = Y_1 + Y_2/(1+r)$

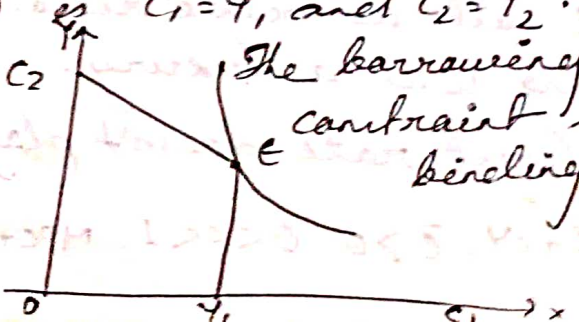
when, $C_1 = 0$

$C_2 = Y_2 + (1+r)Y_1$

Constraints of borrowing:-

For some consumers, the borrowing constraints is not binding and consumption in both periods depends on the present value of life time income, $Y_1 + Y_2/1+r$. For other consumers, the borrowing constraints binds and the consumption function is $C_1 = Y_1$ and $C_2 = Y_2$.





Permanent income hypothesis:-

Permanent income is the part of income that people expect to persist into the future. Transitory income is that part of income that people do not expect to persist. Y^P is average income and Y^t is the random deviation from that average.

$$C = \alpha Y^P$$

$$APC = C/Y = \frac{\alpha Y^P}{Y}$$

When, current income temporarily rise above permanent income APC fall and vice versa.

Life cycle hypothesis:-

Madigliani emphasized that income varies systematically over people's lives and the saving allows consumers to move income from those times in life when income is high to those times when it is low.

$$C = (W + RY)/T$$

$$C = (1/T)W + (R/T)Y$$

Aggregate consumption depends on both wealth and income.

$$C = \alpha W + \beta Y$$

$\alpha \rightarrow$ marginal propensity to consume out of wealth.

$\beta \rightarrow$ MPC out of income.